FEDERAL RESERVE BANK
OF DALLAS

DALLAS, TEXAS
75265-5906

February 13, 2002

Notice 02-09

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

SUBJECT

Final Rules Regarding Regulatory Treatment of Nonfinancial Equity Investments

DETAILS

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency has adopted final rules governing the regulatory capital treatment of equity investments in nonfinancial companies held by banks, bank holding companies, and financial holding companies. The final rules, which become effective April 1, 2002, are substantially similar to the revised proposed rules jointly issued for public comment last year.

The new capital requirements apply symmetrically to equity investments made by banks and their holding companies in nonfinancial companies under the legal authorities specified in the final rules. Among others, these include the merchant banking authority granted by the Gramm-Leach-Bliley Act and the authority to invest in small business investment companies (SBICs) granted by the Small Business Investment Act.

Covered equity investments will be subject to a series of marginal Tier 1 capital charges, with the size of the charge increasing as the organization's level of concentration in equity investments increases. The highest marginal charge specified in the final rules requires a 25 percent deduction from Tier 1 capital for covered investments that aggregate more than 25 percent of an organization's Tier 1 capital. Equity investments through SBICs will be exempt from the new charges to the extent such investments, in the aggregate, do not exceed 15 percent of the banking organization's Tier 1 capital.

The new charges would not apply to individual investments made by banking organizations prior to March 13, 2000. Grandfathered investments made by state banks under section 24(f) of the Federal Deposit Insurance Act also are exempted from coverage.

The agencies also reiterated their intent to apply heightened supervision to banking organizations as their level of concentration in equity investments increases.

ATTACHMENT

A copy of the agencies' final rules is attached.

MORE INFORMATION

For more information, please contact Dorsey Davis, (214) 922-6051, Banking Supervision Department. For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254 or access District Notices on our web site at **http://www.dallasfed.org/banking/notices/index.html**.

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DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 3
[Docket No. 01-03]
RIN 1557-AB14

FEDERAL RESERVE SYSTEM
12 CFR Parts 208 and 225
[Regulations H and Y; Docket No. R-1097]

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 325
RIN 3064-AC47

Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Nonfinancial Equity Investments

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

ACTION: Final rule.

SUMMARY: The OCC, Board and FDIC (collectively, the agencies) are amending their capital guidelines to establish special minimum capital requirements for equity investments in nonfinancial companies. The new capital requirements, which will apply symmetrically to equity investments of banks and bank holding companies, impose a series of marginal capital charges on covered equity investments that increase with the level of a banking organization's overall exposure to equity investments relative to the organization's Tier 1 capital. The final rule is substantially similar to the proposal that the agencies published for comment in February 2001.

EFFECTIVE DATE: The final rule will become effective on April 1, 2002.

FOR FURTHER INFORMATION CONTACT:

OCC: Tommy Snow, Director, Capital Policy (202/874-5070); Karen Solomon, Director (202/874-5090), or Ron Shimabukuro, Senior Attorney (202/874-5090), Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

Board: Michael G. Martinson, Associate Director (202/452-3640), James A. Embersit, Assistant Director (202/452-5249), or Mary Frances Monroe, Senior Supervisory Financial

Analyst (202/452-5231), Division of Banking Supervision and Regulation; Scott G. Alvarez, Associate General Counsel (202/452-3583), or Kieran J. Fallon, Senior Counsel (202/452-5270), Legal Division; Jean Nellie Liang, Assistant Director (202/452-2918), Division of Research & Statistics; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, D.C. 20551. For users of Telecommunications Device for the Deaf ("TDD") only, contact 202/263-4869.

FDIC: Mark S. Schmidt, Associate Director, (202/898-6918), Stephen G. Pfeifer, Examination Specialist, Accounting Section (202/898-8904), Curtis Vaughn, Examination Specialist (202/898-6759), Division of Supervision; Michael B. Phillips, Counsel, (202/898-3581), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.

SUPPLEMENTARY INFORMATION:

A. Background

In March 2000, the Board invited public comment on a proposal to amend its consolidated capital adequacy guidelines for bank holding companies to establish special capital requirements for investments made, directly or indirectly, by bank holding companies in nonfinancial companies.[1] The Board's proposal, which was developed in consultation with the Secretary of the Treasury, applied to nonfinancial investments made directly or indirectly by a bank holding company under a variety of authorities, including investments made by financial holding companies under the merchant banking authority granted by the Gramm-Leach-Bliley Act (GLB Act) and investments made directly or indirectly by a bank holding company through a small business investment company (SBIC). The Board's initial capital proposal would have assessed, at the holding company level, a 50 percent capital charge on the carrying value of each covered investment.

In February 2001, the Board, OCC and FDIC jointly issued for comment a revised capital proposal (revised proposal).[2] The revised proposal attempted to balance the concerns raised by commenters on the Board's initial proposal with the belief of the agencies that banking organizations must maintain sufficient capital to offset the risks associated with equity investment activities. In developing the revised proposal, the agencies were guided by several important principles, including that:

- Equity investment activities in nonfinancial companies generally involve greater risks than traditional bank and financial activities;

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[1] See 65 FR 16480 (March 28, 2000).

[2] See 66 FR 10212 (Feb. 14, 2001).

• The risk of loss associated with a particular equity investment is likely to be the same regardless of the legal authority used to make the investment or whether the investment is held by a bank holding company or a bank; and

• The financial risks to an organization engaged in equity investment activities increase as the level of the organization's investments accounts for a larger portion of its capital, earnings and activities.

In light of these principles, the revised proposal provided for a progression of Tier 1 marginal capital charges that increases with the size of the aggregate equity investment portfolio of the banking organization relative to its Tier 1 capital. The proposed Tier 1 charge ranged from 8 percent for investments that aggregated up to 15 percent of the banking organization's Tier 1 capital, to 25 percent for investments representing 25 percent or more of the banking organization's Tier 1 capital.

The agencies proposed to apply these higher capital charges symmetrically to nonfinancial equity investments held by banks and bank holding companies. In particular, the agencies proposed to apply these charges to investments held directly or indirectly under the merchant banking authority of section 4(k)(4)(H) of the BHC Act; held directly or indirectly by bank holding companies in less than 5 percent of the shares of a nonfinancial company under section 4(c)(6) or 4(c)(7) of the BHC Act; made by bank holding companies or banks in nonfinancial companies through SBICs; held directly or indirectly by bank holding companies or banks in nonfinancial companies under the portfolio investment provisions of Regulation K; and held by banks in nonfinancial companies under section 24 of the Federal Deposit Insurance Act (FDI Act).

The agencies proposed that the higher capital charges would not apply to SBIC investments of a bank or bank holding company to the extent such investments, in the aggregate, did not exceed 15 percent of the banking organization's Tier 1 capital. All SBIC investments, including any amount exempted from the higher proposed charges, would be included in the calculation of a banking organization's aggregate equity investment portfolio for purposes of determining the marginal capital charge applicable to non-SBIC investments and SBIC investments that, in the aggregate, exceed 15 percent of Tier 1 capital. The agencies also proposed to exempt from coverage investments made by state banks under the special grandfather rights established by section 24(f) of the FDI Act.

The agencies requested comment on all aspects of the revised proposal and on a number of specific topics identified in the proposal. For example, the agencies requested comment on whether it would be necessary or appropriate to grandfather individual equity investments that were made before banking organizations received notice that the capital requirements for such investments might change.

B. Overview of Comments

The agencies collectively received approximately 60 comments on the revised proposal, including many comments that were submitted to more than one of the agencies. Commenters included trade associations for the banking, securities and insurance industries, state banking departments and individual banks and bank holding companies. Some commenters supported the lower marginal capital charge structure and level of deductions adopted by the revised proposal. For example, some commenters stated that the marginal approach embodied in the revised proposal was appropriate, logical, and consistent with the agencies' responsibilities to ensure the safety and soundness of banking organizations. One large banking organization with a significant amount of equity investments also stated that the revised proposal would not have a significantly negative impact on its ability to make equity investments. Many commenters also supported the agencies' willingness to take steps to meaningfully address some of the issues raised by commenters concerning the initial proposal.

A number of commenters, however, stated their belief that no special capital charge was necessary for equity investments. Some of these commenters argued that banking organizations are adept at managing the risks of these investment activities and that additional regulatory capital is not necessary to adequately support these activities. Some commenters also expressed concern that the higher capital charges imposed by the revised proposal would place banking organizations at a competitive disadvantage to independent securities firms and foreign banks in the market for making equity investments. In addition, several commenters asserted that the higher proposed charges would discourage independent securities firms that make equity investments as part of their business from affiliating with a bank. Commenters argued that these effects would frustrate Congress' desire, as expressed in the GLB Act, to permit a "two-way street" between securities firms and banking organizations.

Some commenters also asserted that the agencies should delay adoption of a final rule and address the issue of the appropriate capital treatment for equity investments in connection with the broader revisions to the capital rules currently being considered by the Basel Committee on Banking Supervision (Basel Committee). A number of commenters also reiterated their position that banking organizations should be permitted to use their internal capital models to determine the amount of regulatory capital necessary to support the particular investment portfolio of the organization, subject to supervisory review of these models during the examination process. A few commenters suggested that a smaller, uniform capital charge or risk-weight (e.g. a 10 percent Tier 1 capital deduction or a 250 percent risk-weight) would be adequate to offset the risk of all equity investments held by banking organizations, regardless of the size of the organization's overall equity investment portfolio.

A number of commenters also contended that, if a higher capital charge was imposed, the capital charge should apply only to investments made by financial holding companies under the GLB Act's merchant banking authority, and not to any investment made by a banking organization under one or more of the legal authorities that were in effect prior to the GLB Act. Commenters asserted that banking organizations have a history of profitably making investments under these pre-existing authorities and that there is no evidence to support an increase in the regulatory capital charge for such investments. A few commenters also contended that the proposed higher capital charges should not apply to equity investments made by a company engaged in a nonfinancial activity so long as the company was "predominantly" engaged in financial activities.

Commenters strongly supported several specific aspects of the revised proposal. For example, many commenters supported the decision by the agencies to exempt from the new capital charge SBIC investments that, in the aggregate, represented less than 15 percent of the banking organization's Tier 1 capital.[3] Many of these commenters, however, also argued that any SBIC investments that were exempted from the higher proposed charges also should be excluded for purposes of determining the aggregate size of the banking organization's equity portfolio and, thus, the appropriate marginal charge to be applied to non-exempt investments. Commenters also supported the agencies' proposal to exclude from coverage investments made by insurance company subsidiaries of financial holding companies under section 4(k)(4)(I) of the BHC Act; investments made by state banks under the grandfather rights established by section 24(f) of the FDI Act (12 U.S.C. § 1831a(f)); and investments in debt instruments that do not serve as the functional equivalent of equity.

In addition, in response to the agencies' request for comments on the subject, many commenters asserted that any higher capital charges established for nonfinancial equity investments should not apply to investments made before March 13, 2000. These commenters noted that such investments were made before the industry was aware that a higher capital charge might be established for equity investments and argued that applying the higher charges to these pre-existing investments would be inequitable and could cause some investments to become unprofitable. Many of these commenters also argued that any grandfathered investments should not be included in the banking organization's aggregate equity portfolio for purposes of determining the marginal charge applicable to non-exempt investments made on or after March 13, 2000.

Commenters also argued that the higher proposed capital charges should not be applied in determining a banking organization's Tier 1 leverage ratio, because the leverage ratio generally does not account for the relative risks of a banking organization's assets. Finally, some commenters requested that the agencies clarify whether or how the proposed higher charges would apply to particular types of equity investments, including equity investments held in the trading account or for hedging purposes; investments that are acquired in satisfaction of a debt previously contracted (DPC); and investments made by a financial holding company under section 4(k)(1)(B) of the BHC Act in a company that is engaged in activities that the Board has determined are "complementary" to a financial activity.

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[3] One large banking organization, however, opposed providing an exemption for SBIC investments on the grounds that these investments entail the same risks as other types of nonfinancial equity investments.

C. Explanation of the Final Rule

The agencies have carefully reviewed the revised proposal in light of all of the comments received. Following this review, the agencies have adopted a final rule that is substantially similar to the revised proposal that was issued for comment. As described further below, the agencies also have made several changes to the rule to address matters raised by commenters and to further clarify the scope and application of the rule. These changes include a grandfather provision designed to apply the rule's capital charges only to investments made on or after March 13, 2000.

As an initial matter, the agencies believe it is important and appropriate to adopt a final rule at this time that establishes a regulatory minimum capital requirement for equity investments made by banking organizations in nonfinancial companies that is higher than the regulatory minimum capital charge that applies more broadly to banking assets. Data demonstrate that equity investments in nonfinancial companies generally involve greater risks than traditional banking and financial activities. An analysis of the annual returns for the period 1946 through 1998 for publicly traded small capitalization stocks in the United States indicates that a banking organization would have to hold capital well in excess of the current regulatory minimum capital levels to maintain the margin of safety required to retain the lowest investment grade rating on a bond issued to finance a portfolio of small capitalization stocks. Furthermore, as discussed in the revised proposal, data from a study of venture capital investment firms over the past 25 years, information and analysis from two national rating agencies, and a survey of the internal capital allocation policies of several banking organizations and securities firms engaged in equity investment activities all indicate that equity investments require higher capital support than traditional banking activities. The performance of the U.S. equity markets over the past few quarters further evidences the volatility and risk of equity investments.

The level and significance of equity investment activities at banking organizations also has increased substantially in the years since adoption of the original capital rules that govern banks and bank holding companies generally. For example, the size of SBICs owned by banking organizations more than doubled in the period from 1995 to 1999, and aggregate equity investments held by banking organizations during that period more than quadrupled. In addition, as of June 30, 2001, financial holding companies held more than \$8.5 billion in investments under the new GLB Act authority to make merchant banking investments–authority that only became effective on March 13, 2000. Although the growth of these activities recently has slowed, equity investment activities have become, and are likely to continue to be, a significant business line for many banking organizations.

In light of the increased significance of the equity investment activities of banking organizations and the risks associated with these investments, the agencies believe it is important to revise their capital rules to reflect more accurately the risks equity investments may pose to the safety and soundness of banking organizations. For these same reasons, the agencies do not believe it would be prudent or appropriate to delay adoption of a final rule, as some commenters suggested. The agencies are aware of, and are participating actively in, the ongoing comprehensive review and revision of the Basel Capital Accord, which is expected to include provisions addressing equity investment activities. The agencies believe this rule is consistent with the efforts of the Basel Committee to develop a minimum regulatory capital requirement for equities that is more risk-sensitive than the current 100-percent risk-weighting. The agencies note, moreover, that any revised Accord is not expected to become effective until 2005 at the earliest. The agencies view this final rule as an interim step or "bridge" to the revised Accord. The agencies fully expect to revisit the capital charge applicable to equity investments once the Basle Capital Accord is revised, and will at that time decide whether and what, if any, revisions to the agencies' capital guidelines should be adopted in light of the final revised Accord.

The agencies also continue to believe that internal capital models that take account of the different risks and capital needs of the credit and equity activities of a particular banking organization ultimately represent an effective method for determining the capital adequacy of an organization. The agencies do not believe that it would be appropriate at this time, however, to rely on internal capital models, as a replacement for regulatory minimum capital requirements, to address the higher risks associated with the equity investment activities of banking organizations. The stage of development and sophistication of internal models for assessing equity risk exposures varies widely across institutions. While modeling techniques for equity investments are being developed and refined at major U.S. banking organizations, few institutions have adequately robust modeling capabilities for equity investments at the present time.

The agencies note that the Basel Committee is actively considering the circumstances under which it would be appropriate for a banking organization to calculate its capital requirements under an internal models-based approach. As part of this effort, the agencies are working as part of the Basel Committee to develop the criteria under which a banking organization could use internal measurement systems or internal models to estimate the organization's risk exposure to equity investments for risk-based capital purposes.[4] The agencies will continue to work with banking organizations that seek to develop robust and effective internal models and with other domestic and international regulatory agencies to develop a regulatory framework that permits banking organizations to use models that meet appropriate quantitative and qualitative standards in assessing the organization's capital adequacy.

The Board notes that, once the final rule becomes effective on April 1, 2002, the aggregate investment review thresholds that currently apply to the merchant banking investments

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[4] See Basel Committee on Banking Supervision, Working Paper on Risk Sensitive Approaches for Equity Exposures in the Banking Book for IRB Banks (August 2001) ("Equity Risk Working Paper").

of financial holding companies will expire automatically.[5] These thresholds currently require a financial holding company to obtain the Board's approval prior to making additional merchant banking investments if the aggregate carrying value of the holding company's existing merchant banking investments exceeds the lesser of 30 percent of Tier 1 capital, or 20 percent of Tier 1 capital after excluding investments in private equity funds. As the Board previously noted, these review thresholds were adopted as an interim measure pending adoption of a final rule addressing the appropriate regulatory capital treatment of merchant banking investments.

1. Equity Investments Covered by Final Rule

The final rule, like the revised proposal, applies symmetrically to equity investments made by bank holding companies and banks. Bank holding companies and banks generally make equity investments in reliance on, and the capital charge applies only to investments held under, the following authorities–

• The merchant banking authority of section 4(k)(4)(H) of the BHC Act (12 U.S.C. § 1843(k)(4)(H)) and subpart J of the Board's Regulation Y (12 CFR 225.170 et seq.);

• The authority to acquire up to 5 percent of the voting shares of any company under section 4(c)(6) or 4(c)(7) of the BHC Act (12 U.S.C. § 1843(c)(6) and (c)(7));

• The authority to invest in SBICs under section 302(b) of the Small Business Investment Act of 1958 (15 U.S.C. § 682(b));

• The portfolio investment provisions of Regulation K (12 CFR 211.8(c)(3)), including the authority to make portfolio investments through Edge and Agreement corporations;[6] and

• The authority to make investments under section 24 of the FDI Act (other than under section 24(f)) (12 U.S.C. § 1831a).

For purposes of the rule, an equity investment includes the purchase, acquisition or retention of any equity instrument (including common stock, preferred stock, partnership interests, interests in limited liability companies, trust certificates and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into

[5] See 12 CFR 225.174(c); 12 CFR 1500.5(c).

[6] Recently, the Board comprehensively revised Regulation K, which, among other things, governs the foreign activities of U.S. banking organizations. See 66 FR 54346 (Oct. 26, 2001). As part of that action, the portfolio investment provisions previously located at 12 CFR 211.5(b)(1)(iii) were amended and moved to 12 CFR 211.8(c)(3).

equity. The rule generally does not apply to investments in nonconvertible senior or subordinated debt. The agencies, however, may impose the rule's higher charges on any instrument if the agency, based on a case-by-case review of the investment in the supervisory process, determines that the instrument serves as the functional equivalent of equity or exposes the banking organization to essentially the same risks as an equity instrument. The agencies believe this reservation of supervisory authority is appropriate to ensure that the higher capital charges apply to instruments that function as equity, and ensure that banking organizations do not evade the requirements of the rule through financial engineering.

The capital charge applies only to investments held directly or indirectly in nonfinancial companies under one or more of the authorities listed above. For purposes of the final capital rule, a nonfinancial company is defined to mean an entity that engages in any activity that has not been determined to be financial in nature or incidental to financial activities under section 4(k) of the BHC Act. For investments held directly or indirectly by a bank, the term "nonfinancial company" also does not include a company that engages only in activities that are permissible for the parent bank to conduct directly. The rule does not apply to investments made in companies that engage solely in banking and financial activities. Banking organizations have special expertise in managing the risks associated with banking and financial activities.

A few commenters asserted that the proposed higher capital charges should apply only to merchant banking investments made by financial holding companies under section 4(k)(4)(H) of the BHC Act, or should not apply to investments made under one or more of the other investment authorities listed above. The risk of loss associated with a particular equity investment is likely to be the same regardless of the legal authority used by a banking organization to make the investment, or whether the investment is held by a bank holding company or a bank. Supervisory experience, particularly over the past few quarters, has confirmed that significant valuation declines may occur with respect to equity investments held under a variety of legal authorities. It is for these reasons that banking organizations are increasingly making investment decisions and managing equity investment risks across legal entities as a single business line within the organization. It is for these same reasons that the final rule, like the revised proposal, applies symmetrically to nonfinancial equity investments held by banks and bank holding companies and applies to equity investments made under each of the principal legal authorities currently available to banking organizations for making such investments.

As noted above, the final rule applies to investments made by bank holding companies or banks in or through SBICs under section 302(b) of the Small Business Investment Act. In light of Congress' express desire to facilitate the funding of small businesses through SBICs, the statutory limits on the amount of capital a banking organization may invest in SBICs, and the existing regulatory framework governing the formation and operations of SBICs, the agencies proposed to exempt from the higher capital charges SBIC investments of banking organizations that, in the aggregate, did not exceed 15 percent of the Tier 1 capital of the banking organization.

Commenters strongly supported this treatment. Accordingly, the final rule continues to provide an exception for SBIC investments. As described further below (see Part C.4 below), the rule does not place any additional regulatory capital charge on SBIC investments held directly or indirectly by a bank to the extent the aggregate adjusted carrying value of all such investments does not exceed 15 percent of the Tier 1 capital of the bank. For bank holding companies, no additional regulatory capital charge is imposed on SBIC investments held directly or indirectly by the holding company to the extent the aggregate adjusted carrying value of all such investments does not exceed 15 percent of the aggregate of the holding company's pro rata interests in the Tier 1 capital of its subsidiary banks.

The rule also applies to investments held by state banks in a nonfinancial company under section 24 of the FDI Act. Section 24 permits a state bank to acquire equity in a nonfinancial company if the FDIC determines that the investment does not pose a significant risk to the deposit insurance fund. The FDIC is empowered to establish and has established higher capital requirements and other limitations on equity investments of state banks held under this authority, such as investments in companies engaged in real estate investment and development activities. The FDIC has to date in most cases required state banks that make these investments to limit the amount of the investment and to deduct these investments from the bank's capital, effectively imposing a 100 percent capital charge on these investments. Because of the FDIC's practice in establishing higher capital charges, the final rule will not have the effect of imposing additional capital requirements on investments held under section 24 of the FDI Act.[7]

The agencies proposed to exclude from coverage equity investments made by state banks under the grandfather rights established by section 24(f) of the FDI Act and commenters strongly supported this exception. Section 24(f) permits a state bank to make investments only in shares of publicly traded companies and registered investment companies, and only if the investment was permitted under a state law enacted as of a certain date and the state bank engaged in the investment activity as of a certain date. The FDI Act also provides that the total amount of investments made by a state bank under section 24(f) may not exceed the capital of the bank, and expressly authorizes the FDIC to require the divestiture of any investment made under the section if the FDIC determines the investment will have an adverse effect on the safety and soundness of the bank. In light of the limited scope of these investments and the statutory restrictions applicable to them, the agencies have adopted an exemption for these investments in the final rule.

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[7] The final rule permits the Board of Directors of the FDIC, acting directly in exceptional cases and after a review of the proposed activity, to allow a lower capital deduction for investments approved by the Board of Directors under section 24 of the FDI Act so long as the bank's investments under section 24 and SBIC investments represent, in the aggregate, less than 15 percent of the Tier 1 capital of the bank. The FDIC may also impose a higher capital charge on any investment made under section 24 where appropriate.

Some commenters asserted that the proposed higher charges should not apply to any investment made in a company that is predominantly engaged in banking or financial activities. These investments, by definition, involve some mixing of banking and commerce, and present special risks to the investing banking organization. In addition, the agencies believe that the adoption of a "predominantly financial" standard would create significant administrative and verification burdens for banking organizations and their supervisors, and could create opportunities for banking organizations to evade the higher capital charges established by the rule. In this regard, the agencies believe it would be difficult for banking organizations to establish and document adequately, and for the appropriate supervisor to monitor effectively, the mix of a company's financial and nonfinancial activities. On the other hand, the approach adopted by the final rule provides a clear standard for banking organizations and their supervisors to use in identifying investments covered by the rule while, at the same time, excluding from coverage investments in companies engaged solely in banking or financial activities that the banking organization could hold under their traditional authorities to engage in such activities.

In response to questions raised by commenters, the agencies wish to clarify that the rule does not apply to investments made in a community development corporation to promote the public welfare under 12 U.S.C. § 24(Eleventh). In addition, the rule does not apply to equity securities that are acquired in satisfaction of a debt previously contracted (DPC) and that are held and divested in accordance with applicable law, or to unexercised warrants acquired by a bank as additional consideration for making a loan where the warrants are not held under one of the legal authorities covered by the rule.

The final rule also does not apply to equity investments made under section 4(k)(4)(I) of the BHC Act by an insurance underwriting affiliate of a financial holding company. Investments made by insurance underwriting affiliates of a financial holding company generally are already subject to higher capital charges under state insurance laws. The Board expects to monitor financial holding companies with insurance underwriting affiliates to ensure that they do not arbitrage any differences in the capital requirements applicable to equity investments made by insurance companies and other financial holding company affiliates. The Board also currently is considering the appropriate method for accounting for insurance companies and their investments under the Board's consolidated capital adequacy guidelines and will address any issues that arise in this area in a separate proposal.

The agencies proposed to exempt from the higher capital charges any equity instrument that was held in the trading account of the relevant banking organization in accordance with generally accepted accounting principles (GAAP) and as part of an underwriting, market making or dealing activity.

Several commenters asserted that the higher capital charges should not apply to any equity instrument that is held for hedging purposes, or to any equity instrument that is held in the trading account in accordance with GAAP. Some commenters also asked the agencies to clarify the scope of the proposed exemption for equity instruments held in the trading account.

The final rule does not apply the higher capital charges to equity securities acquired and held by a bank or bank holding company as a bona fide hedge of an equity derivative transaction lawfully entered into by the bank or bank holding company. Moreover, banking organizations have separate authority to underwrite, deal in, and make a market in equity securities through a securities broker or dealer that is subject to special capital and accounting requirements, and securities lawfully acquired under these statutory provisions are not covered by the rule.[8]

Because the trading account provision of the revised proposal was included for the purpose of exempting these types of holdings from the capital proposal, the agencies do not believe that, with the clarifications discussed above, a general exemption for investments held in the trading account is necessary. Moreover, a more general exception for equities held in the trading account, as advocated by some commenters, could allow banking organizations to evade the requirements of the rule by placing nonfinancial equity investments in their trading account. Accordingly, the final rule does not include a general exemption for investments that are held in the trading account.

A few commenters questioned whether the proposed charges would apply to investments made by financial holding companies in a company engaged in "complementary" activities. Section 4(k)(1)(B) of the BHC Act (12 U.S.C. § 1843(k)(1)(B)) permits a financial holding company to acquire a company engaged in a nonfinancial activity if the Board finds that the activity is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. A financial holding company must obtain the Board's prior approval to acquire a company under this authority.[9] The Board will review and consider the appropriate capital treatment of investments made by a financial holding company under section 4(k)(1)(B) in connection with its review of any notice filed by a financial holding company to acquire a company engaged in a complementary activity, or in connection with its determination that a particular activity is "complementary" to a financial activity.[10] Accordingly, the final rule does not apply to investments made by a financial holding company under the "complementary" investment authority of section 4(k)(1)(B) of the BHC Act.

The agencies believe that the legal authorities covered by the rule represent the principal

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[8] See 12 U.S.C. §§ 24a, 335 and 1831w (financial subsidiaries of national, state member and state nonmember banks, respectively); 12 U.S.C. § 1843(k)(4)(E) (financial holding companies); and 12 U.S.C. § 1843(c)(8) and J.P. Morgan & Co., Inc., 75 Federal Reserve Bulletin 192 (1989), aff'd sub nom. Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 900 F.2d 360 (D.C. Cir. 1990) (bank holding companies).

[9] See 12 CFR 225.89.

[10] See 65 FR 80384 (Dec. 21, 2000) (requesting comment on a proposal to determine that certain data processing and data transmission activities are complementary to a financial activity and on the appropriate capital treatment for such investments).

legal authorities available to banking organizations for making equity investments in nonfinancial companies. The agencies intend to monitor developments relating to nonfinancial equity investments of banking organizations and may expand the types of investments covered by the rule if necessary to ensure that banking organizations maintain adequate capital to support their equity investment activities.

2. Transition rule for investments made before March 13, 2000

As noted above, the agencies specifically requested comment on whether the higher proposed capital charges should apply to individual investments made by a bank or bank holding company prior to March 13, 2000. The agencies proposed that, if investments made prior to March 13, 2000, were grandfathered, the amount of such investments be included in determining the aggregate size of the banking organization's equity investment portfolio and, thus, the appropriate marginal capital charge that would apply to investments that were not grandfathered.

Commenters strongly supported grandfathering investments that were made prior to March 13, 2000. Commenters noted that these investments were made before the agencies publicly indicated that a higher regulatory capital charge might be imposed, and argued that applying the new charges retroactively to these investments would be unfair and could render certain existing investments unprofitable. Commenters also favored a permanent grandfather for individual investments made prior to March 13, 2000, rather than a phase-in period that would apply the new capital requirements to such investments over a period of years.

After reviewing the comments received, the agencies have determined to exempt from the new capital charges any individual investment that was made by a bank or bank holding company before March 13, 2000, or that was made after such date pursuant to a binding written commitment entered into by the banking organization prior to March 13, 2000.[11] These investments are modest in amount at most banking organizations and will be liquidated over time. As discussed further below (see Part C.4), the adjusted carrying value of any grandfathered investment must be included in determining the total amount of nonfinancial equity investments held by the banking organization in relation to its Tier 1 capital and, thus, the

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[11] A few commenters asserted that grandfather rights should be granted to all investments made prior to the effective date of the final rule. The agencies do not believe granting broader grandfather rights for equity investments would be appropriate in light of the risks these investments pose to banking organizations. Also, the Board in its initial capital proposal specifically gave notice that it expected banking organizations to maintain capital in sufficient amounts to allow the organizations to transition to higher regulatory capital levels for equity investments if required. Thus, the agencies expect that banking organizations will not face significant burdens in complying with the final rule which, as noted above, imposes capital charges that are lower than those initially proposed.

marginal capital charge that applies to the organization's covered equity investments.[12]

The final rule grants these grandfather rights only to investments that were made prior to March 13, 2000, or that were made on or after March 13, 2000 pursuant to a binding written commitment entered into prior to March 13, 2000.[13] For example, if a bank holding company acquired 100 shares of a nonfinancial company under section 4(c)(6) of the BHC Act prior to March 13, 2000, the adjusted carrying value of that investment would be exempt from the rule's higher capital charges. However, if the bank holding company purchased additional shares of the company after March 13, 2000, or made a capital contribution to the company after March 13, 2000, the adjusted carrying value of the additional investment would be subject to the marginal capital charges of the rule (assuming that the additional investment was not made pursuant to a binding written commitment entered into before March 13, 2000). Shares or other interests received by a banking organization through a stock split or stock dividend on an investment made prior to March 13, 2000, are not considered a new investment if the banking organization does not provide any consideration for the shares or interests received and the transaction does not materially increase the organization's proportional interest in the company. On the other hand, shares or interests acquired on or after March 13, 2000, through the exercise of options or warrants acquired before March 13, 2000, will be considered a new investment if the banking organization provides any consideration for the shares or interests received.

An investment qualifies for grandfather rights only if the banking organization has continuously held the investment since March 13, 2000. Thus, in the example discussed above, if the bank holding company sold and repurchased 40 shares of the nonfinancial company after March 13, 2000, those 40 shares would no longer qualify for grandfather rights under the rule. The grandfather status of an investment is not affected if the banking organization determines to hold that investment under a different legal authority than the authority originally used to acquire the investment. A financial holding company could, for example, decide to hold certain investments made through an SBIC or under section 4(c)(6) of the BHC Act prior to March 13, 2000, under the GLB Act's expanded merchant banking authority, and such decision would not affect the grandfathered treatment of the investment under the rule.

3. Marginal Capital Charge Structure

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[12] In addition, all grandfathered investments that are not subject to a deduction under the rule will be risk-weighted at 100 percent and included in the banking organization's risk-weighted assets for purposes of calculating the organization's risk-based capital ratios.

[13] For purposes of the rule, a binding written commitment means a legally binding written agreement that requires the banking organization to acquire shares or other equity of the company, or make a capital contribution to the company, under terms and conditions set forth in the agreement. Options, warrants, and other agreements that give a banking organization the right to acquire equity or make an investment, but do not require the banking organization to take such actions, are not considered a binding written commitment for purposes of the rule.

The agencies are adopting a final marginal capital charge structure that is substantially as outlined in the revised proposal. This structure applies a higher capital charge to equity investments as the aggregate amount of the organization's nonfinancial equity investments increases in relation to its capital. This approach reflects the fact that the financial risks to a banking organization from equity investment activities increases as the level of these activities account for a larger portion of the organization's capital, earnings, and activities. The charges, which are reflected in the following table, are applied by making a deduction from the banking organization's Tier 1 capital.

Table 1
Deduction for
Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the banking organization (as a percentage of the Tier 1 capital of the banking organization)	**Deduction from Tier 1 Capital (as a percentage of the adjusted carrying value of the investment)**
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

Each tier of charges applies, on a marginal basis, to the adjusted carrying value of the banking organization's nonfinancial equity investments that fall within the specified range of the organization's Tier 1 capital.[14] The total adjusted carrying value of a nonfinancial equity investment that is subject to a deduction under the rule is excluded from the banking organization's risk-weighted assets for purposes of computing the denominator of the organization's risk-based capital ratio.

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[14] For purposes of determining the amount of a banking organization's nonfinancial equity investments as a percentage of its Tier 1 capital, Tier 1 capital is calculated before any deduction for disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, disallowed purchased credit card relationships, disallowed credit enhancing interest-only strips (both purchased and retained), disallowed deferred tax assets, and nonfinancial equity investments.

The agencies recently adopted amendments to their capital guidelines to better address the regulatory capital treatment of recourse obligations, residual interests (including credit enhancing interest-only strips) and direct credit substitutes. See 66 FR 59614 (Nov. 29, 2001) ("Securitization Rule"). The amendments to the agencies' capital guidelines adopted by this final rule reflect the changes made to the capital guidelines by the Securitization Rule.

The amount of the deduction is based on the adjusted carrying value of the banking organization's nonfinancial equity investments. The "adjusted carrying value" of an investment is the value at which the investment is recorded on the balance sheet of the banking organization, reduced by (i) net unrealized gains that are included in carrying value but that have not been included in Tier 1 capital and (ii) associated deferred tax liabilities. For example, for investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investment as reflected on the banking organization's balance sheet, less the sum of (i) unrealized gains on those investments included in the organization's other comprehensive income and not reflected in Tier 1 capital and (ii) any associated deferred tax liabilities.

Comments were mixed on using the adjusted carrying value of an investment for purposes of determining the amount of the required deduction. While some commenters favored this approach, others argued that it unfairly penalized well performing investments that are marked-up with the unrealized gains flowing into Tier 1 capital.

The agencies continue to believe that the adjusted carrying value of an investment provides an appropriate benchmark for applying the deduction because it reflects the full amount of an organization's capital exposure to equity investments. Adjusted carrying value reflects both the amount actually invested by the banking organization and any additional unrealized gains (or losses) on the investment that are reflected in the organization's Tier 1 capital. All of the adjusted carrying value of an investment is potentially subject to loss in the event of devaluation of the investment. Applying the charge to the adjusted carrying value of an investment also takes into account that some banking organizations use AFS accounting for GAAP reporting purposes, which is a prudent and appropriate accounting method in many situations and one that results in an effective 100 percent capital charge on unrealized gains.[15]

4. <u>SBIC Investments</u>

The final rule applies to equity investments made by bank holding companies and banks in nonfinancial companies through one or more SBICs that are consolidated with the banking organization, and to equity investments in one or more SBICs that are not consolidated with the banking organization. For the reasons discussed above, the final rule provides an accommodation for SBIC investments made by a bank holding company or bank provided such investments remain within traditional investment ranges. In particular, no additional capital charge is applied to SBIC investments held directly or indirectly by a bank to the extent the aggregate adjusted carrying value of all such investments does not exceed 15 percent of the Tier 1 capital of the bank. In the case of a bank holding company, no additional capital charge is

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[15] The rule does not affect the treatment of unrealized gains and losses on AFS securities for purposes of calculating supplementary (Tier 2) capital. Under the agencies' risk-based capital rules, up to 45 percent of an organization's pretax net unrealized gains on AFS equity securities may be included in Tier 2 capital.

applied to SBIC investments held directly or indirectly by the bank holding company to the extent the aggregate adjusted carrying value of all such investments does not exceed 15 percent of the aggregate of the holding company's pro rata interests in the Tier 1 capital of its subsidiary banks.[16] SBIC investments that are not subject to a deduction under the rule will be risk-weighted at 100 percent and included in the banking organization's risk-weighted assets for purposes of calculating the organization's risk-based capital ratios.

The final rule continues to provide that a banking organization, in calculating the aggregate adjusted carrying value of its nonfinancial equity investments for purposes of determining the appropriate marginal charge to be applied to an equity investment subject to the rule, must include all nonfinancial equity investments held by the organization in or through an SBIC as well as all grandfathered investments that are exempt from the rule's higher capital charges. A number of commenters opposed this treatment and argued that this treatment would effectively subject exempt SBIC investments and grandfathered investments to the rule's higher capital charges.

One of the principles that has guided the agencies during this rulemaking process is that the risks to a banking organization from equity investment activities increase as equity investments constitute a larger component of the organization's capital and operations. Although the agencies, for the reasons discussed above, have determined to provide an exemption for SBIC investments and investments made prior to March 13, 2000, the agencies believe it is appropriate to consider the risks associated with an organization's total equity investment portfolio in determining the marginal charge that would apply to SBIC investments that exceed traditional levels and to investments made on or after March 13, 2000. This approach balances Congress' desire to promote the funding of small businesses through SBICs and the desire of banking organizations to preserve the existing capital treatment of investments made prior to March 13, 2000, with the agencies' strong belief, based on available data, that regulatory capital levels higher than the current requirements are necessary to support the greater risks associated with equity investments and ensure the safety and soundness of banking organizations. The agencies also note that this approach does not impose a higher capital charge on exempted SBIC investments or grandfathered investments. These investments would continue to be subject to the same capital requirements that apply to such investments today. However, these investments could cause a higher marginal capital charge to be imposed on each additional dollar of non-exempt and non-grandfathered investments made by the banking organization to reflect the organization's higher concentration and exposure to equity investment activities.

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[16] The amount a bank holding company may invest in the stock of an SBIC under section 4(c)(5) of the BHC Act and section 302(b) of the Small Business Investment Act is based on the bank holding company's proportionate interest in the capital and surplus of its subsidiary banks. See 12 CFR 225.111. The Board believes a similar methodology is appropriate for determining the level of SBIC investments held directly or indirectly by a bank holding company that qualify for an exemption from the rule's higher capital charges.

If a banking organization has an investment in a SBIC that is consolidated with the banking organization for accounting purposes, but that is not wholly owned by the banking organization, the adjusted carrying value of the organization's nonfinancial equity investments held through the SBIC is equal to the organization's proportionate share of the adjusted carrying value of the SBIC's equity investments in nonfinancial companies. The remainder of the adjusted carrying value of the SBIC's investments, which represents the minority interest holders' proportionate share, is excluded from the banking organization's risk-weighted assets.[17]

Similar treatment applies to investments that a bank holding company holds through equity investment funds that are controlled by the holding company (such as, by acting as general partner of the fund) but that are not wholly owned by the holding company. In these circumstances, the capital charge applies only to the holding company's proportionate share of the fund's investments even if the fund is consolidated in the holding company's financial reporting statements.

In addition, if a less-than-wholly-owned SBIC or investment fund is consolidated into the banking organization's financial statements for accounting and reporting purposes, any minority interest resulting from the consolidation may not be included in the Tier 1 capital of the banking organization. The agencies believe this treatment is appropriate because the minority interest is not available to support the overall financial business of the banking organization and, therefore, should not be included in the banking organization's capital.

The agencies do not expect that any nonfinancial company acquired by a banking organization under one of the legal authorities covered by the rule would be consolidated into the banking organization's financial statements, either because the investment is temporary or limited to a non-controlling stake. However, if consolidation does occur, any resulting minority interest also must be excluded from Tier 1 capital because the minority interest is not available to support the general financial business of the banking organization.

5. Examples of Application of Rule's Marginal Charges

The following two examples illustrate how the rule's marginal charges apply.

Example 1: A financial holding company has $1 million in Tier 1 capital and has

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[17] If a banking organization has an investment in a SBIC that is not consolidated with the banking organization for accounting purposes, that organization may (but is not required to) reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the SBIC's investments that are in companies engaged only in banking or financial activities. A banking organization may adjust its interest in a non-consolidated SBIC in this manner only if the organization has current information that identifies the percentage of the SBIC's investments that are in companies engaged in a nonfinancial activity. This information must be available to examiners upon request.

nonfinancial equity investments with an aggregate adjusted carrying value of $270,000. All of the financial holding company's nonfinancial equity investments are held under the GLB Act's merchant banking authority and all were made after March 13, 2000. The total amount of the financial holding company's required Tier 1 capital deduction would be $28,998, determined as follows: (i) 8 percent of the first $149,999 ($11,999); (ii) 12 percent of the amount between $150,000 and $249,999 ($11,999); and (iii) 25 percent of the amount from $250,000 to $270,000 ($5,000).[18] The average Tier 1 charge on the financial holding company's portfolio would be 10.74 percent.

Example 2: A bank has $1 million in Tier 1 capital and has nonfinancial equity investments with an aggregate adjusted carrying value of $375,000. Of this amount, $100,000 represents the adjusted carrying value of investments made prior to March 13, 2000, and an additional $175,000 represents the adjusted carrying value of investments made through the bank's wholly owned SBIC. The $100,000 in investments made prior to March 13, 2000, and $150,000 of the bank's SBIC investments would not be subject to the rule's marginal capital charges. These amounts are considered for purposes of determining the marginal charge that applies to the bank's covered investments (including the $25,000 of non-exempt SBIC investments). In this case, the total amount of the bank's Tier 1 capital deduction would be $31,250. This figure is 25 percent of $125,000, which is the amount of the bank's total nonfinancial equity portfolio subject to the rule's marginal capital charges. The average Tier 1 capital charge on the bank's entire nonfinancial equity portfolio would be 8.33 percent.

The $31,250 charge in Example 2 reflects the provisions of the rule that impose no additional capital charge on investments made prior to March 13, 2000, and on SBIC investments to the extent such investments do not exceed 15 percent of Tier 1 capital. While these grandfathered and SBIC investments are not subject to a Tier 1 capital deduction under the final rule, these investments would be given a 100 percent risk-weight and would remain subject to the normal Tier 1 and total capital charges applicable to the organization's risk-weighted assets under the agencies's risk-based capital guidelines.

6. Leverage ratio

The revised proposal required banking organizations to apply the proposed capital deduction in calculating the organization's Tier 1 capital. Consequently, the proposal would affect both the organization's risk-based capital ratio and its ratio of Tier 1 capital to average total assets (Tier 1 leverage ratio). The agencies requested comment on whether the final rule should be adjusted to eliminate application of the deduction for purposes of calculating the Tier 1 leverage ratio and, if so, how this might be done. A small number of commenters addressed this issue, and generally opposed incorporating the higher capital charges for equity investments into the calculation of an organization's Tier 1 leverage ratio. Commenters asserted that the leverage ratio was intended to provide an absolute measure of the bank's capital to asset ratio

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[18] For purposes of these examples, all figures have been rounded to the nearest dollar.

without adjusting the bank's assets according to the relative risk associated with different classes of assets.

After carefully reviewing the comments on this issue, the agencies have decided to adopt the approach proposed, which applies the deduction to Tier 1 for both risk-based and leverage capital purposes.[19] In reaching this conclusion, the agencies have carefully considered a number of factors and alternatives. The agencies have long used a uniform definition of Tier 1 capital for both risk-based and leverage capital purposes based, in part, on the view that the nature and composition of "core" capital does not differ depending on whether it is being compared to risk-weighted or average total assets. In addition, although the leverage ratio generally is intended to provide an absolute measure of a banking organization's ratio of core capital to average total assets, the agencies also previously have determined that certain types of assets that involve special risks should be deducted from, and not considered part of, Tier 1 capital for both risk-based and leverage capital purposes.[20] As discussed above, equity investments involve significantly greater risks than those associated with traditional banking and financial activities and, accordingly, the agencies believe it is appropriate to require that these investments be deducted from core capital for leverage capital purposes in the manner provided in the rule.

The agencies note, moreover, that the most direct method of implementing the commenters' proposal would be to require banks to apply the rule's deductions only for risk-based capital purposes. Such an approach would result in many banking organizations having two separate Tier 1 capital amounts–one for risk-based purposes and one for leverage purposes. This dichotomy could create significant confusion in, and burden for, the industry, particularly because a number of regulatory and reporting requirements are based on an organization's "Tier 1 capital" and two such numbers might exist. The agencies also have considered potential alternative approaches that would implement the commenters' suggestion while, at the same time, retaining an uniform definition of Tier 1. These alternative approaches, however, also would significantly increase the complexity and burden of the rule.

The agencies also have reviewed information obtained through the supervisory and examination process for a sample of banking organizations with a significant amount of equity

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[19] A few commenters also asserted that the agencies should, as a general matter, eliminate the Tier 1 leverage ratio for banking organizations. This suggestion is beyond the scope of this targeted rulemaking, and the agencies believe that the leverage ratio continues to be a useful tool in ensuring that banking organizations operate with adequate capital to support their activities.

[20] For example, the agencies' risk-based and leverage capital guidelines may require banking organizations to deduct all or a portion of the following assets from Tier 1 capital: goodwill; mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing interest-only strips; other identifiable intangible assets; and deferred tax assets.

investments. This review indicates that applying the rule's Tier 1 deductions for leverage capital purposes likely will have a de minimis impact on the leverage ratio of banking organizations at this time. For these reasons, the final rule requires banking organizations to make the rule's Tier 1 deductions for both risk-based and leverage capital purposes.

The final rule provides that the total adjusted carrying value of a banking organization's nonfinancial equity investments that is subject to a deduction from Tier 1 capital will be excluded from the organization's average total consolidated assets for purposes of computing the denominator of the organization's Tier 1 leverage ratio. Any amount of equity investments that is not subject to a deduction under the rule (e.g. grandfathered investments and SBIC investments that, in the aggregate, do not exceed 15 percent of Tier 1 capital) must be included in the organization's average total consolidated assets.

7. Risk Management and the Supervisory Process

Although strong capital adequacy is critically important to ensure that equity investment activities do not pose an undue risk to a banking organization, capital strength must be supplemented by strong internal controls and management practices to ensure that equity investment activities are conducted in a safe and sound manner. Accordingly, all banking organizations are expected to develop, maintain and employ sound risk management policies, procedures and systems that are reasonably designed to manage the risks associated with the organization's equity investment activities. These policies, procedures and systems should include established limits on the types and amounts of equity investments that may be made by the banking organization; parameters governing portfolio diversification; sound policies governing the valuation and accounting of investments; periodic reviews of the performance of individual investments and the aggregate portfolio; and strong internal controls, including investment review and authorization procedures and recordkeeping requirements. The level and complexity of an organization's risk management policies, procedures and systems should be commensurate to the size, nature and complexity of the organization's equity investment activities and consistent with any guidance published by the agencies.[21]

The agencies note, moreover, that the capital requirements established by this final rule are viewed as the minimum capital levels required for a banking organization to adequately support its equity investment activities. The agencies' risk-based capital guidelines require banking organizations at all times to maintain capital that is commensurate with the level and nature of the risks to which they are exposed and the agencies fully expect that individual banking organizations will allocate higher economic capital levels, as appropriate, to support their equity investment activities in amounts commensurate with the risk in the individual investment portfolios of the organization.

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[21] See, e.g. Federal Reserve SR Letter No. 00-9 (SPE), Supervisory Guidance on Equity Investment and Merchant Banking Activities (June 22, 2000).

Furthermore, the agencies may impose a higher capital charge on the nonfinancial equity investments of a banking organization if the facts and circumstances indicate that a higher capital level is appropriate in light of the risks associated with the organization's investment activities. The agencies believe that strong capital levels above the minimum requirements are particularly important when a banking organization has a high degree of concentration in nonfinancial equity investments. As proposed, the agencies will apply heightened supervision to the equity investment activities of banking organizations with significant concentrations in equity investments. In addition, capital levels above the minimums established by this rule may be appropriate in light of the nature, concentration or performance of a particular organization's equity investments, or the sufficiency of the organization's policies, procedures, and systems used to monitor and control the risks associated with the organization's equity investments.

8. Regulatory requirements based on Tier 1 capital

A number of regulatory restrictions and reporting requirements are based on, or refer to, a bank's Tier 1 capital. For example, Tier 1 capital is one component used in determining the dollar amount of covered transactions that a bank may have with any one affiliate and all affiliates in the aggregate under section 23A of the Federal Reserve Act, and the amount of extensions of credit that a national bank may have outstanding to a single borrower under the National Bank Act.[22]

The final rule requires banking organizations, in calculating their Tier 1 capital, to deduct the appropriate percentage of their nonfinancial equity investments from the sum of their core capital elements. The organization's Tier 1 capital is the amount remaining after the deduction for nonfinancial equity investments, and after any other deductions and adjustments required by the agencies' capital guidelines. Accordingly, banking organizations must use their Tier 1 capital, calculated in the manner required by the agencies' capital guidelines as amended by this final rule, in determining their compliance with any regulatory restriction or reporting requirement that is based on Tier 1 capital.

C. Regulatory Flexibility Act Analysis

OCC: The OCC hereby certifies, pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b), that the regulatory capital requirements will not have a significant economic impact on a substantial number of small entities. As described in detail elsewhere in the supplementary information, the final rule amends the OCC's risk-based capital guidelines to apply a series of marginal capital charges that increase as the size of a national bank's portfolio of certain nonfinancial equity investments increases in relation to its Tier 1 capital. For the following reasons, the OCC concludes that the new capital requirements are unlikely to have a significant economic impact on a substantial number of small banks.

[22] See 12 CFR 250.242; 12 CFR 32.2(b).

First, the final rule applies to only two categories of national bank investments: investments made pursuant to the Board's Regulation K and investments made in or through, SBICs. The majority of national bank nonfinancial equity investments are in the form of investments made in, or through, SBICs. The OCC believes that SBIC investment activities are conducted primarily by large banks rather than by small banks within the Small Business Administration's definition of "small entity" (asset size of $100 million or less).

Moreover, several key features of the rule mitigate any effect that the increased capital requirements may have on small banks that do engage in nonfinancial equity investments covered by the rule. For example, in order to reduce regulatory burden on banking organizations and in response to comments on the revised proposal, nonfinancial equity investments made before March 13, 2000, are "grandfathered." Commenters noted that because such investments were made before the industry was aware of the possibility of higher capital requirements, applying higher capital requirements to such investments could negatively impact the economics of the transactions. Moreover, the final rule does not apply the higher capital requirements to investments by national banks in community development corporations pursuant to 12 U.S.C. 24(Eleventh), to equity securities acquired in satisfaction of a debt previously contracted, or to certain unexercised warrants.

Finally, the final rule will not have a substantial impact on small entities other than national banks. The new capital requirements apply only to levels of investment that equal or exceed 15 percent of the bank's Tier 1 capital. Most national banks will not be required to hold additional capital for the SBIC investments that they currently hold either because the investments are grandfathered or because the bank's level of investment is below 15 percent. As a result, the new capital charge should not deter prudent new investment, since most national banks could undertake new investments without tripping the 15 percent threshhold.

Board: In accordance with section 4(a) of the Regulatory Flexibility Act (5 U.S.C. § 604(a)), the Board must publish a final regulatory flexibility analysis with this rulemaking. The rule amends the Board's consolidated risk-based and leverage capital adequacy guidelines for state member banks and bank holding companies to establish special minimum regulatory capital requirements for equity investments in nonfinancial companies. See 12 CFR Part 208, Appendix A and Appendix B (state member banks); 12 CFR Part 225, Appendix A and Appendix D (bank holding companies). As discussed more fully above, available data indicate that equity investments generally involve greater risks than the traditional banking and financial activities of banking organizations. Data also indicate that the level and significance of equity investment activities at banking organizations has increased significantly in recent years. The final rule modifies the Board's capital adequacy guidelines to better reflect the riskiness of equity investments and the potential risks such investments pose to the safety and soundness of insured depository institutions.

The Board specifically requested comment on the likely burden that the revised proposal would impose on bank holding companies and state member banks. One bank holding company that owns or controls a substantial quantity of equity investments stated that the revised proposal would not have a significantly adverse impact on its ability to make equity investments. Some commenters, on the other hand, argued that the higher capital charges imposed by the rule would place banking organizations at a competitive disadvantage to independent securities firms and foreign banks in the market for making equity investments, or would discourage securities firms from affiliating with banks. In addition, some commenters also asserted that the agencies should adopt one or more alternative approaches suggested by the commenters. These alternatives included establishing a uniform capital charge or risk-weight for all equity investments, relying on a banking organization's internal capital models to determine the appropriate amount of capital to support a banking organization's equity investment portfolio, and delaying adoption of a final rule pending completion of the ongoing revisions to the Basle Capital Accord.

For the reasons discussed in detail above, the Board believes that the capital charges imposed by the final rule are necessary and appropriate to ensure that state member banks and bank holding companies maintain capital commensurate with the risk associated with their equity investment activities and that these activities do not pose an undue risk to the safety and soundness of insured depository institutions. The Board also has reviewed the alternatives suggested by commenters and, for the reasons discussed above, believes it would not be prudent or appropriate at this time to adopt these approaches as an alternative to the marginal regulatory capital charge structure implemented by the final rule.

The Board notes, moreover, that the final rule includes several features that likely will reduce the potential effect of the rule on bank holding companies (including their bank and nonbank subsidiaries) and state member banks, including in particular small banking organizations and other small entities. As described fully above, the rule exempts from the higher capital charges SBIC investments held by banks and bank holding companies that remain within traditional limits, investments made by banking organizations prior to March 13, 2000, and investments made by state banks under the special grandfather rights granted by section 24(f) of the FDI Act. For covered investments, the rule applies a series of marginal capital charges that increase as the size of the banking organization's equity investment portfolio increases in relation to its Tier 1 capital. The highest marginal Tier 1 charge (25 percent) is well below the uniform charge initially proposed (50 percent).

In addition, once the final rule becomes effective on April 1, 2002, the aggregate investment review thresholds currently applicable to the merchant banking investments of financial holding companies will expire automatically. See 12 CFR 225.174(c); 12 CFR 1500.5(c). Thus, adoption of the final rule will relieve financial holding companies of all sizes from any burden associated with seeking formal Board approval to expand their merchant banking activities.

The Board's supervisory experience also indicates that a significant number of small banks and bank holding companies do not engage in the type of equity investment activities covered by the rule.[23] In addition, the Board's risk-based and leverage capital guidelines generally do not apply to bank holding companies that have less than $150 million in consolidated total assets and, accordingly, the amendments made by the final rule generally would not apply to such small bank holding companies. The Board also has reviewed information concerning a sample banking organizations that are actively engaged in equity investment activities and, based on this review, believes the final rule is not likely to have a significantly adverse impact on banking organizations or their ability to engage in equity investment activities.

FDIC: The final rule amends the FDIC's risk-based and leverage capital standards for state nonmember banks (12 CFR Part 325). These amendments establish the regulatory capital requirements applicable to certain nonfinancial equity investments of state nonmember banks. The FDIC hereby certifies, pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b), that the regulatory capital requirements will not have a significant economic impact on a substantial number of small entities because of the exclusion in this final rule for grandfathered equity investments by state banks under section 24(f) of the FDI Act and the grandfather provision that was added to this final rule for nonfinancial equity investments made before March 13, 2000.

Since March 13, 2000, the FDIC has received approximately 37 applications and notices under section 24 of the FDI Act for equity investment activities in nonfinancial companies. It is anticipated that most of these equity investment activities would be covered under this rule. However, the capital charges required in this final rule for nonfinancial equity investments would be less than the capital charges imposed by the FDIC for the great majority of the nonfinancial equity investment activities approved by the FDIC under section 24 since March 13, 2000. Also, these section 24 notices and applications have involved investments that generally were significantly below 15 percent of the respective banks' Tier 1 capital.

In order to reduce regulatory burden on banking organizations and in response to comments on the revised proposal, the final rule provides for a "grandfather" provision for nonfinancial equity investments made before March 13, 2000. These commenters noted such investments were made before the industry was aware that a higher capital charge might be established for nonfinancial equity investments.

In addition, the FDIC notes that the final rule includes several features that likely will reduce the potential effect of the rule on banking organizations and, especially, small banking organizations and other small entities. The final rule exempts from the higher capital charges SBIC investments held by banking organizations that remain within traditional limits, and equity investments made by state nonmember banks under the grandfather rights granted by Congress

[23] For purposes of the Regulatory Flexibility Act, small entities are defined to include state member banks and bank holding companies that have $100 million or less in assets. See 13 CFR 121.201.

in section 24(f) of the FDI Act. For covered investments, the rule applies a series of marginal capital charges that increase as the size of the banking organization's equity investment portfolio increases in relation to its Tier 1 capital. The highest marginal Tier 1 charge (25 percent) under the final rule is well below the uniform capital charge initially proposed by the Board for bank holding companies (50 percent of Tier 1 capital).

In response to questions raised by commenters, the agencies have clarified in this preamble to the final rule that the rule does not apply to investments made in a community development corporation to promote welfare under 12 U.S.C. § 24(Eleventh). In addition, the rule does not apply to equity securities that are acquired in satisfaction of a DPC and that are held and divested in accordance with applicable law, or to unexercised warrants acquired by a bank as additional consideration for making a loan where the warrants are not held under one of the legal authorities covered by this final rule.

D. Paperwork Reduction Act

OCC: The OCC has determined that this final 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.).

Board: In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3505; 5 CFR 1320 App. A.1), the Board has reviewed this final rule under the authority delegated to the Board by the Office of Management and Budget. No collections of information as defined in the Paperwork Reduction Act are contained in the final rule.

FDIC: The FDIC has determined that this proposal 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.).

E. Executive Order 12866 Determination

OCC: The OCC has determined that this final rule does not constitute a "significant regulatory action" for the purposes of Executive Order 12866. The final rule amends the OCC's risk-based capital guidelines with respect to the regulatory capital treatment applicable to certain nonfinancial equity investments by national banks. While the general effect of this final rule is to raise the capital requirements for certain nonfinancial equity investments held by banking organizations, for the following reasons, the OCC does not believe that this final rule will have a significant economic impact on national banks.

This final rule applies a series of marginal capital charges that increase as the size of the banking organization's equity investment portfolio increases in relation to its Tier 1 capital. Specifically with respect to national banks, the final rule only applies to two categories of national bank investments: investments made pursuant to the Board's Regulation K and investments made in or through SBICs. The majority of national bank nonfinancial equity investments are in the form of investments made in, or through SBICs. However, under the final rule SBIC investments held by a national bank in amounts that remain within traditional limits (15 percent of Tier 1 capital) are exempted from the higher capital requirements. The final rule also clarifies that the higher capital requirements do not apply to national bank investments in community development corporations pursuant to 12 U.S.C. § 24(Eleventh), to equity securities acquired in satisfaction of a debt previously contracted, or to certain unexercised warrants.

In addition, in order to reduce regulatory burden on banking organizations and in response to comments on the revised proposal, nonfinancial equity investments made before March 13, 2000, are "grandfathered." Commenters noted that because such investments were made before the industry was aware of the possibility of higher capital requirements, applying higher capital requirements to such investments could negatively impact the economics of the transactions.

F. Unfunded Mandates Act of 1995

OCC: Section 202 of the Unfunded Mandates Reform Act of 1995, 2 U.S.C. 1532 (Unfunded Mandates Act), requires that an agency prepare a budgetary impact statement before promulgating any rule likely to result in a Federal mandate that may result in the 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 the agency to identify and consider a reasonable number of regulatory alternatives before promulgating the rule. The OCC has determined that this rule will not result in expenditures by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year. Accordingly, the OCC has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered. While the general effect of this final rule is to raise the capital requirements for nonfinancial equity investments held by banking organizations, for the following reasons, the OCC does not believe that this final rule will result in expenditures of $100 million or more in any one year.

This final rules applies a series of marginal capital charges that increase as the size of the banking organization's equity investment portfolio increases in relation to its Tier 1 capital. Specifically with respect to national banks, the final rule only applies to two categories of national bank investments: investments made pursuant to the Board's Regulation K and investments made in or through SBICs. The majority of national bank nonfinancial equity investments are in the form of investments made in, or through SBICs. However, under the final rule SBIC investments held by a national bank in amounts that remain within traditional limits (15 percent of Tier 1 capital) are exempted from the higher capital requirements. The final rule also clarifies that the higher capital requirements do not apply to national bank investments in community development corporations pursuant to 12 U.S.C. § 24(Eleventh), to equity securities acquired in satisfaction of a debt previously contracted, or to certain unexercised warrants.

In addition, in order to reduce regulatory burden on banking organizations and in response to comments on the revised proposal, nonfinancial equity investments made before

March 13, 2000, are "grandfathered." Commenters noted that because such investments were made before the industry was aware of the possibility of higher capital requirements, applying higher capital requirements to such investments could negatively impact the economics of the transactions.

G. Use of "Plain Language"

Section 722 of the GLB Act requires the agencies to use "plain language" in all proposed and final rules published after January 1, 2000. The agencies invited comment on whether the proposed rule was drafted in plain language and clearly presented. No commenters specifically addressed this issue. The agencies have used a variety of "plain language" techniques to ensure that the final rule is presented in a clear fashion, including using numerous topical headings in the rule, easy-to-read tables to set forth the marginal capital charge structure adopted by the rule, and textual examples to illustrate application of the rule. The agencies believe the final rule is written plainly and clearly.

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 record keeping requirements, Securities.

12 CFR Part 225

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

12 CFR Part 325

Administrative practice and procedure, Banks, banking, Capital adequacy, Reporting and record keeping requirements, State non-member banks.

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Chapter I

Authority and Issuance

For the reasons set out in the joint preamble, the Office of the Comptroller of the Currency amends part 3 of chapter I of title 12 of the Code of Federal Regulations 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. The first sentence in paragraph (a) of section 3.2 is amended to read as follows:

(a) *Adjusted total assets* means the average total assets figure required to be computed for and stated in a bank's most recent quarterly *Consolidated Report of Condition and Income* (Call Report) minus end-of-quarter intangible assets, deferred tax assets, and credit-enhancing interest-only strips, that are deducted from Tier 1 capital, and minus nonfinancial equity investments for which a Tier 1 capital deduction is required pursuant to section 2(c)(5) of appendix A of this part 3.

* * *

3. In section 1, paragraph (c) of appendix A:

A. Paragraphs (17) through (31) are redesignated as paragraphs (20) through (34); paragraphs (12) through (16) are redesignated as paragraphs (14) through (18); and paragraphs (1) through (11) are redesignated as paragraphs (2) through (12).

B. New paragraphs (1), (13) and (19) are added to read as follows:

APPENDIX A TO PART 3--RISK-BASED CAPITAL GUIDELINES

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

* * * * *

(c) * * *

(1) *Adjusted carrying value* means, for purposes of section 2(c)(5) of this appendix A, the aggregate value that investments are carried on the balance sheet of the bank reduced by any unrealized gains on the investments that are reflected in such carrying value but excluded from the bank's Tier 1 capital and reduced by any associated deferred tax liabilities. For example, for

investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank) less any unrealized gains on those investments that are included in other comprehensive income and that are not reflected in Tier 1 capital, and less any associated deferred tax liabilities. Unrealized losses on AFS nonfinancial equity investments must be deducted from Tier 1 capital in accordance with section 1(c)(8) of this appendix A. The treatment of small business investment companies that are consolidated for accounting purposes under generally accepted accounting principles is discussed in section 2(c)(5)(ii) of this appendix A. For investments in a nonfinancial company that is consolidated for accounting purposes, the bank's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the bank's Tier 1 capital in accordance with section 2(c)(2) of this appendix A). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit equivalent amounts of the company's off-balance sheet items) are excluded from the bank's risk-weighted assets.

* * * * *

(13) *Equity investment* means, for purposes of paragraph (c)(19) of this section and section 2(c)(5) of this appendix A, any equity instrument including warrants and call options that give the holder the right to purchase an equity instrument, any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity. An investment in any other instrument, including subordinated debt or other types of debt instruments, may be treated as an equity investment if the OCC determines that the instrument is the functional equivalent of equity or exposes the bank to essentially the same risks as an equity instrument.

* * * * *

(19) *Nonfinancial equity investment* means any equity investment held by a bank in a nonfinancial company through a small business investment company (SBIC) under section 302(b) of the Small Business Investment Act of 1958 (15 U.S.C. 682(b)) or under the portfolio investment provisions of Regulation K (12 CFR 211.8(c)(3)). An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in a SBIC that is not consolidated with the bank is treated as a nonfinancial equity investment in the manner provided in section 2(c)(5)(ii)(C) of this appendix A. A nonfinancial company is an entity that engages in any activity that has not been determined to be permissible for a bank to conduct directly or to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act (12 U.S.C. 1843(k)).

* * * * *

4. In section 2 of appendix A:

A. Paragraph (a)(3) is amended;

B. New paragraph (c)(1)(v) is added;

C. Paragraph (c)(5) is redesignated as paragraph (c)(6);

D. Tables A through D in sections 3 and 4 of this appendix A are redesignated as Tables B through E, respectively;

E. All references to Tables A through D in this appendix A are revised to refer to Tables B through E, respectively; and

F. New paragraph (c)(5), including new Table A, is added to read as follows:

APPENDIX A TO PART 3--RISK-BASED CAPITAL GUIDELINES

* * * * *

Section 2. Components of Capital

* * * * *

(a) * * *

(3) Minority interests in the equity accounts of consolidated subsidiaries, except that minority interests in a small business investment company or investment fund that holds nonfinancial equity investments, and minority interests in a subsidiary that is engaged in nonfinancial activities and is held under one of the legal authorities listed in section 1(c)(19) of this appendix A, are not included in Tier 1 capital or total capital.

* * * * *

(c) * * *

(1) * * *

(v) Nonfinancial equity investments as provided by section 2(c)(5) of this appendix A.

* * * * *

(5) *Nonfinancial equity investments.* (i) *General.* A bank must deduct from its Tier 1 capital the appropriate percentage, as determined in accordance with Table A, of the adjusted carrying value of all nonfinancial equity investments held by the bank and its subsidiaries.

Table A--Deduction for Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by banks (As a percentage of the Tier 1 capital of the bank)[1]	**Deduction from Tier 1 Capital** (As a percentage of the adjusted carrying value of the investment)
Less than 15 percent	8.0 percent
Greater than or equal to15 percent but less than 25 percent	12.0 percent
Greater than or equal to 25 percent	25.0 percent

[1] For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of Tier 1 capital, Tier 1 capital is defined as the sum of the Tier 1 capital elements net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, but prior to the deduction for disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, disallowed purchased credit card relationships, disallowed credit-enhancing interest only strips (both purchased and retained), disallowed deferred tax assets, and nonfinancial equity investments.

(B) Deductions for nonfinancial equity investments must be applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the bank's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank equals 20 percent of the Tier 1 capital of the bank, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the bank's Tier 1 capital, and 12 percent of the adjusted carrying value of all investments equal to, or in excess of, 15 percent of the bank's Tier 1 capital.

(C) The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under section 2(c)(5) of this appendix A is excluded from the bank's weighted risk assets for purposes of computing the denominator of the bank's risk-based capital ratio. For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from Tier 1 capital, the entire adjusted carrying value of the investment will be excluded from risk-weighted assets in calculating the denominator of the risk-based capital ratio.

(D) Banks engaged in equity investment activities, including those banks with a high concentration in nonfinancial equity investments (*e.g.*, in excess of 50 percent of Tier 1 capital), will be monitored and may be subject to heightened supervision, as appropriate, by the OCC to ensure that such banks maintain capital levels that are appropriate in light of their equity investment activities, and the OCC may impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the bank, or other information, indicate that a higher minimum capital requirement is appropriate.

(ii) *Small business investment company investments.* (A) Notwithstanding section 2(c)(5)(i) of this appendix A, no deduction is required for nonfinancial equity investments that are made by a bank or its subsidiary through a SBIC that is consolidated with the bank, or in a SBIC that is not consolidated with the bank, to the extent that such investments, in the aggregate, do not exceed 15 percent of the Tier 1 capital of the bank. Except as provided in paragraph (c)(5)(ii)(B) of this section, any nonfinancial equity investment that is held through or in a SBIC and not deducted from Tier 1 capital will be assigned to the 100 percent risk-weight category and included in the bank's consolidated risk-weighted assets.

(B) If a bank has an investment in a SBIC that is consolidated for accounting purposes but the SBIC is not wholly owned by the bank, the adjusted carrying value of the bank's nonfinancial equity investments held through the SBIC is equal to the bank's proportionate share of the SBIC's adjusted carrying value of its equity investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (*i.e.,* the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank.

(C) If a bank has an investment in a SBIC that is not consolidated for accounting purposes and has current information that identifies the percentage of the SBIC's assets that are equity investments in nonfinancial companies, the bank may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. The amount by which the adjusted carrying value of the bank's investment in the SBIC is reduced under this paragraph will be risk weighted at 100 percent and included in the bank's risk-weighted assets.

(D) To the extent the adjusted carrying value of all nonfinancial equity investments that the bank holds through a consolidated SBIC or in a nonconsolidated SBIC equals or exceeds, in the aggregate, 15 percent of the Tier 1 capital of the bank, the appropriate percentage of such amounts, as set forth in Table A, must be deducted from the bank's Tier 1 capital. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held through a consolidated SBIC and in a nonconsolidated SBIC (including any nonfinancial equity investments for which no deduction is required) must be included in determining, for purposes of Table A the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital.

(iii) *Nonfinancial equity investments excluded.* (A) Notwithstanding section 2(c)(5)(i) and (ii) of this appendix A, no deduction from Tier 1 capital is required for the following:

(*1*) Nonfinancial equity investments (or portion of such investments) made by the bank prior to March 13, 2000, and continuously held by the bank since March 13, 2000.

(*2*) Nonfinancial equity investments made on or after March 13, 2000, pursuant to a legally binding written commitment that was entered into by the bank prior to March 13, 2000, and that required the bank to make the investment, if the bank has continuously held the investment since the date the investment was acquired.

(*3*) Nonfinancial equity investments received by the bank through a stock split or stock dividend on a nonfinancial equity investment made prior to March 13, 2000, provided that the bank provides no consideration for the shares or interests received, and the transaction does not materially increase the bank's proportional interest in the nonfinancial company.

(*4*) Nonfinancial equity investments received by the bank through the exercise on or after March 13, 2000, of an option, warrant, or other agreement that provides the bank with the right, but not the obligation, to acquire equity or make an investment in a nonfinancial company, if the option, warrant, or other agreement was acquired by the bank prior to March 13, 2000, and the bank provides no consideration for the nonfinancial equity investments.

(B) Any excluded nonfinancial equity investments described in section 2(c)(5)(iii)(A) of this appendix A must be included in determining the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital for purposes of Table A. In addition, any excluded nonfinancial equity investments will be risk weighted at 100 percent and included in the bank's risk-weighted assets.

Dated: January 4, 2002

John D. Hawke, Jr (Signed)

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John D. Hawke, Jr.
Comptroller of the Currency

Federal Reserve System

Authority and Issuance

For the reasons set forth in the preamble, the Board of Governors of the Federal Reserve System amends parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations as follows:

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

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

Authority: 12 U.S.C. 24, 24a, 36, 92a, 93a, 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, 1831w, 1835a, 1842(*l*), 1882, 2901-2907, 3105, 3310, 3331-3351, and 3906-3909; 15 U.S.C. 78b, 781(b), 781(g), 781(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 following revisions are made:

a. In section II.A–

i. The undesignated paragraph following paragraph 1.(iii) is revised;

ii. One sentence is added at the end of paragraph 1.c., Minority interest in equity accounts of consolidated subsidiaries; and

iii. The first undesignated paragraph following paragraph 2.(v) is revised.

b. In section II.B–

i. A new paragraph (v) is added at the end of the introductory paragraph;

ii. Paragraph 1.e.ii is revised;

iii. Paragraph 4.b is revised; and

iv. A new paragraph 5 is added at the end of section II.B.

c. In sections III. and IV., footnotes 21 through 48 are redesignated as footnotes 27 through 54, respectively.

d. Attachment II is revised.

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

* * * * *

II. * * *

A. * * *

1. * * *

Tier 1 capital is generally defined as the sum of core capital elements[5] less any amounts of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted in accordance with section II.B. of this appendix.

* * * * *

c. * * * Minority interests in small business investment companies, investment funds that hold nonfinancial equity investments (as defined in section II.B.5.b.), and subsidiaries engaged in nonfinancial activities are not included in the bank's Tier 1 or total capital base if the bank's interest in the company or fund is held under one of the legal authorities listed in section II.B.5.b.

* * * * *

2. * * *

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, other intangible assets, interest-

[5] [Reserved]

only strips receivables and nonfinancial equity investments that are required to be deducted in accordance with section II.B. of this appendix).

* * * * *

B. * * *
(v) Nonfinancial equity investments–portions are deducted from the sum of core capital elements in accordance with section II.B.5 of this Appendix.

* * * * *

1. * * *
e. * * *
ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing I/Os, tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

* * * * *

4. * **
b. The reported amount of deferred-tax assets, net of any valuation allowance for deferred-tax assets, in excess of the lesser of these two amounts is to be deducted from a bank's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os, any disallowed deferred-tax assets, and any nonfinancial equity investments. 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.

* * * * *

5. Nonfinancial equity investments. a. General. A bank must deduct from its core capital elements the sum of the appropriate percentages (as determined below) of the adjusted carrying value of all nonfinancial equity investments held by the bank or by its direct or indirect subsidiaries. For purposes of this section II.B.5, investments held by a bank include all investments held directly or indirectly by the bank or any of its subsidiaries.

b. Scope of nonfinancial equity investments. A nonfinancial equity investment means any equity investment held by the bank in a nonfinancial company: through a small business investment company (SBIC) under section 302(b) of the Small Business Investment Act of 1958 (15 U.S.C. 682(b))[21]; or under the portfolio investment provisions of the Board's Regulation K (12 CFR 211.8(c)(3)). A nonfinancial company is an entity that engages in any activity that has not been determined to be permissible for the bank to conduct directly, or to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act (12 U.S.C. 1843(k)).

c. Amount of deduction from core capital. i. The bank must deduct from its core capital elements the sum of the appropriate percentages, as set forth in Table 1, of the adjusted carrying value of all nonfinancial equity investments held by the bank. The amount of the percentage deduction increases as the aggregate amount of nonfinancial equity investments held by the bank increases as a percentage of the bank's Tier 1 capital.

Table 1
Deduction for
Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank (as a percentage of the Tier 1 capital of the bank)[1]	**Deduction from Core Capital Elements (as a percentage of the adjusted carrying value of the investment)**
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

[1] For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of Tier 1 capital, Tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, but prior to the deduction for any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

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[21] An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in an SBIC that is not consolidated with the bank is treated as a nonfinancial equity investment.

ii. These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent bank's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank equals 20 percent of the Tier 1 capital of the bank, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the bank's Tier 1 capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the bank's Tier 1 capital.

iii. The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under this paragraph is excluded from the bank's risk-weighted assets for purposes of computing the denominator of the bank's risk-based capital ratio.[22]

iv. As noted in section I, this Appendix establishes *minimum* risk-based capital ratios and banks are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a bank from nonfinancial equity investments increases with its concentration in such investments and strong capital levels above the minimum requirements are particularly important when a bank has a high degree of concentration in nonfinancial equity investments (e.g., in excess of 50 percent of Tier 1 capital). The Federal Reserve intends to monitor banks and apply heightened supervision to equity investment activities as appropriate, including where the bank has a high degree of concentration in nonfinancial equity investments, to ensure that each bank maintains capital levels that are appropriate in light of its equity investment activities. The Federal Reserve also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the bank, or other information, indicate that a higher minimum capital requirement is appropriate.

d. SBIC investments. i. No deduction is required for nonfinancial equity investments that are held by a bank through one or more SBICs that are consolidated with the bank or in one or more SBICs that are not consolidated with the bank to the extent that all such investments, in the aggregate, do not exceed 15 percent of the bank's Tier 1 capital. Any nonfinancial equity investment that is held through or in an SBIC and that is not required to be deducted from Tier 1 capital under this paragraph (d) will be assigned a 100 percent risk-weight and included in the bank's consolidated risk-weighted assets.[23]

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[22] For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from Tier 1 capital, the entire adjusted carrying value of the investment will be excluded from risk-weighted assets in calculating the denominator for the risk-based capital ratio.

[23] If a bank has an investment in an SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank, the adjusted carrying value of the bank's nonfinancial

(continued...)

ii. To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holds through one or more SBICs that are consolidated with the bank or in one or more SBICs that are not consolidated with the bank exceeds, in the aggregate, 15 percent of the bank's Tier 1 capital, the appropriate percentage of such amounts (as set forth in Table 1) must be deducted from the bank's core capital elements. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held through a consolidated SBIC and in a non-consolidated SBIC (including any investments for which no deduction is required) must be included in determining, for purposes of Table 1, the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital.

e. Transition provisions. No deduction under this section II.B.5 is required to be made with respect to the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that was made by the bank prior to March 13, 2000, or that was made by the bank after such date pursuant to a binding written commitment[24] entered into prior to March 13, 2000, provided that in either case the bank has continuously held the investment since the relevant investment date.[25] For purposes of this paragraph (e), a nonfinancial equity investment

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[23](...continued)
equity investments through the SBIC is equal to the bank's proportionate share of the adjusted carrying value of the SBIC's equity investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (i.e. the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank. If a bank has an investment in an SBIC that is not consolidated for accounting purposes and has current information that identifies the percentage of the SBIC's assets that are equity investments in nonfinancial companies, the bank may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. If a bank reduces the adjusted carrying value of its investment in a non-consolidated SBIC to reflect financial investments of the SBIC, the amount of the adjustment will be risk weighted at 100 percent and included in the bank's risk-weighted assets.

[24] A "binding written commitment" means a legally binding written agreement that requires the bank to acquire shares or other equity of the company, or make a capital contribution to the company, under terms and conditions set forth in the agreement. Options, warrants, and other agreements that give a bank the right to acquire equity or make an investment, but do not require the bank to take such actions, are not considered a binding written commitment for purposes of this section II.B.5.

[25] For example, if a bank made an equity investment in 100 shares of a nonfinancial company prior to March 13, 2000, the adjusted carrying value of that investment would not be subject to a deduction under this section II.B.5. However, if the bank made any additional equity investment in the company after March 13, 2000, such as by purchasing additional shares of the company (including through the exercise of options or warrants acquired before or after March 13, 2000) or by making a capital contribution to the company and such investment was
(continued...)

made prior to March 13, 2000, includes any shares or other interests received by the bank through a stock split or stock dividend on an investment made prior to March 13, 2000, provided the bank provides no consideration for the shares or interests received and the transaction does not materially increase the bank's proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired prior to March 13, 2000, is not considered to be an investment made prior to March 13, 2000, if the bank provides any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this paragraph (e) must be included in determining the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital for purposes of Table 1. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this paragraph (e) will be assigned a 100-percent risk weight and included in the bank's consolidated risk-weighted assets.

f. Adjusted carrying value. i. For purposes of this section II.B.5., the "adjusted carrying value" of investments is the aggregate value at which the investments are carried on the balance sheet of the bank reduced by any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank's Tier 1 capital and associated deferred tax liabilities. For example, for investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank) less any unrealized gains on those investments that are included in other comprehensive income and not reflected in Tier 1 capital, and associated deferred tax liabilities.[26]

ii. As discussed above with respect to consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial company that is consolidated for accounting purposes under generally accepted accounting principles, the bank's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the bank's core capital in accordance with section II.B.1 of this Appendix). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these

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[25](...continued)
not made pursuant to a binding written commitment entered into before March 13, 2000, the adjusted carrying value of the additional investment would be subject to a deduction under this section II.B.5. In addition, if the bank sold and repurchased, after March 13, 2000, 40 shares of the company, the adjusted carrying value of those 40 shares would be subject to a deduction under this section II.B.5.

[26] Unrealized gains on AFS equity investments may be included in supplementary capital to the extent permitted under section II.A.2.e of this Appendix. In addition, the unrealized losses on AFS equity investments are deducted from Tier 1 capital in accordance with section II.A.1.a of this Appendix.

assets (as well as the credit equivalent amounts of the company's off-balance sheet items) should be excluded from the bank's risk-weighted assets for regulatory capital purposes.

g. Equity investments. For purposes of this section II.B.5., an equity investment means any equity instrument (including common stock, preferred stock, partnership interests, interests in limited liability companies, trust certificates and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity where the instrument or feature is held under one of the legal authorities listed in section II.B.5.b. above. An investment in any other instrument (including subordinated debt) may be treated as an equity investment if, in the judgment of the Federal Reserve, the instrument is the functional equivalent of equity or exposes the state member bank to essentially the same risks as an equity instrument.

* * * * *

Attachment II -- Summary of Definition of Qualifying Capital for State Member Banks*

Using the Year-End 1992 Standard

Components	**Minimum Requirements**
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	Banks should avoid using minority interests to subsidiaries introduce elements not otherwise qualifying for tier 1 capital.
Less: Goodwill, other intangible assets, credit-enhancing interest-only strips and nonfinancial equity investments required to be deducted from capital[1]	

[1] Requirements for the deduction of other intangible assets, residual interests and nonfinancial equity investments are set forth in section II.B. of this appendix.
[2] Amounts in excess of limitations are permitted but do not qualify as capital.
[3] 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.

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,[2] 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)	
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.[3]
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 a formal rulemaking
TOTAL CAPITAL (tier 1 + tier 2 - deductions)	Must equal or exceed 8% of weighted-risk assets

* * * * *

3. In Appendix B to part 208, in section II.b., footnotes 2 and 3 are revised and the fourth sentence of section II.b. is revised to read as follows:

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

* * * * *

II. * * *

b. * * *[2] As a general matter, average total consolidated assets are defined as

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[2] 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 assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, exceed 100 percent of Tier 1 capital; nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 25 percent of Tier 1 capital; amounts of (continued...)

the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income (Call Reports), less goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, are in excess of 25 percent of Tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of Tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted Tier 1 capital; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitations set forth in section II.B.4 of Appendix A of this part; and the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from Tier 1 capital.[3]

* * * * *

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

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

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

2. In Appendix A to part 225, the following revisions are made:

a. In section II.A–

i. The undesignated paragraph following paragraph 1.(iv) is revised;

ii. One sentence is added at the end of paragraph 1.c., Minority interest in equity accounts of consolidated subsidiaries; and

iii. The first undesignated paragraph following paragraph 2.(v) is revised.

b. In section II.B.–

i. A new paragraph (v) is added at the end of the introductory paragraph;

ii. Paragraph 1.e.ii is revised;

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[2](...continued)
credit enhancing interest-only strips in excess of 25 percent of Tier 1 capital; other identifiable intangible assets; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations; and a percentage of the bank's nonfinancial equity investments. The Federal Reserve may exclude certain other investments in subsidiaries or associated companies as appropriate.

[3] Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B in Appendix A of this part.

iii. Paragraph 4.b is revised; and
iv. A new paragraph 5 is added at the end of section II.B.

c. In sections III. and IV., footnotes 24 through 51 are redesignated as footnotes 31 through 58, respectively.

d. Attachment II is revised.

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

* * * * *
II. * * *
A. * * *
1. * * *
Tier 1 capital is generally defined as the sum of core capital elements[6] less any amounts of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted in accordance with section II.B. of this appendix.

* * * * *

c. * * * Minority interests in small business investment companies, investment funds that hold nonfinancial equity investments (as defined in section II.B.5.b.), and subsidiaries engaged in nonfinancial activities are not included in the banking organization's Tier 1 or total capital base if the banking organization's interest in the company or fund is held under one of the legal authorities listed in section II.B.5.b.

* * * * *

2. * * *
The maximum amount of tier 2 capital that may be included in an institution's qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted in accordance with section II.B. of this appendix).

* * * * *

B. * * *
(v) Nonfinancial equity investments–portions are deducted from the sum of core capital elements in accordance with section II.B.5 of this Appendix.

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[6] [Reserved]

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1. * * *
e. * * *
ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing I/Os, tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

* * * * *

4. * **
b. The reported amount of deferred-tax assets, net of any valuation allowance for deferred-tax assets, in excess of the lesser of these two amounts is to be deducted from a banking organization's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os, any disallowed deferred-tax assets, and any nonfinancial equity investments. 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.

* * * * *

5. <u>Nonfinancial equity investments</u>. a. <u>General</u>. A bank holding company must deduct from its core capital elements the sum of the appropriate percentages (as determined below) of the adjusted carrying value of all nonfinancial equity investments held by the parent bank holding company or by its direct or indirect subsidiaries. For purposes of this section II.<u>B</u>.5, investments held by a bank holding company include all investments held directly or indirectly by the bank holding company or any of its subsidiaries.

b. <u>Scope of nonfinancial equity investments</u>. A nonfinancial equity investment means any equity investment held by the bank holding company: under the merchant banking authority of section 4(k)(4)(H) of the BHC Act and subpart J of the Board's Regulation Y (12 CFR 225.175 et seq.); under section 4(c)(6) or 4(c)(7) of BHC Act in a nonfinancial company or in a company that makes investments in nonfinancial companies; in a nonfinancial company through a small business investment company (SBIC) under section 302(b) of the Small Business

Investment Act of 1958;[24] in a nonfinancial company under the portfolio investment provisions of the Board's Regulation K (12 CFR 211.8(c)(3)); or in a nonfinancial company under section 24 of the Federal Deposit Insurance Act (other than section 24(f)).[25] A nonfinancial company is an entity that engages in any activity that has not been determined to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act (12 U.S.C. 1843(k)).

c. Amount of deduction from core capital. i. The bank holding company must deduct from its core capital elements the sum of the appropriate percentages, as set forth in Table 1, of the adjusted carrying value of all nonfinancial equity investments held by the bank holding company. The amount of the percentage deduction increases as the aggregate amount of nonfinancial equity investments held by the bank holding company increases as a percentage of the bank holding company's Tier 1 capital.

Table 1
Deduction for
Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank holding company (as a percentage of the Tier 1 capital of the parent banking organization)[1]	**Deduction from Core Capital Elements (as a percentage of the adjusted carrying value of the investment)**
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

[24] An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in an SBIC that is not consolidated with the parent banking organization is treated as a nonfinancial equity investment.

[25] See 12 U.S.C. 1843(c)(6), (c)(7) and (k)(4)(H); 15 U.S.C. 682(b); 12 CFR 211.5(b)(1)(iii); and 12 U.S.C. 1831a. In a case in which the Board of Directors of the FDIC, acting directly in exceptional cases and after a review of the proposed activity, has permitted a lesser capital deduction for an investment approved by the Board of Directors under section 24 of the Federal Deposit Insurance Act, such deduction shall also apply to the consolidated bank holding company capital calculation so long as the bank's investments under section 24 and SBIC investments represent, in the aggregate, less than 15 percent of the Tier 1 capital of the bank.

[1] For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of Tier 1 capital, Tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, but prior to the deduction for any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

ii. These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent holding company's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank holding company equals 20 percent of the Tier 1 capital of the bank holding company, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the company's Tier 1 capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the company's Tier 1 capital.

iii. The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under this paragraph is excluded from the bank holding company's risk-weighted assets for purposes of computing the denominator of the company's risk-based capital ratio.[26]

iv. As noted in section I, this Appendix establishes *minimum* risk-based capital ratios and banking organizations are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a banking organization from nonfinancial equity investments increases with its concentration in such investments and strong capital levels above the minimum requirements are particularly important when a banking organization has a high degree of concentration in nonfinancial equity investments (e.g., in excess of 50 percent of Tier 1 capital). The Federal Reserve intends to monitor banking organizations and apply heightened supervision to equity investment activities as appropriate, including where the banking organization has a high degree of concentration in nonfinancial equity investments, to ensure that each organization maintains capital levels that are appropriate in light of its equity investment activities. The Federal Reserve also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the banking organization, or other information, indicate that a higher minimum capital requirement is appropriate.

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[26] For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from Tier 1 capital, the entire adjusted carrying value of the investment will be excluded from risk-weighted assets in calculating the denominator for the risk-based capital ratio.

d. SBIC investments. i. No deduction is required for nonfinancial equity investments that are held by a bank holding company through one or more SBICs that are consolidated with the bank holding company or in one or more SBICs that are not consolidated with the bank holding company to the extent that all such investments, in the aggregate, do not exceed 15 percent of the aggregate of the bank holding company's pro rata interests in the Tier 1 capital of its subsidiary banks. Any nonfinancial equity investment that is held through or in an SBIC and not required to be deducted from Tier 1 capital under this paragraph (d) will be assigned a 100 percent risk-weight and included in the parent holding company's consolidated risk-weighted assets.[27]

ii. To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holding company holds through one or more SBICs that are consolidated with the bank holding company or in one or more SBICs that are not consolidated with the bank holding company exceeds, in the aggregate, 15 percent of the aggregate Tier 1 capital of the company's subsidiary banks, the appropriate percentage of such amounts (as set forth in Table 1) must be deducted from the bank holding company's core capital elements. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held through a consolidated SBIC and in a non-consolidated SBIC (including any investments for which no deduction is required) must be included in determining, for purposes of Table 1, the total amount of nonfinancial equity investments held by the bank holding company in relation to its Tier 1 capital.

e. Transition provisions. No deduction under this section II.B.5 is required to be made with respect to the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that was made by the bank holding company prior to March 13, 2000, or

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[27] If a bank holding company has an investment in an SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank holding company, the adjusted carrying value of the bank holding company's nonfinancial equity investments through the SBIC is equal to the holding company's proportionate share of the adjusted carrying value of the SBIC's equity investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (i.e. the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank holding company. If a bank holding company has an investment in a SBIC that is not consolidated for accounting purposes and has current information that identifies the percentage of the SBIC's assets that are equity investments in nonfinancial companies, the bank holding company may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. If a bank holding company reduces the adjusted carrying value of its investment in a non-consolidated SBIC to reflect financial investments of the SBIC, the amount of the adjustment will be risk weighted at 100 percent and included in the bank's risk-weighted assets.

that was made after such date pursuant to a binding written commitment[28] entered into by the bank holding company prior to March 13, 2000, provided that in either case the bank holding company has continuously held the investment since the relevant investment date.[29] For purposes of this paragraph (e), a nonfinancial equity investment made prior to March 13, 2000, includes any shares or other interests received by the bank holding company through a stock split or stock dividend on an investment made prior to March 13, 2000, provided the bank holding company provides no consideration for the shares or interests received and the transaction does not materially increase the bank' holding company's proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired prior to March 13, 2000, is <u>not</u> considered to be an investment made prior to March 13, 2000, if the bank holding company provides any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this paragraph (e) must be included in determining the total amount of nonfinancial equity investments held by the bank holding company in relation to its Tier 1 capital for purposes of Table 1. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this paragraph (e) will be assigned a 100-percent risk weight and included in the bank holding company's consolidated risk-weighted assets.

f. <u>Adjusted carrying value</u>. i. For purposes of this section II.<u>B</u>.5., the "adjusted carrying value" of investments is the aggregate value at which the investments are carried on the balance sheet of the consolidated bank holding company reduced by any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank holding company's Tier 1 capital and associated deferred tax liabilities. For example, for investments

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[28] A "binding written commitment" means a legally binding written agreement that requires the banking organization to acquire shares or other equity of the company, or make a capital contribution to the company, under terms and conditions set forth in the agreement. Options, warrants, and other agreements that give a banking organization the right to acquire equity or make an investment, but do not require the banking organization to take such actions, are not considered a binding written commitment for purposes of this section II.<u>B</u>.5.

[29] For example, if a bank holding company made an equity investment in 100 shares of a nonfinancial company prior to March 13, 2000, that investment would not be subject to a deduction under this section II.<u>B</u>.5. However, if the bank holding company made any additional equity investment in the company after March 13, 2000, such as by purchasing additional shares of the company (including through the exercise of options or warrants acquired before or after March 13, 2000) or by making a capital contribution to the company, and such investment was not made pursuant to a binding written commitment entered into before March 13, 2000, the adjusted carrying value of the additional investment would be subject to a deduction under this section II.<u>B</u>.5. In addition, if the bank holding company sold and repurchased shares of the company after March 13, 2000, the adjusted carrying value of the re-acquired shares would be subject to a deduction under this section II.<u>B</u>.5.

held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank holding company) less any unrealized gains on those investments that are included in other comprehensive income and not reflected in Tier 1 capital, and associated deferred tax liabilities.[30]

ii. As discussed above with respect to consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial company that is consolidated for accounting purposes under generally accepted accounting principles, the parent banking organization's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the consolidated bank holding company's core capital in accordance with section II.B.1 of this Appendix). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit equivalent amounts of the company's off-balance sheet items) should be excluded from the banking organization's risk-weighted assets for regulatory capital purposes.

g. Equity investments. For purposes of this section II.B.5, an equity investment means any equity instrument (including common stock, preferred stock, partnership interests, interests in limited liability companies, trust certificates and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity where the instrument or feature is held under one of the legal authorities listed in section II.B.5.b. above. An investment in any other instrument (including subordinated debt) may be treated as an equity investment if, in the judgment of the Federal Reserve, the instrument is the functional equivalent of equity or exposes the state member bank to essentially the same risks as an equity instrument.

* * * * *

Attachment II -- Summary of Definition of Qualifying Capital for Bank Holding Companies*

Using the Year-End 1992 Standard

Components	**Minimum requirements**
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; bank holding companies should avoid undue reliance on preferred stock in tier 1
Qualifying cumulative perpetual preferred stock	Limited to 25% of the sum of common stock, qualifying perpetual stock, and minority interests.

[30] Unrealized gains on AFS investments may be included in supplementary capital to the extent permitted under section II.A.2.e of this Appendix. In addition, the unrealized losses on AFS equity investments are deducted from Tier 1 capital in accordance with section II.A.1.a of this Appendix.

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, other intangible assets, credit-enhancing interest-only strips and nonfinancial equity investments 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 tier1[2]; 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.[3]
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 a formal rulemaking.
TOTAL CAPITAL (tier 1 + tier 2 - deductions)	Must equal or exceed 8% of weighted-risk assets.

* * * * *

3. In Appendix D to part 225, in section II.b., footnotes 3 and 4 are revised and the fourth sentence of section II.b. is revised to read as follows.

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[1] Requirements for the deduction of other intangible assets and residual interests are set forth in section II.B.1. of this appendix.
[2] Amounts in excess of limitations are permitted but do not qualify as capital.
[3] 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.

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

* * * * *

II. * * *
b. * * *[3] 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 organization's Consolidated Financial Statements (FR Y-9C Report), less goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, are in excess of 25 percent of Tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of Tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of Appendix A of this part; and the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from Tier 1 capital.[4]

* * * * *

By order of the Board of Governors of the Federal Reserve System, January 7, 2002.

Jennifer J. Johnson (Signed)

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[3] Tier 1 capital for banking organizations includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of Tier 1 capital.) In addition, as a general matter, Tier 1 capital excludes goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, exceed 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 25 percent of Tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of Tier 1 capital; all other identifiable intangible assets; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations; and a percentage of the organization's nonfinancial equity investments. The Federal Reserve may exclude certain other 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. of Appendix A of this part.

Jennifer J. Johnson
Secretary of the Board

Federal Deposit Insurance Corporation

12 CFR Chapter III

Authority and Issuance

For the reasons set forth in the joint preamble, the Board of Directors of the Federal Deposit Insurance Corporation amends part 325 of chapter III of title 12 of the Code of Federal Regulations 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, as amended by Pub. L. 103-325, 108 Stat. 2160, 2233 (12 U.S.C. 1828 note); Pub. L. 102-242, 105 Stat. 2236, 2386, as amended by Pub. L. 102-550, 106 Stat. 3672, 4089 (12 U.S.C. 1828 note).

2. In § 325.2, paragraphs (v) and (x) are revised to read as follows:

§ 325.2 Definitions.

*   *   *   *   *

(v) *Tier 1 capital* or *core capital* means the sum of common stockholders' equity, noncumulative perpetual preferred stock (including any related surplus), and minority interests in consolidated subsidiaries, minus all intangible assets (other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f)), minus credit-enhancing interest-only strips that are not eligible for inclusion in core capital pursuant to § 325.5(f), minus deferred tax assets in excess of the limit set forth in § 325.5(g), minus identified losses (to the extent that Tier 1 capital would have been reduced if the appropriate accounting entries to reflect the identified losses had been recorded on the insured depository institution's books), minus investments in financial subsidiaries subject to 12 CFR part 362, subpart E, and minus the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from Tier 1 capital as set forth in section I.B.(6) of appendix A to this part.

*   *   *   *   *

(x) *Total assets* means the average of total assets required to be included in a banking institution's "Reports of Condition and Income" (Call Report) or, for savings associations, the consolidated total assets required to be included in the "Thrift Financial Report," as these reports may from time to time be revised, as of the most recent report date (and after making any necessary subsidiary adjustments for state nonmember banks as described in §§ 325.5(c) and 325.5(d) of this part), minus intangible assets (other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f)), minus credit-enhancing interest-only strips that are not eligible for inclusion in core capital pursuant to § 325.5(f), minus deferred tax assets in excess of the limit set forth in § 325.5(g), minus assets classified loss and any other assets that are deducted in determining Tier 1 capital, and minus the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from Tier 1 capital as set forth in section I.B.(6) of appendix A to this part. For banking institutions, the average of total assets is found in the Call Report schedule of quarterly averages. For savings associations, the consolidated total assets figure is found in Schedule CSC of the Thrift Financial Report.

3. Paragraphs (f)(3), (f)(4), and (g)(2)(i) of § 325.5 are revised to read as follows:

§ 325.5 Miscellaneous.

* * * * *

(f) *Treatment of mortgage servicing assets, purchased credit card relationships, nonmortgage servicing assets, and credit-enhancing interest-only strips.*

* * * * *

(3) *Tier 1 capital limitations*.

(i) The maximum allowable amount of mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets in the aggregate will be limited to the lesser of:

(A) 100 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed nonmortgage servicing assets, any disallowed credit-enhancing interest-only strips, any disallowed deferred tax assets, and any nonfinancial equity investments; or

(B) The sum of the amounts of mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets, determined in accordance with paragraph (f)(2) of this section.

(ii) The maximum allowable amount of credit-enhancing interest-only strips, whether purchased or retained, will be limited to the lesser of:

(A) 25 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed nonmortgage servicing assets, any disallowed credit-enhancing interest-only strips, any disallowed deferred tax assets, and any nonfinancial equity investments; or

(B) The sum of the face amounts of all credit-enhancing interest-only strips.

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

(i) 25 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed nonmortgage servicing assets, any disallowed credit-enhancing interest-only strips, any disallowed deferred tax assets, and any nonfinancial equity investments; or

(ii) The sum of the amounts of purchased credit card relationships and nonmortgage servicing assets determined in accordance with paragraph (f)(2) of this section.

(g) * * *

(2) *Tier 1 capital limitations.* (i) The maximum allowable amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, will be limited to the lesser of:

(A) The amount of deferred tax assets that are dependent upon future taxable income that is expected to be realized within one year of the calendar quarter-end date, based on projected future taxable income for that year; or

(B) 10 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing interest-only strips, any disallowed deferred tax assets, and any nonfinancial equity investments.

* * * * *

4. In appendix A to part 325:

A. Amend section I.A.1 (*Core capital elements (Tier 1));*.

B. Amend section I.B.by adding a new paragraph (6);

C. Amend section I. by redesignating footnotes 16 through 40 as footnotes 24 through 48, respectively; and

D. Revise Table I.

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

*   *   *   *   *

I. *   *   *

A. *   *   *

1. *Core capital elements (Tier 1) consists of:*

i. Common stockholders' equity capital (includes common stock and related surplus, undivided profits, disclosed capital reserves that represent a segregation of undivided profits, and foreign currency translation adjustments, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values);

ii. Noncumulative perpetual preferred stock,[2] including any related surplus; and

iii. Minority interests in the equity capital accounts of consolidated subsidiaries.

At least 50 percent of the qualifying total capital base should consist of Tier 1 capital. Core (Tier 1) capital is defined as the sum of core capital elements minus all intangible assets (other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f)),[3] minus credit-enhancing interest-only strips that are not eligible for inclusion in core capital pursuant to § 325.5(f)), minus any disallowed deferred tax assets, and minus any amount of nonfinancial equity investments required to be deducted pursuant to section I.B.(6) of this Appendix.

Although nonvoting common stock, noncumulative perpetual preferred stock, and minority interests in the equity capital accounts of consolidated subsidiaries are normally included in Tier 1 capital, voting common stockholders' equity generally will be expected to be the dominant form of Tier 1 capital. Thus, banks should avoid undue reliance on nonvoting equity, preferred stock and minority interests.

Although minority interests in consolidated subsidiaries are generally included in regulatory capital, exceptions to this general rule will be made if the minority interests fail to provide meaningful capital support to the consolidated bank. Such a situation could arise if the minority interests are entitled to a preferred claim on essentially low risk assets of the subsidiary.

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[2] Preferred stock issues where the dividend is reset periodically based, in whole or in part, upon the bank's current credit standing, including but not limited to, auction rate, money market or remarketable preferred stock, are assigned to Tier 2 capital, regardless of whether the dividends are cumulative or noncumulative.

[3] An exception is allowed for intangible assets that are explicitly approved by the FDIC as part of the bank's regulatory capital on a specific case basis. These intangibles will be included in capital for risk-based capital purposes under the terms and conditions that are specifically approved by the FDIC.

Similarly, although credit-enhancing interest-only strips and intangible assets in the form of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships are generally recognized for risk-based capital purposes, the deduction of part or all of the credit-enhancing interest-only strips, mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships may be required if the carrying amounts of these assets are excessive in relation to their market value or the level of the bank's capital accounts. Credit-enhancing interest-only strips, mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships and deferred tax assets that do not meet the conditions, limitations and restrictions described in § 325.5(f) and (g) of this part will not be recognized for risk-based capital purposes.

Minority interests in small business investment companies, investment funds that hold nonfinancial equity investments (as defined in section I.B.(6)(ii)), and subsidiaries that are engaged in nonfinancial activities are not included in a bank's Tier 1 or total capital base if the bank's interest in the company or fund is held under one of the legal authorities listed in section I.B.(6)(ii) .

*   *   *   *   *

I.B.   *   *   *

(6) *Nonfinancial equity investments.* (i) *General*. A bank must deduct from its Tier 1 capital the sum of the appropriate percentage (as determined below) of the adjusted carrying value of all nonfinancial equity investments held by the bank or by its direct or indirect subsidiaries. For purposes of this section I.B.(6), investments held by a bank include all investments held directly or indirectly by the bank or any of its subsidiaries..

(ii) *Scope of nonfinancial equity investments*. A nonfinancial equity investment means any equity investment held by the bank in a nonfinancial company: through a small business investment company (SBIC) under section 302(b) of the Small Business Investment Act of 1958 (15 U.S.C. 682(b));[11] under the portfolio investment provisions of Regulation K issued by the Board of Governors of the Federal Reserve System (12 CFR 211.8(c)(3)); or under section 24 of the Federal Deposit Insurance Act (12 U.S.C. 1831a), other than an investment held in accordance with section 24(f) of that Act.[12] A

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[11]An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in a SBIC that is not consolidated with the bank is treated as a nonfinancial equity investment.

[12] The Board of Directors of the FDIC, acting directly, may, in exceptional cases and after a review of the proposed activity, permit a lower capital deduction for investments approved by the Board of Directors under section 24 of the FDI Act so long as the bank's
(continued...)

nonfinancial company is an entity that engages in any activity that has not been determined to be permissible for the bank to conduct directly, or to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act (12 U.S.C. 1843(k)).

(iii) *Amount of deduction from core capital*. (A) The bank must deduct from its Tier 1 capital the sum of the appropriate percentages, as set forth in Table 1, of the adjusted carrying value of all nonfinancial equity investments held by the bank. The amount of the percentage deduction increases as the aggregate amount of nonfinancial equity investments held by the bank increases as a percentage of the bank's Tier 1 capital.

Table 1

Deduction for
Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank (as a percentage of the Tier 1 capital of the bank)[13]	**Deduction from Tier 1 Capital (as a percentage of the adjusted carrying value of the investment)**
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

[12](...continued)
investments under section 24 and SBIC investments represent, in the aggregate, less than 15 percent of the Tier 1 capital of the bank. The FDIC reserves the authority to impose higher capital charges on any investment where appropriate.

[13] For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of Tier 1 capital, Tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, but prior to the deduction for any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing interest-only strips (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

(B) These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent bank's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank equals 20 percent of the Tier 1 capital of the bank, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the bank's Tier 1 capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the bank's Tier 1 capital.

(C) The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under this paragraph is excluded from the bank's risk-weighted assets for purposes of computing the denominator of the bank's risk-based capital ratio and from total assets for purposes of calculating the denominator of the leverage ratio.[14]

(D) This Appendix establishes *minimum* risk-based capital ratios and banks are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a bank from nonfinancial equity investments increases with its concentration in such investments and strong capital levels above the minimum requirements are particularly important when a bank has a high degree of concentration in nonfinancial equity investments (e.g., in excess of 50 percent of Tier 1 capital). The FDIC intends to monitor banks and apply heightened supervision to equity investment activities as appropriate, including where the bank has a high degree of concentration in nonfinancial equity investments, to ensure that each bank maintains capital levels that are appropriate in light of its equity investment activities. The FDIC also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the bank, or other information, indicate that a higher minimum capital requirement is appropriate.

(iv) *SBIC investments*. (A) No deduction is required for nonfinancial equity investments that are held by a bank through one or more SBICs that are consolidated with the bank or in one or more SBICs that are not consolidated with the bank to the extent that all such investments, in the aggregate, do not exceed 15 percent of the bank's Tier 1 capital. Any nonfinancial equity investment that is held through an SBIC or in an SBIC and that is not required to be deducted from Tier 1 capital under this section I.B.(6)(iv) will be assigned a 100 percent risk-weight and included in the bank's consolidated risk-weighted assets.[15]

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[14] For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from Tier 1 capital, the entire adjusted carrying value of the investment will be excluded from both risk-weighted assets and total assets in calculating the respective denominators for the risk-based capital and leverage ratios.

[15] If a bank has an investment in a SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank, the adjusted carrying value of the bank's nonfinancial equity investments through the SBIC is equal to the bank's proportionate share of the adjusted

(continued...)

(B) To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holds through one or more SBICs that are consolidated with the bank or in one or more SBICs that are not consolidated with the bank exceeds, in the aggregate, 15 percent of the bank's Tier 1 capital, the appropriate percentage of such amounts (as set forth in Table 1) must be deducted from the bank's common stockholders' equity in determining the bank's Tier 1 capital. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held by a bank through a consolidated SBIC and in a non-consolidated SBIC (including any investments for which no deduction is required) must be included in determining, for purposes of Table 1, the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital.

(v) *Transition provisions*. No deduction under this section I.B.6 is required to be made with respect to the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that was made by the bank prior to March 13, 2000, or that was made by the bank after such date pursuant to a binding written commitment[16] entered into prior to March 13, 2000, provided that in either case the bank has continuously held the investment since the relevant investment date.[17] For purposes of this section I.B.(6)(v) a nonfinancial equity

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[15](...continued)
carrying value of the SBIC's investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (i.e., the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank. If a bank has an investment in a SBIC that is not consolidated for accounting purposes and has current information that identifies the percentage of the SBIC's assets that are equity investments in nonfinancial companies, the bank may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. If a bank reduces the adjusted carrying value of its investment in a non-consolidated SBIC to reflect financial investments of the SBIC, the amount of the adjustment will be risk weighted at 100 percent and included in the bank's risk-weighted assets.

[16] A "binding written commitment" means a legally binding written agreement that requires the bank to acquire shares or other equity of the company, or make a capital contribution to the company, under terms and conditions set forth in the agreement. Options, warrants, and other agreements that give a bank the right to acquire equity or make an investment, but do not require the bank to take such actions, are not considered a binding written commitment for purposes of this section I.B.(6)(v).

[17] For example, if a bank made an equity investment in 100 shares of a nonfinancial company prior to March 13, 2000, the adjusted carrying value of that investment would not be subject to a deduction under this section I.B.(6). However, if the bank made any additional equity investment in the company after March 13, 2000, such as by purchasing additional shares of the company (including through the exercise of options or warrants acquired before or after March 13, 2000) or by making a capital contribution to the company and such investment was not made pursuant to a binding written commitment entered into before March 13,2000, the adjusted carrying value of the additional investment would be subject to a deduction under this (continued...)

investment made prior to March 13, 2000, includes any shares or other interests received by the bank through a stock split or stock dividend on an investment made prior to March 13, 2000, provided the bank provides no consideration for the shares or interests received and the transaction does not materially increase the bank's proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired prior to March 13, 2000, is *not* considered to be an investment made prior to March 13, 2000, if the bank provides any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section I.B.(6)(v) must be included in determining the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital for purposes of Table 1. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section I.B.(6)(v) will be assigned a 100-percent risk weight and included in the bank's consolidated risk-weighted assets.

(vi) *Adjusted carrying value.* (A) For purposes of this section I.B.(6), the "adjusted carrying value" of investments is the aggregate value at which the investments are carried on the balance sheet of the bank reduced by any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank's Tier 1 capital and associated deferred tax liabilities. For example, for equity investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of those investments (as reflected on the consolidated balance sheet of the bank) less any unrealized gains on those investments that are included in other comprehensive income and not reflected in Tier 1 capital, and associated deferred tax liabilities.[18]

(B) As discussed above with respect to consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial company that is consolidated for accounting purposes under generally accepted accounting principles, the bank's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the bank's core capital in accordance with section I.A.1 of this Appendix). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit equivalent amounts of the company's off-balance sheet items) should be excluded from the bank's risk-weighted assets for regulatory capital purposes.

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[17](...continued)
section I.B.(6). In addition, if the bank sold and repurchased, after March 13, 2000, 40 shares of the company, the adjusted carrying value of those 40 shares would be subject to a deduction under this section I.B.(6).

[18] Unrealized gains on available-for-sale equity investments may be included in Tier 2 capital to the extent permitted under section I.A.2.(f) of this Appendix. In addition, the net unrealized losses on available-for-sale equity investments are deducted from Tier 1 capital in accordance with section I.A.1 of this Appendix.

(vii) *Equity investments*. For purposes of this section I.B.(6), an equity investment means any equity instrument (including common stock, preferred stock, partnership interests, interests in limited liability companies, trust certificates and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity where the instrument or feature is held under one of the legal authorities listed in section I.B.(6)(ii) above. An investment in any other instrument (including subordinated debt) may be treated as an equity investment if, in the judgment of the FDIC, the instrument is the functional equivalent of equity or exposes the bank to essentially the same risks as an equity instrument..

* * * *

Table I -- Definition of Qualifying Capital

Components	**Minimum Requirements**
(1) CORE CAPITAL (Tier 1)	Must equal or exceed 4% of weighted-risk assets.
(a) Common stockholders' equity	No limit.[1]
(b) Noncumulative perpetual preferred stock and any related surplus	No limit.[1]
(c) Minority interest in equity accounts of consolidated	No limit.[1]
(d) Less: All intangible assets other than certain mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships.	([2])
(e) Less: Certain credit-enhancing interest-only strips and nonfinancial equity investments required to be deducted from capital.	([3])
(f) Less: Certain deferred tax assets.	([4])
(2) SUPPLEMENTARY CAPITAL (Tier 2)	Total of tier 2 is limited to 100% of tier 1[5]
(a) Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets[5]

Components	Minimum Requirements
(b) Unrealized gains on certain equity securities.[6]	Limited to 45% of pretax net unrealized gains.[6]
(c) Cumulative perpetual and long-term preferred stock (original maturity of 20 years or more) and any related surplus	No limit within tier 2; long-term preferred is amortized for capital purposes as it approaches maturity.
(d) Auction rate and similar preferred stock (both cumulative and non-cumulative).	No limit within Tier 2.
(e) Hybrid capital instruments (including mandatory convertible debt securities).	No limit within Tier 2.
(f) Term subordinated debt and intermediate-term preferred stock (original weighted average maturity of five years or more).	Term subordinated debt and intermediate-term preferred stock are limited to 50% of Tier 1[5] and amortized for capital purposes as they approach maturity.
(3) DEDUCTIONS (from sum of tier 1 and tier 2)	
(a) Investments in banking and finance subsidiaries that are not consolidated for regulatory capital purposes.	
(b) Intentional, reciprocal cross-holdings of capital securities issued by banks.	
(c) Other deductions (such as investment in other subsidiaries or joint ventures) as determined by supervisory authority	On a case-by-case basis or as a matter of policy after formal consideration of relevant issues.
(4) TOTAL CAPITAL	Must equal or exceed 8% or weighted-risk assets

[1] No express limits are placed on the amounts of nonvoting common, noncumulative perpetual preferred stock, and minority interests that may be recognized as part of Tier 1 capital. However, voting common stockholders' equity capital generally will be expected to be the

dominant form of Tier 1 capital and banks should avoid undue reliance on other Tier 1 capital elements.

[2] The amounts of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships that can be recognized for purposes of calculating Tier 1 capital are subject to the limitations set forth in § 325.5(f). All deductions are for capital purposes only; deductions would not affect accounting treatment.

[3] The amounts of credit-enhancing interest-only strips that can be recognized for purposes of calculating Tier 1 capital are subject to the limitations set forth in § 325.5(f). The amounts of nonfinancial equity investments that must be deducted for purposes of calculating Tier 1 capital are set forth in section I.B.(6) of appendix A to part 325.

[4] Deferred tax assets are subject to the capital limitations set forth in § 325.5(g).

[5] Amounts in excess of limitations are permitted but do not qualify as capital.

[6] Unrealized gains on equity securities are subject to the capital limitations set forth in paragraph I.A2.(f) of appendix A to part 325.

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By order of the Board of Directors, Federal Deposit Insurance Corporation.

Dated at Washington, D.C., this 10th day of December, 2001.

Robert E. Feldman (Signed)

Robert E. Feldman, Executive Secretary