

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. **10624**]
February 26, 1993]

RISK-BASED CAPITAL GUIDELINES

- **Comment Requested, by March 15, on Amount of
Deferred-Tax Assets Includable in Tier I Capital**
- **Final Rule on Capital Treatment of Intangible Assets**

*To All State Member Banks, and Bank Holding
Companies, in the Second Federal Reserve District:*

Deferred-Tax Assets Proposal

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued for public comment proposed amendments to its capital adequacy guidelines for state member banks and bank holding companies to establish a limitation on the amount of certain deferred tax assets that may be included in the Tier 1 capital calculation for risk-based and leverage capital purposes.

Comment should be received by March 15, 1993.

The proposed amendments would provide that:

- 1) deferred tax assets that are dependent on an institution's future taxable income would be limited for regulatory capital purposes to the amount that can be realized within one year of a quarter-end report date or ten percent of Tier 1 capital, whichever is less; and,
- 2) no limit for regulatory capital purposes would be placed on deferred tax assets that can be realized from taxes paid in prior carry-back years.

The proposed amendments were developed by the Board consistent with recommendations made by the Federal Financial Institutions Examination Council for federally supervised banks and thrift institutions in response to the Financial Accounting Standard Board Statement No. 109, "Accounting for Income Taxes" (FASB 109), which must be adopted no later than the first quarter of 1993, or the beginning of the institution's first fiscal year thereafter, if later.

Printed on the following pages is an excerpt from the *Federal Register* of February 11, containing the text of the Board's proposal. Comments thereon should be submitted by March 15, 1993, and may be sent to the Board, as specified in the notice, or to our Bank Analysis Department.

Final Rule on Intangible Assets

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued a final rule revising its capital adequacy guidelines for bank holding companies and state member banks to provide explicit guidance on the types of intangible assets that may be included in the Tier 1 capital calculation for risk-based and leverage capital purposes.

The rule is effective March 15, 1993.

The revised guidelines also include limits and discounts that are applicable to those intangible assets included in capital.

The revision was formulated in a coordinated effort by the staffs of the four federal financial institutions regulatory agencies and, when made final by the other agencies, will achieve greater consistency among the agencies with respect to the capital treatment of intangible assets.

In addition, certain aspects of the final rule implement provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").

Enclosed, for the institutions addressed and for others who maintain sets of Board regulations, is the text of the Board's final rule on this matter, also as published in the *Federal Register* of February 11. Additional, single copies of the enclosure can be obtained at this Bank (33 Liberty Street) from the Issues Division on the first floor, or by calling our Circulars Division (Tel. No. 212-720-5215 or 5216).

* * *

Questions on either of these matters may be directed to Manuel J. Schnaidman, Manager, Bank Analysis Department (Tel. No. 212-720-6710), or to Anne Wakelin of that Department (Tel. No. 212-720-6962).

E. GERALD CORRIGAN,
President.

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulation H, Regulation Y; Docket No. R-0795]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed revisions to capital adequacy guidelines.

SUMMARY: The Board of Governors of the Federal Reserve System (Board, Federal Reserve or FRB) is proposing to amend its capital adequacy guidelines for state member banks and bank holding companies to establish a limitation on the amount of certain deferred tax assets that may be included in (that is, not deducted from) the Tier 1 capital calculation for risk-based and leverage capital purposes. Under the proposal, deferred tax assets that can be realized through carrybacks to taxes paid on income earned in prior periods generally would not be subject to limitation for regulatory capital purposes. On the other hand, deferred tax assets that can only be realized if an institution earns taxable income in the future would be limited for regulatory capital purposes to the amount that the institution is projected to realize within one year of the quarter-end report date—based on the institution's projection of taxable income for that year—or 10 percent of Tier 1 capital, whichever is less. Deferred tax assets in excess of these limitations would be deducted from Tier 1 capital and from assets for purposes of calculating both the risk based and leverage capital ratios. The capital proposal was developed on a consistent basis by the Board, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (hereafter, the "federal banking agencies" or the "agencies") in response to the Financial Accounting Standards Board's (FASB) issuance of Statement No. 109, "Accounting for Income Taxes" (FASB 109) in February 1992. This FASB accounting standard must be adopted by state member banks and bank holding companies for regulatory reporting and financial reporting purposes no later than the first quarter of 1993, or the beginning of their first fiscal year thereafter, if later.

DATES: Comments on the proposed revisions to the Federal Reserve Board's risk-based and leverage capital guidelines should be submitted on or before March 15, 1993.

ADDRESSES: Comments on the Federal

Reserve Board's proposal, which should refer to Docket No. R-0795 may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenues, NW., Washington, DC 20551; or delivered to room B-2223, Eccles Building, between 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 9 a.m. and 5 p.m. weekdays, except as provided in § 261.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Charles H. Holm, Project Manager, (202) 452-3502; John M. Frech, Supervisory Financial Analyst, (202) 452-2275; Nancy J. Rawlings, Senior Financial Analyst, (202) 452-3059, Regulatory Reporting and Accounting Issues Section; Barbara J. Bouchard, Senior Financial Analyst, (202) 452-3072, Policy Development Section, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

1. Background

Characteristics of Deferred Tax Assets

Deferred tax assets are assets that reflect, for financial reporting purposes, benefits of certain aspects of the tax laws. Deferred tax assets may arise because of specific limitations under tax laws of different tax jurisdictions that require that certain net operating losses (i.e., when, for tax purposes, expenses exceed revenues) or tax credits be carried forward if they cannot be used to recover taxes previously paid. These "tax carryforwards" are realized only if the institution generates sufficient future taxable income during the carry forward period.

Deferred tax assets may also arise from the tax effects of certain events that have been recognized in one period for financial statement purposes but will result in deductible amounts in a future period for tax purposes, i.e., the tax effects of "deductible temporary differences". For example, many depository institutions and bank holding companies may report higher income to taxing authorities than they

reflect in their regulatory reports¹ because their loan loss provisions are expensed for reporting purposes but are not deducted for tax purposes until the loans are charged off.

Deferred tax assets arising from an organization's deductible temporary differences may or may not exceed the amount of taxes previously paid that the organization could recover if the differences fully reversed at the report date. Some of these deferred tax assets may theoretically be "carried back" and recovered from taxes previously paid. On the other hand, when such deferred tax assets exceed such previously paid tax amounts, they will be realized only if there is sufficient future taxable income during the carryforward period.²

FASB 109

In February 1992, the FASB issued Statement No. 109, which supersedes Accounting Principles Board Opinion No. 11 (APB 11) and FASB Statement No. 96. FASB 109 provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax assets. FASB 109 potentially allows some state member banks and bank holding companies to record significantly higher deferred tax assets than previously permitted under generally accepted accounting principles (GAAP) and the federal banking agencies' prior reporting policies. Unlike the general practice under previous standards, FASB 109 permits the reporting of deferred tax assets that are dependent upon future taxable income.³ However, FASB 109

¹ State member banks are required to file quarterly Consolidated Reports of Condition and Income (Call Reports) with the Federal Reserve. Bank holding companies with total consolidated assets of \$150 million or more file Consolidated Financial Statements for Bank Holding Companies (FR Y-9C reports) on a quarterly basis with the Federal Reserve.

² Hereafter, such deferred tax assets and deferred tax assets arising from tax carryforwards are referred to as "deferred tax assets that are dependent upon future taxable income."

³ Prior supervisory policies of the OCC and FDIC, as set forth in Banking Circular 202 and Bank letter BL-36-85, respectively, limited the reporting of deferred tax assets in the regulatory reports filed by national banks and insured state nonmember banks to the amount of taxes previously paid which are potentially available through carryback of net operating losses. As such, the OCC and FDIC did not permit the reporting of deferred tax assets that are dependent upon future taxable income in the Call Reports filed by national and insured state nonmember banks. The FRB and OTS did not issue policies explicitly addressing the recognition of deferred tax assets. Consequently, state member banks and savings institutions were able to report deferred tax assets in accordance with GAAP. Prior to FASB 109, GAAP, as set forth in APB 11 and FASB 96, also for the most part did not permit the reporting of deferred tax assets that are dependent upon future taxable income.

requires the establishment of a valuation allowance to reduce the net deferred tax asset to an amount that is more likely than not (i.e., a greater than 50 percent likelihood) to be realized.

FASB 109 is effective for fiscal years beginning on or after December 15, 1992, but early adoption of this standard was encouraged by the FASB. The adoption of this standard could result in the reporting of additional deferred tax assets in Call Reports and FR Y-9C reports that would directly increase an institution's undivided profits (retained earnings) and thus its Tier 1 capital.

Concerns Regarding Deferred Tax Assets That Are Dependent Upon Future Taxable Income

Certain regulatory concerns exist with respect to including in capital deferred tax assets that are dependent upon future taxable income. Realization of such assets depends on whether a banking organization has sufficient future taxable income during the carryforward period. Since a banking organization that is in a net operating loss carryforward position is often experiencing financial difficulties, its prospects for generating sufficient taxable income in the future are uncertain. In addition, the condition of and future prospects for an organization often can and do change very rapidly in the banking environment. This raises concerns about the realizability of deferred tax assets that are dependent upon future taxable income, even when an organization appears on the surface to be sound and well-managed. Thus, for many organizations, such deferred tax assets may not be realized and, for other organizations, there will be a high degree of subjectivity in determining the realizability of this asset.

In addition, as an organization's condition deteriorates, it is less likely that deferred tax assets that are dependent upon future taxable income will be realized. Therefore, the organization would be expected under FASB 109 to reduce its deferred tax assets through increases to the asset's valuation allowance. Additions to this allowance would reduce the organization's regulatory capital at precisely the time it needs capital support the most. Thus, the reporting of deferred tax assets that are dependent upon future taxable income raises, for safety and soundness reasons, a supervisory concern.

Moreover, net operating loss carryforwards of an acquired banking organization can be severely limited to the acquirer when an acquisition or change in control occurs. If an acquisition is structured as a taxable

asset purchase, the net operating loss carryforwards are generally extinguished. In addition, if an acquisition or change in control qualifies as a tax-free reorganization, a strict limitation (Section 382 of the Internal Revenue Code) on the use of the acquired institution's net operating loss carryforwards generally applies. This limitation is based on the value of the acquired institution at the time of its acquisition, and thus the potential value of a net operating loss carryforward to a prospective purchaser tends to decline as the institution's financial condition weakens.

Because of these concerns, in March 1992, the Federal Reserve and the other federal banking agencies issued separate letters to the banking organizations under their supervision expressing concerns about FASB 109 and stated that banking organizations should not adopt FASB 109 for regulatory reporting purposes until the agencies had determined the appropriate regulatory reporting and capital treatment.

FFIEC Request for Comment

On August 3, 1992, the agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), requested public comment on various regulatory reporting and capital treatments for deferred tax assets of depository institutions (57 FR 34135). In the comment request, the agency staffs indicated that, while no final decision would be made until all comments were received, their preference would be to limit the amount of deferred tax assets that could be reported to the amount that could be recovered through the carryback of losses against taxes previously paid (hereafter referred to as the "carryback approach"). Under the carryback approach, depository institutions' deferred tax assets that are dependent upon future taxable income could not be reported as assets for regulatory reporting purposes and, thus, would be excluded from regulatory capital.

The FFIEC received 198 comment letters in response to its request for comment, primarily from banks, thrifts, and holding companies. The vast majority of the commenters indicated that they believe that strong reasons exist for adopting FASB 109 for both regulatory reporting and capital purposes. These commenters generally asserted that deferred tax assets that are

dependent upon future taxable income are valuable assets for many institutions and that FASB 109 provides sufficient criteria for measuring these assets and for distinguishing those institutions that will be able to realize these assets from those that will not. Furthermore, the commenters indicated that, under the carryback approach, the agencies were effectively proposing a liquidation value approach to deferred tax assets and that such an approach is inconsistent with the going concern concept used for measuring other assets and liabilities.

Commenters also noted that tax laws have changed significantly in the last several years, and many banking organizations will have a longer carryforward period (i.e., 15 years) than they now have to absorb all losses beginning in 1994. (For these organizations, the carryforward period for losses attributable to bad debts is now five years.) Thus, these commenters indicated there is a greater likelihood that in the future carryforwards will ultimately be realized. Moreover, commenters indicated that, as a result of changes in tax laws that require some banking organizations to deduct charge-offs, rather than provisions for loan losses, for tax purposes, even strong banking organizations may have large amounts of deferred tax assets that are dependent upon future taxable income.

Commenters also expressed concern that the carryback approach could create a difference between the deferred tax assets reported in GAAP financial statements and regulatory reports, thereby creating an additional reporting burden for institutions. Commenters also questioned whether banking organizations could compete equally with other financial services companies if the carryback approach were imposed.

Some commenters indicated that, if the agencies did limit deferred tax assets, they should permit the recognition of some deferred tax assets that are dependent upon future taxable income and should set the limitation for capital purposes rather than for reporting purposes.

II. Proposal

The Federal Reserve and the other agencies remain concerned about the realizability and characteristics of deferred tax assets that are dependent upon future taxable income. On the other hand, the agencies believe that many of the comments received in response to the FFIEC request for comment have merit. In this regard, some relatively strong organizations have large amounts of deferred tax assets that are dependent upon future

⁴ OTS's letter indicated that savings associations could adopt the provisions of FASB 109, except that any deferred tax asset could not exceed what was allowed to be reported under APB 11 or FASB 96.

taxable income. Such deferred tax assets could not be reported under the carryback approach. Yet there is a high likelihood in some cases that such assets will be realized. Thus, the agencies believe that the recognition of some amounts of deferred tax assets that are dependent upon future taxable income is appropriate. Furthermore, the agencies believe that their supervisory concerns regarding deferred tax assets can be adequately addressed by setting forth a limitation through the capital standards rather than through reporting instructions. Such an approach would not result in a difference between GAAP and regulatory reporting requirements.

Therefore, after careful consideration of the comments received, the FFIEC decided that banks and savings associations should adopt FASB 109 for reporting purposes in Call Reports and Thrift Financial Reports (TFRs) beginning in the first quarter of 1993 (or the beginning of their first fiscal year thereafter, if later). Furthermore, the Board decided that bank holding companies should adopt FASB 109 in FR Y-9C Reports at the same time.

The FFIEC, in reaching its decision on regulatory reporting, also recommended that each of the federal banking and thrift regulatory agencies should amend its regulatory capital standards to limit the amount of deferred tax assets that are dependent upon future taxable income that can be included in regulatory capital to the lesser of:

- (1) The amount of deferred tax assets that is expected to be realized within one year of the quarter-end date,⁵ based on an organization's projections of future taxable income (exclusive of tax carryforwards and reversals of existing temporary differences) for that year. Such projections should include the estimated effect of tax planning strategies that the organization expects to implement to realize tax carryforwards that will otherwise expire during the year, or
- (2) 10 percent of Tier 1 capital.

When the recorded amount of deferred tax assets that are dependent

⁵ For purposes of determining the limit in (1) above, the Board proposes that state member banks and bank holding companies should assume that all temporary differences fully reverse at the report date. Other than this provision, the one-year cutoff for projections of future taxable income, and the inclusion of an organization's tax planning strategies as part of those projections, state member banks and bank holding companies should adhere to FASB 109 when determining this limit. Consistent with FASB 109 and the separate entity method discussed later in this proposal, the Board proposes to permit the netting of deferred tax liabilities and assets for a particular tax-paying component of a state member bank or bank holding company and within a particular tax jurisdiction. Netting of deferred tax assets and liabilities attributable to different tax-paying components of a state member bank or bank holding company or to different tax jurisdictions would not be permitted.

upon future taxable income, net of the valuation allowance for deferred tax assets, exceeds this limitation, the excess amount is to be deducted from Tier 1 capital and from assets in regulatory capital calculations.⁶ Deferred tax assets which can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences would generally not be limited.

The Board is proposing to adopt the recommendation of the FFIEC in full, as summarized immediately above.⁷ Furthermore, consistent with the recommendations of the FFIEC, FASB 109, and longstanding policy of the Board and the other agencies, the Board is proposing that the capital limit should be determined on a separate entity basis for each state member bank.⁸ However, in some cases, a state member bank's holding company may not have the financial capability to reimburse the institution for tax benefits derived from the institution's carryback of net operating losses or tax credits. In these cases, the amount of carryback potential the bank may consider in calculating the capital limit on deferred tax assets should be limited to the lesser amount which it could reasonably expect to have refunded by its parent. Bank holding companies generally would determine the limit on a consolidated basis.

Consistent with FASB 109, the limit would also be determined on a tax jurisdiction-by-jurisdiction basis. A limit for one jurisdiction (e.g., the United States) in excess of the reported amount of deferred tax assets for that jurisdiction should not be used to effectively increase the limit for other

⁶ With respect to the regulatory capital limitation, a transition provision applies to deferred tax assets reported as of September 30, 1992, under APB 11 or FASB 96. For some state member banks and bank holding companies, such reported deferred tax assets may be in excess of the amount otherwise includable in regulatory capital under this proposal. The amount of this excess deferred tax asset would be includable in capital subject to the following phase-out provisions. For these purposes, the amount of this excess deferred tax asset must be amortized each period on a straight-line basis and must be fully amortized within two years. Furthermore, such excess deferred tax assets are subject to previously-existing rules and supervisory policy, including periodic evaluation as to realization and as to their contribution to the banking organization's ability to absorb losses.

⁷ Under the Board's risk-based capital guidelines, all deferred tax assets included in capital would continue to be assigned a risk weight of 100 percent.

⁸ Under the separate entity method, a bank (together with its consolidated subsidiaries) that is a subsidiary of a holding company is treated as a separate taxpayer rather than as part of the consolidated group of which it is a member.

jurisdictions (e.g., the state in which the organization is chartered).

The agencies plan to issue additional regulatory reporting guidance on FASB 109 in the first quarter of 1993. The amount of deferred tax assets that organizations report in their regulatory reports and use to meet capital requirements will be subject to review by examiners.

The proposed capital limitation is intended to balance the Board's concerns about deferred tax assets that are dependent upon future taxable income against the fact that such assets will, in many cases, be realized. The proposed approach generally permits full inclusion of deferred tax assets potentially recoverable from carrybacks, since there is a high likelihood that such amounts will be realized. In addition, the proposed approach also includes those deferred tax assets that are dependent upon future taxable income, if any, that can be recovered from projected taxable income during the next year. The Board is proposing to limit projections of future taxable income to one year because, in general, the Board believes that many organizations are able to make reasonable projections of taxable income for the following twelve month period and then achieve their projected results. However, the reliability of these projections and the ability to actually achieve them tends to decrease significantly beyond that time period. Deferred tax assets that are dependent upon future taxable income are further limited to 10 percent of Tier 1 capital, since the Board believes such assets should not comprise a large portion of an organization's capital base given the uncertainty of realization associated with these assets and the difficulty in selling these assets apart from the organization.

Questions for Comment

While the Board is seeking public comment on all aspects of its proposal on the capital treatment of deferred tax assets, it seeks specific comment on the following questions.

- (1) Under previous GAAP as set forth in Accounting Principles Board Opinion No. 16, "Business Combinations," (APB 16) the reported value of an asset (other than goodwill) acquired in a purchase business combination is adjusted for the tax effect of the difference between the market or appraised value of the asset and its tax basis. FASB 109 changes this treatment by requiring that this tax effect be recorded separately in a deferred tax account. This change in treatment could cause a large increase in

the reported amount of certain identifiable intangible assets, such as core deposit intangibles, which are deducted for purposes of computing regulatory capital. Should these increases in such identifiable intangible assets be deducted for purposes of computing regulatory capital ratios? Are there any other provisions of FASB 109 which the agencies should consider for purposes of applying a different regulatory capital treatment than has been proposed above?

(2) The Board is interested in receiving comments on ways of reducing the potential burden associated with this proposal and requests comments on this matter. For example, is a limitation based on projections of future taxable income difficult to implement? Would it be simpler to base a capital limitation on deferred tax assets without consideration of future projections of taxable income, such as permitting only healthy organizations to include in capital deferred tax assets that are dependent upon future taxable income up to a specified percentage of Tier 1 capital (e.g., 5 or 10 percent)? Would there be any other method that would be simpler to administer while recognizing the Board's concerns about deferred tax assets? Also, for example, the limitation, as proposed, would be based on the separate entity method. Would another method be more appropriate for determining the limitation on deferred tax assets and for tax-sharing agreements in general?

(3) The proposal would require tax planning strategies to be included as part of an institution's projections of taxable income for the next year. Furthermore, the proposal would require organizations to assume that all temporary differences fully reverse at the report date. In addition, the proposal would permit grandfathering of amounts previously reported if they were in excess of the proposed limitation, provided the excess amounts are amortized on a straight line basis over two years. Comment is specifically requested on the appropriateness of these provisions.

III. Regulatory Flexibility Act Analysis

The Board does not believe that the adoption of this proposal would have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations), in accordance with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). In this regard, the vast majority of small banking organizations currently have very limited amounts of net deferred tax

assets, which are the subject of this proposal, as a component of their capital structures. Furthermore, adoption of this proposal, in combination with the recent adoption of FASB 109 for regulatory reporting purposes, will allow many organizations to increase the amount of deferred tax assets they include in regulatory capital. In addition, because the risk-based and leverage capital guidelines generally do not apply to bank holding companies with consolidated assets of less than \$150 million, this proposal will not affect such companies.

IV. Paperwork Reduction Act

The following information about paperwork relates only to Federal Reserve (FR) reports, which are approved by the Federal Reserve Board under delegated authority from the Office of Management and Budget.

The proposed amendments to the Capital Adequacy Guidelines would require one additional line item to Schedule HC-I, Part I, of the Consolidated Financial Statements for Bank Holding Companies With Total Consolidated Assets of \$150 Million or More or With More Than One Subsidiary Bank (FR Y-9C; OMB No. 7100-0128). The new item, Memorandum item 8, would be titled "Deferred tax assets disallowed for regulatory capital purposes." The proposed additional item will be reviewed by the Federal Reserve Board under delegated authority from the Office of Management and Budget after consideration of comments received during the public comment period. Comments on the proposed additional item should be submitted to the Federal Reserve under procedures described earlier in this notice.

Description of Affected Report

Report Title: Consolidated Financial Statements for Bank Holding Companies With Total Consolidated Assets of \$150 Million or More, or With More Than One Subsidiary Bank.

This report is filed by all bank holding companies that have total consolidated assets of \$150 million or more and by all multibank holding companies regardless of size. The following bank holding companies are exempt from filing the FR Y-9C, unless the Board specifically requires an exempt company to file the report: bank holding companies that are subsidiaries of another bank holding company and have total consolidated assets of less than \$1 billion; bank holding companies that have been granted a hardship exemption by the Board under section

4(d) of the Bank Holding Company Act; and foreign banking organizations as defined by 211.23(b) of Regulation K.
Agency Form Number: FR Y 9-C.
OMB Docket Number: 7100-0128.
Frequency: Quarterly.
Reporters: Bank Holding Companies.
Annual Reporting Hours: 148,054.
Estimated Average Hours per Response: Range from 5 to 1,250.
Number of Respondents: 1,598.
Small businesses are affected.

List of Subjects

12 CFR Part 208

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

12 CFR Part 225

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

For the reasons set forth in the preamble, the Board is proposing to amend 12 CFR parts 208 and 225 as follows:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM

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

Authority: 12 U.S.C. 36, 321-338, 248(a), 248(c), 461, 481-486, 601, 611, 1814, 1823(f), 3105, 3310, 3331-3351 and 3906-3909; 15 U.S.C. 78b, 78f(b), 78f(g), 78f(i), 78o-4(c)(5), 78q, 78q-1, and 78w.

Appendix A—[Amended]

2. Appendix A to part 208 is amended by adding paragraph II.B.(iv) to read as follows:

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

- * * * * *
- A. * * *
- B. * * *
- (i) * * *
- (ii) * * *
- (iii) * * *

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

* * * * *

3. Appendix A to part 208 is amended by revising footnote 19 in paragraph II.B.3.; by removing footnote designator 20 from the end of paragraph II.B.3.; by adding paragraph II.B.4.; and by adding footnote designator 20 in paragraph II.B.4. and revising footnote 20 to read as follows:

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

- A. * * *
B. * * *
1. * * *
2. * * *
3. * * * 19

4. Deferred tax assets. The amount of deferred tax assets that are dependent upon future taxable income, net of the valuation allowance for deferred tax assets, that may be included in, that is, not deducted from, a bank's capital may not exceed the lesser of: (a) The amount of these deferred tax assets that the bank is expected to realize within one year of the quarter-end date, based on its projections of future taxable income for that year, 20 or (b) 10 percent of Tier 1 capital. For purposes of calculating this limitation, Tier 1 capital is defined as the sum of core capital elements, net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships. The recorded amount of such deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of this limitation is to be deducted from a bank's core capital elements in determining Tier 1 capital. The amount of deferred tax assets that can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences generally would not be deducted from capital. However, regardless of the above limitations, the amount of carryback potential a bank may consider in calculating

19 Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's Policy Statement on Nonvoting Equity Investments, 12 CFR 225.143 (Federal Reserve Regulatory Service 4-172.1; 68 Federal Reserve Bulletin 413 (1982)). In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital. The Board intends to monitor nonreciprocal holdings of other banking organizations' capital instruments and to provide information on such holdings to the Basle Supervisors' Committee as called for under the Basle capital framework.

20 Projected future taxable income should not include net operating loss carryforwards to be used during that year or the amount of existing temporary differences a bank expects to reverse within the year. Such projections should include the estimated effect of tax planning strategies that the organization expects to implement to realize tax carryforwards that will otherwise expire during the year.

21 At the end of 1992, Tier 1 capital for state member banks includes common equity, minority interest in the equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, as a general matter, Tier 1 capital excludes goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; all other intangible assets; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

the capital limit on deferred tax assets may not exceed the amount which it could reasonably expect to have refunded by its parent.

Appendix B—[Amended]

4. Appendix B to part 208 is amended by revising footnote 2 and by revising the last sentence of the second paragraph in section II., to read as follows:

II. The Tier 1 Leverage Ratio

* * * * * As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income ("Call Report"), less goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4. 3

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

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

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

Appendix A—[Amended]

2. Appendix A to part 225 is amended by adding paragraph II.B.(iv) to read as follows:

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

- A. * * *
B. * * *
(i) * * *
(ii) * * *
(iii) * * *
(iv) Deferred tax assets—portions are deducted from the sum of core capital elements in accordance with section II.B.4. of this appendix.

3. Appendix A to part 225 is amended by revising footnote 22 in paragraph II.B.3.; by removing footnote designator 23 from the end of paragraph II.B.3.; by adding paragraph II.B.4.; and by adding

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

footnote designator 23 in paragraph II.B.4. and revising footnote 23 to read as follows:

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

- A. * * *
B. * * *
1. * * *
2. * * *
3. * * * 22

4. Deferred tax assets. The amount of deferred tax assets that are dependent upon future taxable income, net of the valuation allowance for deferred tax assets, that may be included in, that is, not deducted from, a bank holding company's capital may not exceed the lesser of: (a) the amount of these deferred tax assets that the bank holding company is expected to realize within one year of the quarter-end date, based on its projections of future taxable income for that year, 23 or (b) 10 percent of Tier 1 capital. For purposes of calculating this limitation, Tier 1 capital is defined as the sum of core capital elements, net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships. The recorded amount of such deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of this limitation is to be deducted from a bank holding company's core capital elements in determining Tier 1 capital. The amount of deferred tax assets that can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences generally would not be deducted from capital.

Appendix D—[Amended]

4. Appendix D to part 225 is amended by revising footnote 3 and by revising the last sentence of the second paragraph in section II., to read as follows:

II. The Tier 1 Leverage Ratio

* * * * * Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's Policy Statement on Nonvoting Equity Investments, 12 CFR 225.143 (Federal Reserve Regulatory Service 4-172.1; 68 Federal Reserve Bulletin 413 (1982)). In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital. The Board intends to monitor nonreciprocal holdings of other banking organizations' capital instruments and to provide information on such holdings to the Basle Supervisors' Committee as called for under the Basle capital framework.

23 Projected future taxable income should not include net operating loss carryforwards to be used during that year or the amount of existing temporary differences a bank holding company expects to reverse within the year. Such projections should include the estimated effect of tax planning strategies that the organization expects to implement to realize tax carryforwards that will otherwise expire during the year.

* * * * * As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of

³At the end of 1992, Tier 1 capital for bank holding companies 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 purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; all other intangible assets; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain

the allowance for loan and lease losses) reported on the banking organization's Consolidated Financial Statement ("FR Y-9C Report"), less goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve

limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

determines should be deducted from Tier 1 capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4.⁴

* * * * *
Board of Governors of the Federal Reserve System, February 1, 1993.
William W. Wiles,
Secretary of the Board.
[FR Doc. 93-2984 Filed 2-10-93; 8:45 am]
BILLING CODE 6210-01-P

⁴Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. of Appendix A to this Part.

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Amendments to
CAPITAL ADEQUACY GUIDELINES
12 CFR Parts 208 and 225

Types of Intangible Assets
Includable in the Tier I
Capital Calculation for
Risk-based and
Leverage Capital Purposes

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FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulation H, Regulation Y; Docket No. R-0748]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule to the Capital Adequacy Guidelines.

SUMMARY: The Board of Governors of the Federal Reserve System (Board or Federal Reserve) is revising its capital adequacy guidelines for bank holding companies and state member banks to provide explicit guidance on the types of intangible assets that may be included in (that is, not deducted from) the Tier 1 capital calculation for risk-based and leverage capital purposes. The revision also includes limits and discounts that are applicable to those intangible assets included in capital. The revision was formulated in conjunction with the staffs of the four federal financial institutions regulatory agencies (the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS)) and, when made final by the other agencies, will achieve greater consistency among the agencies with respect to the capital treatment of intangible assets. In addition, certain aspects of the final rule implement provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

EFFECTIVE DATE: March 15, 1993.

FOR FURTHER INFORMATION CONTACT: Rhoger H Pugh, Assistant Director (202/728-5883), Norah M. Barger, Manager (202/452-2402), Thomas R. Boemio, Supervisory Financial Analyst (202/452-2982), Robert E. Motyka.

Supervisory Financial Analyst (202/452-3621), Division of Banking Supervision and Regulation. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

I. Background

The international bank capital standards (Basle Accord)¹ require that banks deduct goodwill from their core capital elements in determining Tier 1 capital for risk-based capital purposes.² The Basel framework, which by its terms applies only to internationally active banks, was adopted by the Federal Reserve for all state member banks. The Board also chose to apply, generally on a consolidated basis, a risk-based capital framework similar to the Basel Accord to U.S. bank holding companies.³ Under this framework, bank holding companies are also required to deduct goodwill from Tier 1 capital. Furthermore, the Board has adopted a leverage capital standard for state member banks and bank holding companies.⁴ Since Tier 1 capital serves as the numerator of the leverage ratio, goodwill also is deducted from the core capital elements for purposes of the leverage standard.

A. Current Treatment of Identifiable Intangible Assets

The Basel Accord does not address the treatment of identifiable intangible assets, that is, intangible assets other than goodwill. Consequently, under the Basel framework, U.S. bank regulators have discretion in specifying the treatment of these other intangible

assets. In evaluating the appropriateness of including particular intangible assets in an organization's capital, the Federal Reserve and the other federal banking agencies consider a number of factors, including the following criteria, sometimes referred to as the "three-part test":

1. The reliability and predictability of any cash flows associated with the asset and the degree of certainty that can be achieved in periodically determining the asset's useful life and value;
2. The marketability of the asset, that is, the existence of an active and liquid market; and
3. The salability of the asset, that is, the feasibility of selling the asset apart from the financial institution or from the bulk of its assets.

All the agencies have determined that purchased mortgage servicing rights (PMSRs)⁵ generally meet these criteria and all allow such assets to be included in Tier 1 capital, subject to certain limits. The agencies currently differ on the extent to which other intangibles meet the criteria, and each follows somewhat different procedures regarding their treatment.

The FDIC and OCC fully deduct all intangibles other than PMSRs from Tier 1 capital. The Federal Reserve does not automatically deduct any identifiable intangible assets from Tier 1 capital, but determines the appropriateness of their inclusion in the calculation of an organization's capital position on a case-by-case basis. The Board has long considered the level and quality of identifiable intangible assets in assessing the capital adequacy and overall asset quality of banking institutions since even those intangible assets that meet the above criteria usually contain a relatively high degree of risk. The OTS has concluded that, at least in some cases, certain other identifiable intangible assets (for example, core deposit intangibles, or

CDIs)⁶ may meet the three criteria and, therefore, has not required the deduction of some of these other identifiable intangible assets in calculating capital ratios.

All the agencies specify limits on the amount of intangibles that institutions can include in capital. The Board's current risk-based capital guidelines indicate that while all intangible assets will be monitored, identifiable intangible assets in excess of 25 percent of Tier 1 capital are subject to particularly close scrutiny. The OCC permits PMSRs to account for up to 25 percent of Tier 1 capital. The OTS permits PMSRs to be included up to 50 percent of Tier 1 capital, and other qualifying intangibles (for example, CDIs) are limited to 25 percent of Tier 1 capital. The FDIC permits PMSRs up to 50 percent of Tier 1 capital. Both the OTS and the FDIC impose certain valuation and discounting requirements on PMSRs included in capital.

B. Proposal for the Treatment of Identifiable Intangible Assets

For some time, the agencies have been reviewing the capital treatment of identifiable intangible assets with the aim of developing greater uniformity among the agencies in the treatment of these assets for capital adequacy purposes. On the basis of this review, the Board, on February 19, 1992, proposed for public comment revisions to its capital adequacy guidelines to provide explicit guidance on certain types of intangible assets that may be included in capital, namely PMSRs and purchased credit card relationships (PCCRs),⁷ as well as specifications for appropriate limits on the amount of such assets that may be included within capital. The proposed revisions represented a proposal jointly developed by the staffs of the four federal financial institutions regulatory

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

² The risk-based capital guidelines utilize the ratio of a banking organization's Tier 1 capital and Tier 2 capital to the organization's total on-balance sheet assets and off-balance sheet credit arrangements, adjusted for their relative risks. Tier 1 capital is composed of core capital elements such as common equity and qualifying perpetual preferred stock, while Tier 2 capital is composed of supplementary capital elements such as the allowance for loan and lease losses and subordinated debt.

³ For bank holding companies with consolidated assets of less than \$150 million, the risk-based capital guidelines generally are applied on a bank-only basis.

⁴ The leverage capital guidelines utilize a ratio of the banking organization's Tier 1 capital elements to its total average on-balance sheet assets.

⁵ PMSRs are identifiable intangible assets associated with the right to service mortgage loans. PMSRs generally arise when an institution purchases such rights from another entity that originated the mortgage loans. An organization that acquires PMSRs has the obligation to collect principal and interest payments, and escrow amounts from the mortgagor, and to insure that all amounts collected are passed on to the appropriate parties. In return for performing these functions, the servicer receives a fee, which is generally based on the remaining principal amount due on the mortgages being serviced.

⁶ CDIs are identifiable intangible assets associated with the value of the relatively low cost funding afforded by core depositor relationships (that is, certain nonbrokered retail deposits) acquired from another depository institution. CDIs generally arise when an organization purchases another depository institution or some of its branches and assumes the related deposit liabilities. The value of CDIs is based upon the assumption that the lower cost

source of funds provided by core depositor relationships will continue to be available to the acquiring institution for a period of time after the acquisition.

⁷ PCCRs are identifiable intangible assets associated with the right to provide future advances and other services to credit cardholders and to provide correspondent merchant processing under credit card arrangements that have been originated by, and purchased from, another entity. PCCRs generally arise when a credit card portfolio is bought and the purchaser acquires the current advances outstanding under the credit card arrangements, which are tangible assets, as well as the right to provide future services to the cardholders, which is an intangible asset. The value of PCCRs derives from the anticipated profit the purchaser will earn from interest on future advances, fees charged for other future credit card-related services, after covering expenses and other operating costs such as credit losses.

agencies with respect to the regulatory capital treatment of intangible assets.

The Federal Reserve also proposed that, to the extent that PMSRs are determined to be includable in Tier 1 capital, they should be subject to certain valuation requirements that are consistent with provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). In that regard, section 475 of the Act provides that the federal banking agencies determine the amount of PMSRs includable in the calculation of an institution's capital, if such servicing rights are valued at not more than 90 percent of their fair market value, and are reviewed on at least a quarterly basis. In addition, the Federal Reserve proposed that institutions determine the fair market value and book value of PMSRs includable in capital in accordance with criteria already set forth in the current FDIC and OTS rules regarding these intangible assets. Since the calculation of the fair market value for PCCRs is at least as subjective as it is for PMSRs, the Federal Reserve also proposed that PCCRs be subject to the same valuation requirements as PMSRs.

The changes in the capital treatment of intangible assets were proposed for incorporation into the capital ratios used for both examinations and applications purposes. The proposal stated, however, that, consistent with the existing capital guidelines, the Board may in certain cases continue to evaluate an organization's tangible capital ratios (after deducting all intangibles) in assessing its overall capital adequacy, if warranted in the judgment of the Board.

C. Proposal in Detail

The Board proposed the following treatment for identifiable intangible assets for purposes of the risk-based and leverage capital guidelines:

1. PMSRs and PCCRs would be considered qualifying intangible assets. As such, they would not have to be deducted from capital provided that, in the aggregate, they do not exceed 50 percent of Tier 1 capital and provided that PCCRs do not exceed a sublimit of 25 percent of Tier 1 capital. PMSRs and PCCRs in excess of these limits would be deducted from an organization's core capital elements in determining Tier 1 capital.⁸

⁸ PMSRs and PCCRs that are included in (that is, are not deducted from) capital would be included in the calculation of total risk-weighted assets at a risk weight of 100 percent for risk-based capital purposes and would be included in total average assets for leverage capital purposes. PMSRs and PCCRs that are not included in (that is, are deducted from) capital would not be included in

2. The limits on PMSRs and PCCRs would be based on a percentage of Tier 1 capital before excess holdings of these assets are deducted, but after goodwill and all other nonqualifying identifiable intangible assets (for example, CDIs) are deducted.

3. Institutions would be required to determine the fair market value and to review the book value of their PMSRs and PCCRs at least quarterly. Banking organizations that wish to include these assets in capital would not be able to carry them for regulatory reporting purposes at a book value that exceeds the discounted value of their estimated future net cash flows. The discounted cash flow provision is a current requirement in the guidelines of the FDIC and the OTS. The discount rate used for this purpose should not be less than that derived at the time of acquisition, based upon the estimated cash flows and the price paid for the asset at the time of purchase.

4. For purposes of calculating Tier 1 capital, the amount of PMSRs and PCCRs an organization could include in capital could not exceed the lesser of 90 percent of the fair market value of the assets (this provision is consistent with section 475 of FDICIA), 90 percent of their original purchase price (as currently required by the FDIC and the OTS), or 100 percent of their book value.

5. CDIs and all other identifiable intangible assets would be deducted from the core capital elements for purposes of calculating an institution's Tier 1 capital, just as goodwill, in accordance with the Basle Accord, is deducted.⁹

II. Public Comments on the Proposal

The comment period for this proposal ended March 27, 1992. Of the forty-five public comment letters received that addressed the proposal, thirty-two indicated varying levels of support for the Board's effort to revise its capital adequacy guidelines with regard to the treatment of identifiable intangible assets. Most of the commenters offering support for the Board's effort, however, expressed concerns or very strong reservations with various aspects of the proposal. The thirteen respondents that explicitly opposed the proposal based their opposition on one or more of the

the calculation of total risk-weighted assets for risk-based capital purposes and would be deducted from total average assets for leverage capital purposes.

⁹ Like goodwill, CDIs and all other intangible assets not includable in capital would not be included in the calculation of total risk-weighted assets for risk-based capital purposes and would be deducted from average total assets for leverage capital purposes.

following reasons: the proposed treatment of intangibles is too restrictive for capital adequacy purposes; the valuation methods are arbitrary and complex, and are not in accordance with GAAP; the treatment ignores the risk reduction properties of CDIs and other identifiable intangible assets; and the proposal, if implemented, would create a competitive disadvantage between U.S. banking organizations and nonfinancial institutions and between U.S. banking organizations and foreign banks.

A. Issues Raised by Commenters

Nine respondents indicated that the three-part test should be used to determine which intangible assets would be eligible for inclusion in capital. Fifteen respondents agreed that PMSRs and/or PCCRs meet the three criteria and, thus, should be included in Tier 1 capital. Of the eighteen commenters that addressed the issue of limitations on the amount of PMSRs and PCCRs that can be included in capital, seven specifically stated that they favored the proposed aggregate limit of 50 percent of Tier 1 capital.

Seven commenters opposed both the 50 percent aggregate limit and 25 percent sublimit for PCCRs on the grounds that these limits were arbitrary and unjustified in view of the proposal's other valuation requirements for these assets and were inconsistent with generally accepted accounting principles (GAAP), which does not impose any limitations on the inclusion of these assets within capital. Ten respondents specifically opposed the 25 percent sublimit for PCCRs, which they contended are inherently as valuable as PMSRs and, thus, should be treated in the same manner as PMSRs for capital purposes.

Thirteen commenters specifically addressed what they perceived as the proposal's ambiguity with regard to whether or not an institution's qualifying intangibles, that is, PMSRs and PCCRs, would be deducted from capital for applications purposes. These commenters maintained that banking organizations should be aware of the criteria they are being measured against when filing applications and that ambiguity on this matter indicated that the Board viewed these intangibles as worthless even though the proposal states that they have value.

All twenty-two commenters that addressed the proposed deduction of CDIs from Tier 1 opposed it and supported a full or partial inclusion of CDIs in Tier 1 capital. Commenters asserted that CDIs meet the criteria in the three-part test and have real

economic value. These commenters contended that the proposal, if implemented, could discourage institutions from purchasing deposits from those institutions that are experiencing financial difficulties or are failing, thereby depleting the deposit insurance funds and increasing the ultimate cost of closing an institution to the taxpayers.

Fifteen respondents expressed opposition to an automatic deduction of other identifiable intangible assets such as purchased trust servicing rights, purchased investment management relationships, purchased home equity rights, and merchant servicing rights. These commenters stated that although many of these assets are classified as intangible assets for accounting purposes, they are economically equivalent to tangible assets.

Three respondents discussed internally generated servicing rights, which the proposal did not address. It was noted that although the value of these off-balance sheet assets are often substantial, they are not included in the Board's consideration of an institution's capital adequacy. Commenters maintained that the discounted value of PMSRs and PCCRs should be offset by the value of internally generated servicing rights.

Twelve commenters urged the Board to consider some type of grandfathering for identifiable intangible assets subject to deduction from capital that were acquired prior to issuance of the proposal. While the proposal did not contemplate grandfathering, respondents contended that the deduction of preexisting intangible assets would be unfair to banking organizations that had purchased the assets at a price that reflected the existing rules and had established businesses based upon these rules. Others stated that some organizations that currently include CDIs in their capital calculations would experience substantial reductions in regulatory capital. Several commenters indicated that they could support a transitional period to provide for an orderly conversion to the new standard.

B. Responses to the Board's Questions

Question 1: Twenty-four commenters responded to the first question posed by the Board which inquired whether the approaches proposed for the valuation and discounting of PMSRs and PCCRs were appropriate.

Eleven commenters specifically addressed the issue of limiting the amount of PMSRs and PCCRs included in capital to 90 percent of fair market value. Four respondents supported the

10 percent discount, which is consistent with the provisions regarding evaluation of PMSRs in section 475 of FDICIA. Seven others opposed this discount requirement on the grounds that it is inconsistent with GAAP and is unnecessary in view of the active and liquid markets for these assets. Seven commenters also opposed the proposal that the amount of qualifying intangible assets includable in capital be limited to 90 percent of the original purchase price on the grounds that such a discount is not required by either GAAP or FDICIA and offers little supervisory benefit in view of the other valuation requirements.

Nine of the ten commenters addressing the proposal that the fair market value of PMSRs and PCCRs be determined by applying an appropriate market discount rate to the expected net future cash flows supported the proposed valuation approach. One commenter preferred use of the original discount rate. Six of the commenters indicated that while the use of an actual market sales price for PMSRs and PCCRs would be beneficial in the overall assessment of the fair market value of these assets, it would not be an adequate substitute for the proposed method. A seventh commenter indicated that use of recent sales prices for PCCRs would strengthen the validity of the fair market value determined by the proposed approach.

Fifteen commenters addressed the proposed approach to determine the book value of PMSRs and PCCRs included in capital. Fourteen respondents were against either the requirement that these assets be valued on their books using a discounted approach or the specification that the discount rate applied to the estimated future net cash flows be no lower than the rate used at the time of acquisition. The one commenter that supported both requirements stated that the use of the original discount rate would maintain consistency in measuring subsequent cash flows with the original projections.

Commenters opposing the discounted approach requirement stated that it was inconsistent with GAAP, which permits but does not require that an asset's expected cash flows be discounted to determine the asset's book value, and that it should be eliminated since it is neither required by GAAP nor mandated by FDICIA. The ten respondents objecting to the requirement for what they viewed as an artificial floor on the discount rate stated that it could result in a book value that not only was lower than amortized cost, but also was lower than fair market value. These organizations argued that banks need

flexibility in applying an appropriate discount rate that would reflect current market and portfolio conditions.

Although the Board did not propose requiring an independent evaluation of identifiable intangible assets, six respondents commented on such evaluations, which the FDIC and the OTS currently require on an annual basis for intangibles included in capital. Four organizations agreed that an institution should be allowed to assess internally the value of its intangibles without incurring the cost of an independent third party evaluation and commended the Board for not proposing such a requirement. Two other organizations, however, supported the requirement of an annual independent evaluation on the grounds that it would promote a conservative approach to quarterly reviews and, thereby, help to prevent abuses.

Nine commenters addressed the proposal's requirement that banking organizations determine the book value and fair market value of PMSRs and PCCRs at least quarterly. Four organizations supported the requirement, while five opposed it. Four of these five institutions objected on the grounds of cost and favored annual instead of quarterly reviews. The fifth stated that valuations should be performed more frequently than quarterly.

Four commenters inquired whether the requirement limiting the amount of qualifying intangibles in capital to the lesser of 90 percent of fair market value, 90 percent of original purchase price, or 100 percent of book value, would be applied on a pool-by-pool or aggregate portfolio basis. The proposal did not address this issue. The four commenters favored application of the limitation on an aggregate portfolio basis, which they viewed as consistent with GAAP and with the way in which institutions dispose of these assets. They also expressed the view that applying limitations on a pool-by-pool basis would unjustly result in a reduction of a portfolio's value for purchases that had decreased in value, without permitting offsetting increases for purchases that had risen in value.

Question 2: Eight respondents addressed the second question posed by the Board which asked how the recent large level of mortgage refinancings had affected the market for, and values of, PMSRs and requested general market information on identifiable intangible assets.

The eight commenters all agreed that the value of PMSRs is inversely related to the speed of prepayments associated with mortgage refinancings. They noted

that the recent decrease in interest rates had prompted a surge of refinancings of loans with high interest rates, resulting in an increase in prepayments and, thus, a decrease in the value attached to existing PMSRs. Some respondents stated that the value of PMSRs related to new mortgage originations at lower interest rates and purchases of lower rate mortgages have maintained or increased their value since anticipated prepayments are expected to be low due to the reduced interest rates at which the mortgages were originated. As a result, the aggregate value of an institution's PMSRs may have either increased or decreased depending upon the institution's portfolio mix of PMSRs related to existing loans at higher interest rates and those related to new loans at lower interest rates.

Several commenters stated that although the recent refinancings have, in general, negatively affected the market for existing PMSRs, the income generated from new originations and the use of hedge instruments has had a positive impact on institutions' earnings. The majority of respondents to this question concurred that the market for new PMSRs remains competitive.

Question 3: Nine respondents addressed the Board's third question which inquired as to the reasons for which banking organizations buy PMSRs and whether it would be appropriate to limit an organization's involvement in PMSRs based on their ability to manage the associated prepayment risk.

Some respondents to this question indicated that PMSRs provide banks with a stable source of revenue and an attractive return on equity. Others maintained that their PMSRs portfolios were integral components of their overall mortgage lending business. A few commenters agreed that PMSRs were useful hedges against changing interest rates since their returns are negatively correlated to returns on other assets held by depository institutions. Most respondents stated that an organization's overall interest rate risk management system should include the evaluation of the prepayment risk associated with PMSRs.

Question 4: Nine respondents addressed the Board's fourth question which solicited views on the appropriate capital treatment for excess servicing rights, which GAAP currently classifies as tangible assets.

Most of these commenters agreed that excess servicing rights should not be deducted from capital, nor treated like PMSRs for capital purposes, even though these assets possess

characteristics similar to those of PMSRs.

III. Final Amendments to the Capital Adequacy Guidelines With Regard to the Capital Treatment of Intangible Assets

After review of the comments received and further consideration of the issues involved, and following consultations with the other federal banking agencies, the Board is now issuing in final form amendments to its risk-based and leverage capital guidelines to provide explicit guidance on the types and amounts of intangible assets that state member banks and bank holding companies may include in capital. These final amendments have been developed in consultation with the other federal banking agencies and are consistent with international capital standards.

As proposed, the Board will allow banking organizations to include in capital PMSRs and PCCRs, but will require the deduction of CDIs and other identifiable intangible assets. While PMSRs and PCCRs clearly meet the three criteria set forth in the proposal as some of the factors considered in determining the appropriateness of including intangible assets in capital, CDIs and other identifiable intangible assets do not.

A review of the comments indicated that inclusion in the proposed rule of the three-part test as a means for determining which identifiable intangible assets could be included in regulatory capital led some respondents to conclude that the Board did not necessarily intend to require the deduction of all identifiable intangible assets other than PMSRs and PCCRs. Accordingly, to avoid any confusion with regard to the Board's views on which intangibles qualify for inclusion in capital, the three-part test will be eliminated from the final rule. These three criteria, however, will continue to be considered in the assessment of the quality of an institution's intangible assets for purposes of evaluating its overall capital position.

A number of the commenters that objected to the exclusion from capital of CDIs and other identifiable intangible assets argued that, at a minimum, such assets that institutions had previously acquired should be grandfathered into capital. After further consideration of this matter, the Board agrees that to the extent institutions were permitted to include such assets in capital prior to issuance of the proposal, they should not now be required to deduct those assets from capital. Accordingly, for supervisory purposes, the Board will

permit institutions to incorporate into their capital ratios identifiable intangible assets other than PMSRs and PCCRs that were acquired prior to February 19, 1992. It should be noted, however, that the Federal Reserve's longstanding practice has been to deduct these assets from capital for purposes of evaluating an organization's capital position for applications purposes. Accordingly, the Board believes that it would be inappropriate to include in the calculation of capital ratios used for applications purposes any CDIs or identifiable intangible assets other than PMSRs or PCCRs, whether or not such assets were acquired prior to February 19, 1992.

As proposed, the final rule will permit PMSRs and PCCRs to be included in capital only to the extent that, in the aggregate, they do not exceed 50 percent of Tier 1 capital. PCCRs also will be subject to a sublimit of 25 percent of Tier 1 capital. While several commenters objected to the lower limitation on PCCRs includable in capital, the Board believes that this sublimit is appropriate since the market for PCCRs does not have the liquidity and maturity of the market for PMSRs and the assumptions used in the valuation of PCCRs generally are less objective and subject to less market discipline than those used in the valuation of PMSRs.

In the interest of simplicity, these limits on PMSRs and PCCRs will be based, as proposed, on a percentage of Tier 1 capital before excess holdings of these assets are deducted, that is, the sum of core capital elements (for example, common equity and qualifying perpetual preferred stock) less goodwill and other nonqualifying intangible assets. This method of calculation, however, could result in the inclusion in capital of PMSRs and PCCRs in an amount greater than 50 percent, and of PCCRs in an amount greater than 25 percent, of Tier 1 capital net of goodwill, other nonqualifying intangible assets, and deductible amounts of PMSRs and PCCRs. Thus, it would be possible for an institution to report a positive amount of Tier 1 capital even though its holdings of PMSRs and PCCRs exceed the sum of its core capital elements. Accordingly, as proposed, the final rule contains cautionary language that indicates that excessive holdings of PMSRs and PCCRs includable in capital may be viewed as an unsafe and unsound practice.

For purposes of calculating Tier 1 capital, the amount of PMSRs and PCCRs an organization may include in capital cannot exceed the lesser of 90 percent of the fair market value of these

assets or 100 percent of their book value. The proposal also would have limited the amount of these assets includable in capital to not more than 90 percent of the original purchase price of the asset. Several commenters opposed this requirement on the grounds that it would impose a recordkeeping burden but provide little supervisory benefit in light of the other proposed valuation requirements. In addition, respondents noted that FDICIA does not require this limitation. The Board believes these arguments have merit and, accordingly, is eliminating this limitation from the final rule.

Like the proposal, the final rule does not specify whether the limitation to the lesser of 90 percent of fair market value or 100 percent of book value should be applied on a pool-by-pool or aggregate basis. The use of an aggregate approach by some institutions in the past to avoid recording a writedown of individual assets by purchasing new assets does raise concerns with regard to the use of such an approach. However, the Board believes that these concerns are mitigated by the other valuation requirements that are being imposed on PMSRs and PCCRs. Accordingly, the rule does not specify either the pool-by-pool or aggregate approach.

As proposed, institutions will be required to determine the fair market value and to review the book value of their PMSRs and PCCRs at least quarterly. Unlike the FDIC and the OTS, the Federal Reserve did not propose that these assets be subject to an annual independent valuation, and the final rule does not contain such a valuation requirement. However, the rule does note that the Federal Reserve, on a case-by-case basis, may require an institution to obtain independent valuations of its intangible assets.

The proposal indicated that if an institution wished to allow PMSRs to be recognized for inclusion in regulatory capital, it would have to carry them at a book value equal to the discounted value of their future net servicing income. The discount rate used for this purpose could not be less than that derived at the time of acquisition, based upon the estimated cash flows and the price paid for the asset at the time of purchase. Many commenters expressed opposition to the use of the discounted approach to determining book value, as well as to a mandated floor on the discount rate. The Board, however, continues to support these requirements for the determination of the book value of PMSRs and PCCRs for several reasons. The use of a discounted approach, while not required by GAAP,

is permitted by GAAP. Since this approach is more conservative than an undiscounted approach, the Board believes it is the most appropriate method to use for intangible assets included in the calculation of regulatory capital.

The Board also believes it is more appropriate for institutions to use the original discount rate, which is an objectively determinable rate, rather than a market-based rate as suggested by some commenters. The original discount rate is based on the original purchase price relative to the estimated future net cash flows at the time of purchase. Market-based discount rates are much less objective and are subject to greater manipulation and abuse. Moreover, the original discount rate reflects the economics of a transaction at its inception and, thus, its use is consistent with the historical cost accounting model.

In addition, determining the book value of PMSRs and PCCRs based on expected net cash flows discounted at the original discount rate makes the characteristics of these qualifying intangible assets similar to those of certain tangible assets (for example, excess servicing fees receivable) that currently have no specific capital limitations. This requirement, therefore, provides additional justification for the inclusion of these qualifying intangible assets in regulatory capital.

While a number of commenters disagreed with the proposed discounted approach for the valuation of PMSRs and PCCRs, the Board continues to support the proposed approach to the valuation of these assets. However, the Board believes that these valuation requirements are more appropriately framed in the context of regulatory reporting requirements rather than in the context of a regulatory capital rule. Accordingly, the Board is eliminating from the final rule the requirement that the book value of PMSRs and PCCRs included in capital be accounted for on a discounted basis, using a discount rate that is no less than that employed at the time of acquisition. These requirements, however, will be incorporated into instructions for the reporting of PMSRs and PCCRs in the Reports of Condition and Income for state member banks (Call Report) and the Consolidated Financial Statements for bank holding companies with total consolidated assets of \$150 million or more (FR Y-9C Report).¹⁰

¹⁰ For bank holding companies, these instructions will take the form of additional line items to Risk-Based Capital Schedule HC-I, which pertains to risk-weighted assets.

The Board is clarifying that the capital treatment of intangible assets set forth in the final rule will be incorporated into the capital ratios used for both examinations and applications purposes. The final rule, however, notes that in assessing an organization's capital position for applications purposes, the Board reserves the right as it deems appropriate to take into account the quality and composition of an organization's capital, together with the quality and value of its tangible and intangible assets. Nonetheless, as mentioned above, any previously acquired CDIs or other identifiable intangible assets apart from PMSRs or PCCRs that may be grandfathered into capital for supervisory purposes will not be included in the calculation of an institution's capital ratios for applications purposes.

IV. Regulatory Flexibility Act Analysis

The Federal Reserve Board does not believe adoption of this final rule would have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations), in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). In this regard, the vast majority of small banking organizations have very limited amounts of identifiable intangible assets, which are the subject of this final rule, as a component of their capital structures. In addition, because the risk-based and leverage capital guidelines generally do not apply to bank holding companies with consolidated assets of less than \$150 million, this final rule will not affect such companies.

List of Subjects

12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, banking, Branches, Capital adequacy, Confidential business information, Currency, Dividend payments, Federal Reserve System, Flood insurance, Publication of reports of condition, Reporting and recordkeeping requirements, Securities, State member banks.

12 CFR Part 225

Administrative practice and procedure, Appraisals, Banks, banking, Capital adequacy, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities, State member banks.

For the reasons set out in the preamble, and pursuant to the Board's

authority under section 5(b) of the Bank Holding Company Act of 1956 (12 U.S.C. 1844(b)), and section 910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3909), the Board is amending 12 CFR parts 208 and 225 as follows:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM

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

Authority: 12 U.S.C. 36, 248(a), 248(c), 321-338, 461, 481-486, 601, 611, 1814, 1823(j), 3105, 3310, 3331-3351, and 3906-3909; 15 U.S.C. 78b, 78f(b), 78f(g), 78f(i), 78c-4(c) (5), 78q, 78q-1, and 78w.

Appendix A—[Amended]

2. Appendix A to part 208 is amended by revising the first sentence and by removing the second sentence of the first undesignated paragraph of section II.A.1.; by revising the first undesignated paragraph of section II.A.2.; by revising the first sentence of section II.A.2.d.; by revising paragraph (i) of section II.B.; by revising section II.B.1.b.; and by revising footnote 16 of section II.B.2., to read as follows:

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

* * * * *

A. * * *
1. * * *

Tier 1 capital is generally defined as the sum of core capital elements⁹ less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix.

* * * * *

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 and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix).

* * * * *

d. * * * The aggregate amount of term subordinated debt (excluding mandatory convertible debt) and intermediate-term preferred stock that may be treated as supplementary capital is limited to 50 percent of Tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix). * * *

* * * * *

B. * * *

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

(b) Certain identifiable intangible assets, that is, intangible assets other than

⁹ During the transition period and subject to certain limitations set forth in section IV below, Tier 1 capital may also include items defined as supplementary capital elements.

goodwill—deducted from the sum of core capital elements in accordance with section II.B.1.b. of this appendix.

* * * * *

1. * * *
a. * * *

b. *Other intangible assets.* The only types of identifiable intangible assets that may be included in, that is, not deducted from, a bank's capital are readily marketable purchased mortgage servicing rights and purchased credit card relationships, provided that, in the aggregate, the total amount of these assets included in capital does not exceed 50 percent of Tier 1 capital. Purchased credit card relationships are subject to a separate sublimit of 25 percent of Tier 1 capital.¹⁴

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

Banks must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair market value of purchased mortgage servicing rights and purchased credit card relationships also must be determined at least quarterly. The fair market value generally shall be determined by applying an appropriate market discount rate to the expected future net cash flows. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates.

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

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

The amount of purchased mortgage servicing rights and purchased credit card relationships that a bank may include in capital shall be the lesser of 90 percent of their fair market value, as determined in accordance with this section, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions in the commercial bank Consolidated Reports of Condition and Income (Call Report). If both the application of the limits on purchased mortgage servicing rights and purchased credit card relationships and the adjustment of the balance sheet amount for these intangibles would result in an amount being deducted from capital, the bank would deduct only the greater of the two amounts from its core capital elements in determining Tier 1 capital.

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

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

2. * * * 10 * * *

3. Appendix A to part 208 is amended by revising the last undesignated paragraph of section III.C.4. to read as follows:

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

* * * * *

C. * * *

4. * * *

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

* * * * *

4. Appendix A to part 208 is amended by revising the first, second, and third sentences of the first undesignated paragraph of section IV.A. to read as follows:

IV. Minimum Supervisory Ratios and Standards

* * * * *

A. * * *

¹⁰ An exception to this deduction would be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith. The requirements for consolidation are spelled out in the instructions to the Call Report.

As reflected in Attachment VI, by year-end 1992, all state member banks should meet a minimum ratio of qualifying total capital to weighted risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of Tier 1 capital. For purposes of section IV.A., Tier 1 capital is defined as the sum of core capital elements less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix. The maximum amount of supplementary capital elements that qualifies as Tier 2 capital is limited to 100 percent of Tier 1 capital.***

5. In Appendix A to part 208, the table in Attachment II is amended by revising the fifth entry of the left column and by revising footnote 1 of the fifth entry of the left column to read as follows:

ATTACHMENT II—SUMMARY DEFINITION OF QUALIFYING CAPITAL FOR STATE MEMBER BANKS* USING THE YEAR-END 1992 STANDARDS

Table with 2 columns: Components, and a row for 'Less: Goodwill and other intangible assets required to be deducted from capital.'

* See discussion in section II of the guidelines for a complete description of the requirements for, and the limitations on, the components of qualifying capital. Requirements for the deduction of other intangible assets are set forth in section II.B.1.b. of this appendix.

6. In Appendix A to part 208, the table in Attachment VI is amended by revising the second entry of the fourth column and by adding a new footnote number 3 to the second entry of the fourth column to read as follows:

ATTACHMENT VI—SUMMARY Final Arrangement—Year-End 1992

Table with 2 columns: Components, and a row for 'Common equity, qualifying noncumulative perpetual preferred stock, and minority interest less goodwill and other intangible assets required to be deducted from capital.'

3 Requirements for the deduction of other intangible assets are set forth in section II.B.1.b. of this appendix.

Appendix B—[Amended]

7. Appendix B to part 208 is amended by revising footnote 2 and by revising the last sentence of the second undesignated paragraph of section II to read as follows:

II. The Tier 1 Leverage Ratio

*** As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income (Call Report), less goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other intangible assets; and any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital.3

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

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

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

Appendix A—[Amended]

2. Appendix A to part 225 is amended by revising the first sentence and by removing the second sentence of the first undesignated paragraph of section II.A.1.; by revising the first undesignated paragraph of section II.A.2.; by revising the first sentence of section II.A.2.d.; by revising paragraph (i) of section II.B.; by revising section II.B.1.b.; and by revising footnote 17 of section II.B.2. to read as follows:

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

A.*** 1.***

Tier 1 capital is generally defined as the sum of core capital elements4 less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix.

2 At the end of 1992, Tier 1 capital for state member banks includes common equity, minority interest in equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, as a general matter, Tier 1 capital excludes goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; and all other intangible assets. The Federal Reserve may exclude certain 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. of appendix A to this part.

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

2.***

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

d.*** The aggregate amount of term subordinated debt (excluding mandatory convertible debt) and intermediate-term preferred stock that may be treated as supplementary capital is limited to 50 percent of Tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix).***

B.***

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

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

1.*** a.***

b. Other intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, an organization's capital are readily marketable purchased mortgage servicing rights and purchased credit card relationships, provided that, in the aggregate, the total amount of these assets included in capital does not exceed 50 percent of Tier 1 capital. Purchased credit card relationships are subject to a separate sublimit of 25 percent of Tier 1 capital.15

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

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

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unsound manner because of overreliance on intangible assets in Tier 1 capital.

Bank holding companies must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair market value of purchased mortgage servicing rights and purchased credit card relationships also must be determined at least quarterly. The fair market value generally shall be determined by applying an appropriate market discount rate to the expected future net cash flows. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates.

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

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

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

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

2. * * * 17 * * *

3. Appendix A to part 225 is amended by revising the last undesignated paragraph of section III.C.4. to read as follows:

¹⁷ An exception to this deduction would be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith. The requirements for consolidation are spelled out in the instructions to the FR Y-9C Report.

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

C. * * *
4. * * *

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

4. Appendix A to part 225 is amended by revising the first, second, third, and fourth sentences of the first undesignated paragraph of section IV.A. to read as follows:

IV. Minimum Supervisory Ratios and Standards

A. * * *

As reflected in Attachment VI, by year-end 1992, all bank holding companies⁵⁶ should meet a minimum ratio of qualifying total capital to weighted risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of Tier 1 capital. For purposes of section IV.A., Tier 1 capital is defined as the sum of core capital elements less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix. The maximum amount of supplementary capital elements that qualifies as Tier 2 capital is limited to 100 percent of Tier 1 capital. In addition, the combined maximum amount of subordinated debt and intermediate-term preferred stock that qualifies as Tier 2 capital is limited to 50 percent of Tier 1 capital.

5. In Appendix A to part 225, the table in Attachment II is amended by revising the fifth entry of the left column and by revising footnote 1 of the fifth entry of the left column to read as follows:

ATTACHMENT II—SUMMARY DEFINITION OF QUALIFYING CAPITAL FOR BANK HOLDING COMPANIES* (USING THE YEAR-END 1992 STANDARDS)

Components
* * * * *
Less: Goodwill and other intangible assets required to be deducted from capital. ¹
* * * * *

¹ 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.

⁵⁶ As noted in section I above, bank holding companies with less than \$150 million in consolidated assets would generally be exempt from the calculation and analysis of risk-based ratios on a consolidated holding company basis, subject to certain terms and conditions.

¹ Requirements for the deduction of other intangible assets are set forth in section II.B.1.b. of this appendix.

6. In Appendix A to part 225, the table in Attachment VI is amended by revising the second entry of the fourth column; by revising footnote 1; and by revising footnote 3, which is referenced in the second entries of the second, third, and fourth columns, to read as follows:

ATTACHMENT VI—SUMMARY
Final Arrangement—Year-End 1992

Common equity, qualifying noncumulative and cumulative perpetual preferred stock,¹ and minority interest less goodwill and other intangible assets required to be deducted from capital.²

¹ Cumulative perpetual preferred stock is limited within Tier 1 to 25% of the sum of common stockholders' equity, qualifying perpetual preferred stock, and minority interest.

² Requirements for the deduction of other intangible assets are set forth in section II.B.1.b. of this appendix.

Appendix D—[Amended]

7. Appendix D to part 225 is amended by revising footnote 3 and by revising the last sentence of the second undesignated paragraph of section II to read as follows:

II. The Tier 1 Leverage Ratio

* * * * *
* * * * *
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 banking organization's Consolidated Financial Statements (FR Y-9C Report), less goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other intangible assets; and any investments in subsidiaries or associated companies that the Federal Reserve

³ At the end of 1992, Tier 1 capital for bank holding companies includes common equity, minority interest in 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 purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; and all other intangible assets. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

determines should be deducted from Tier 1 capital.⁴

* * * * *

Board of Governors of the Federal Reserve System, February 2, 1993.

William W. Wiles,

Secretary of the Board.

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⁴Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. of Appendix A to this Part.