FEDERAL RESERVE BANK OF NEW YORK

[Circular No. **10686**
January 24, 1994]

CAPITAL ADEQUACY GUIDELINES

Amendments to Regulations H and Y

To All Depository Institutions, and Others Concerned,
in the Second Federal Reserve District:

The following statement has been issued by the Board of Governors of the Federal Reserve System:

> The Federal Reserve Board announced adoption of amendments to its risk-based capital guidelines affecting the treatment of certain multifamily housing loans.
>
> This rule is effective December 31, 1993.
>
> The revised guidelines for state member banks and bank holding companies lower the risk weight from 100 percent to 50 percent for multifamily housing loans meeting criteria that are specified in the proposal. This change was directed by a provision of section 618(b) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRRIA).
>
> The Board's notice is attached.
>
> In a separate action on December 16, 1993, the Board approved a recommendation from the Federal Financial Institution Examination Council to seek public comment on a Notice of Proposed Rulemaking and an Advanced Notice of Proposed Rulemaking concerning the regulatory treatment of recourse arrangements and direct credit substitutes which, to the extent they apply to multifamily housing loans, would, if adopted, also satisfy the requirements of certain provisions of section 618(b) of RTCRRIA.
>
> This notice will be issued at a later date.

Enclosed — for depository institutions in the Second Federal Reserve District and others who maintain sets of regulations of the Board of Governors — is the text of the amendments to Regulations H and Y, which have been reprinted in the *Federal Register* of December 29, 1993; additional, single copies may be obtained at this Bank (33 Liberty Street) from the Issues Division on the first floor, or by contacting the Circulars Division (Tel. No. 212-720-5215 or 5216). Questions regarding the regulations may be directed to Stephanie Martin, Financial Specialist, Bank Analysis Function (Tel. No. 212-720-1418).

William J. McDonough,
President.

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Board of Governors of the Federal Reserve System

CAPITAL ADEQUACY GUIDELINES

Amendments to Regulations H and Y

Effective December 31, 1993

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–0756]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System is amending its risk-based capital guidelines for state member banks and bank holding companies. This final rule implements section 618(b) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 and section 305(b)(1)(B) of the Federal Deposit Insurance Corporation Improvement Act of 1991. The effect of the final rule will be to permit state member banks and bank holding companies to lower from 100 percent to 50 percent the risk weight assigned to certain multifamily housing loans.

EFFECTIVE DATE: This final rule is effective as of December 31, 1993.

FOR FURTHER INFORMATION CONTACT: Rhoger H. Pugh, Assistant Director (202/728–5883), Norah M. Barger, Manager (202/452–2402), Robert E. Motyka, Supervisory Financial Analyst (202/452–3621), or Barbara J. Bouchard, Senior Financial Analyst (202/452–3072), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452–3544), Board of Governors of the Federal Reserve, 20th & C Street NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

On April 10, 1992, the Federal Reserve Board (Board) issued for public comment a proposal to amend its risk-based capital guidelines that would lower the risk weight from 100 percent to 50 percent for certain multifamily housing loans meeting specified criteria. This proposal was made to satisfy the requirements of section 618(b) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRRIA). In addition, this proposal would implement section 305(b)(1)(B) of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) which requires the Federal banking agencies [1] to revise their risk-based capital guidelines to reflect the actual performance and expected risk of loss of multifamily housing loans.

Section 618(b) of RTCRRIA mandates that a 50 percent risk weight be accorded to loans for multifamily housing meeting certain criteria. These statutory criteria were incorporated into the Board's proposal and include the following:

(1) The loan is secured by a first lien;

(2) The ratio of the principal obligation to the appraised value of the property, that is, the loan-to-value (LTV) ratio does not exceed 80 percent (75 percent if the loan is based on a floating interest rate);

(3) The annual net operating income generated by the property (before debt service) is not less than 120 percent of the annual debt service on the loan (115 percent if the loan is based on a floating interest rate);

(4) Amortization of principal and interest is over a period of not more than 30 years and the minimum maturity for repayment of principal is not less than 7 years; and

(5) All principal and interest payments have been made on the loan on time for a period of not less than one year prior to placement in the 50 percent risk category.

Section 618(b) also provides that the appropriate Federal banking agencies may establish additional criteria that a multifamily housing loan must meet before being accorded a 50 percent risk weight. In this regard, and in agreement with the other Federal banking agencies, the Board's proposed amendment set forth the following four additional criteria to ensure that only those multifamily housing loans that expose an institution to minimal levels of credit risk would receive a 50 percent risk weight:

(1) The loan-to-value ratio used for the purpose of the statutory criterion cited above is based upon the most current appraised value of the property (which normally would be the appraised value at the time the loan was originated, unless a more recent evaluation or appraisal has been performed);

(2) The loan is performing in accordance with its original terms and is not more than 90 days past due or carried in nonaccrual status;

(3) The average annual occupancy for the property securing the loan has been

[1] The three other Federal banking agencies have also issued for public comment similar proposals to lower the risk weight for multifamily housing loans meeting the specified criteria. The Office of Thrift Supervision (OTS) currently permits certain multifamily loans to be included in the 50 percent risk weight category. The proposal issued by the OTS would modify its existing criteria for such loans to qualify for a 50 percent risk weight.

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at least 60 percent for the preceding year; and

(4) The loan has been made in accordance with prudent underwriting standards.

The existing risk-based capital guidelines provide that loans secured by mortgages on 1- to 4-family residential properties must meet the first, second, and fourth additional criteria in order to be assigned a 50 percent risk weight. The third proposed criterion is a requirement under the OTS guidelines for loans for multifamily housing accorded a 50 percent risk weight.

Under the proposed revision to the risk-based capital guidelines, privately-issued securities backed by multifamily housing loans that meet the above cited criteria at the time the securities are originated would also qualify for inclusion in the 50 percent risk category provided that the structure of the security meets certain technical criteria set forth in the guidelines. This treatment would parallel the treatment for privately-issued securities backed by loans for 1- to 4-family residential properties under the risk-based capital guidelines. Application of this treatment to a security backed by multifamily housing loans means that the security would not qualify for inclusion in the 50 percent risk category unless all the underlying mortgages have been outstanding and performing for at least one year prior to origination of the security.

Section 618(b)(2) of RTCRRIA requires the agencies to amend their capital regulations and guidelines to provide that any loan fully secured by a first lien on a multifamily housing property that is sold subject to a pro rata loss sharing arrangement should be treated as sold to the extent that loss is incurred by the purchaser of the loan. Section 618(b)(3) of RTCRRIA directs the agencies to take into account other loss sharing arrangements, in connection with the sale of any loan that is fully secured by a first lien on multifamily housing property, to determine the extent to which such loans should be treated as sold.

The Board's existing guidelines set forth guidance on the treatment of assets sold with recourse, including those sold subject to loss sharing arrangements.

The risk-based capital guidelines for state member banks state that the risk-based capital definition of the sale of assets with recourse, including assets sold subject to loss sharing arrangements, is the same as the definition contained in the instructions to the commercial bank Consolidated Reports of Condition and Income (Call Report) glossary entry for "sales of assets." Those instructions set out conditions that must be met in order for a bank to treat a sale of assets as a true sale and, thus, to remove from its balance sheet assets it has sold. Assets that have been sold and removed from a bank's balance sheet in accordance with the Call Report instructions are excluded from the calculation of risk-weighted assets.

Specifically with regard to the sale of assets, the Call Report instructions provide:

if the risk retained by the seller is limited to some fixed percentage of any losses that might be incurred and there are no other provisions resulting in retention of risk, either directly or indirectly, by the seller, the maximum amount of possible loss for which the selling bank is at risk (the stated percentage times the sale proceeds) shall be reported as a borrowing and the remaining amount of the assets transferred reported as a sale.

This treatment, which applies to sales of multifamily housing loans subject to pro rata loss sharing arrangements, is consistent with the language of section 618(b)(2) of RTCRRIA.

The Call Report instructions also provide that other transfers of assets, including the sale of assets subject to other loss sharing arrangements, generally are reported as sales only if the selling institution:

(1) Retains no risk of loss from assets transferred resulting from any cause, and

(2) Has no obligation to any party for the payment of principal or interest on the assets transferred resulting from any cause. This treatment, which applies to sales of multifamily housing loans subject to other loss sharing arrangements, is consistent with the language of section 618(b)(3) of RTCRRIA.

Bank holding companies generally file their regulatory reports in accordance with generally accepted accounting principles (GAAP). Under GAAP, bank holding companies are permitted to treat some asset sales with recourse, including those sold subject to loss sharing arrangements, as "true" sales and, thus, may remove the assets from the balance sheet. The risk-based capital guidelines for bank holding companies state that where such transactions have been removed from the balance sheet but meet the definition of assets sold with recourse contained in the instructions to the Call Report, the assets sold must be included in the calculation of risk-weighted assets. For this purpose the assets that are sold are treated as an off-balance sheet exposure and are converted at 100 percent to a credit equivalent amount and assigned to the appropriate risk weight. This existing treatment, which applies to sales of multifamily housing loans subject to pro rata and other loss sharing arrangements, is consistent with the requirements of RTCRRIA sections 618(b) (2) and (3).

Comments Received

Public comments were received from twenty-three respondents: ten banking organizations, three savings institutions, nine trade associations, and one law firm. Of the twenty-three commenters, eighteen favored lowering the risk weight for qualifying multifamily mortgages from 100 percent to 50 percent; one opposed the lower risk weight; and four gave no overall opinion on the proposal. Commenters responding favorably to the proposal generally agreed that, although loans for multifamily residential properties could be riskier than loans for 1- to 4-family properties, the combination of the criteria required by section 618(b) of RTCRRIA and the additional criteria proposed by the Board should assure that only high quality multifamily housing loans would be included in the 50 percent risk weight category. The one commenter that did not support the proposal expressed the view that certain multifamily loans should stay in the 100 percent risk category because of the historically higher charge-off rates associated with these assets.

Several commenters requested clarification as to whether the qualifying criteria would be applied only once at the time of loan origination or on a continuous basis. Three respondents addressed the application of the annual net operating income-to-debt service ratio as applied to loans to finance multifamily buildings owned by cooperative housing corporations. They noted that since this type of property is generally operated as a not-for-profit enterprise, it would not meet the proposed annual net operating income-to-debt service coverage standard and thus, loans to finance acquisition of such properties could not qualify for the 50 percent risk weight category. Two commenters discussed the treatment of securities backed by multifamily housing loans. One of these commenters expressed the view that the requirement that a multifamily housing loan must perform in accordance with its terms for at least one year before it could qualify for a 50 percent risk weight would prevent securitization of multifamily loans at origination. This commenter also noted that it would be difficult to monitor each underlying loan in a

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security for continuous compliance with the qualifying criteria.

Final Rule

After review of the public comments, and in agreement with the other Federal banking agencies, the Board is adopting a final rule amending the risk-based capital guidelines to lower the risk weight from 100 percent to 50 percent for loans secured by mortgages on multifamily residential properties meeting certain conditions as well as for securities backed by such qualifying mortgages. This final rule implements section 618(b) of RTCRRIA and section 305(b)(1)(B) of FDICIA. The criteria a multifamily housing loan must meet to be included in the 50 percent risk category are the same as those proposed, except that the 80 percent average annual occupancy requirement has been eliminated and clarification has been made with regard to other criteria.

Following consultations with the other agencies, the Board has decided to eliminate the requirement that the property financed must have maintained an average annual occupancy rate of at least 80 percent for the previous year. Comments received by the other agencies indicated that the additional safeguards this occupancy criterion might provide would be minimal in comparison to the increased record-keeping burden it would create. The Board believes that the remaining criteria should be sufficient to satisfy concerns related to safety and soundness of loans secured by multifamily residential property that are assigned a 50 percent risk weight.

Several commenters noted that certain cooperative properties and other not-for-profit multifamily residential properties may not be able to generate sufficient cash flow to satisfy the annual net operating income-to-debt service ratio required in the qualifying criteria. In light of these comments, the final rule specifies that cooperative and other not-for-profit multifamily residential properties may be deemed to satisfy the annual net operating income-to-debt service ratio requirement if they generate sufficient cash flow to provide comparable protection to the institution. Sufficient cash flow to provide comparable protection may be generated in a variety of ways, for example, through additions to special operating reserve accounts or special subsidies provided by Federal, state, local, or private sources. This comparable protection accommodation could allow low- and moderate-income not-for-profit multifamily housing projects to qualify for the 50 percent risk category, provided that they meet the other criteria.

The Board notes that the annual debt service ratio requirements must be satisfied on an on-going basis for a multifamily housing loan to continue to receive a 50 percent risk weight.

In addition, the final rule states that for purposes of satisfying the one year's timely performance criterion in the case where the existing owner of a multifamily residential property is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on a timely basis in accordance with the terms of the loan for at least the preceding year.

The existing risk-based capital guidelines specify that prudent underwriting standards include a conservative loan-to-value ratio, and the proposed rule stated that, in the case of a loan secured by multifamily residential property, the loan-to-value ratio would not be deemed conservative if it exceeded 80 percent (75 percent if the loan is based on a floating interest rate). The final rule notes that prudent underwriting standards dictate that a loan-to-value ratio used in the case of a loan to acquire a property would not be deemed conservative unless the value is based on the lower of the purchase price of the property or the value as determined by the most current appraisal or, if appropriate, the most current evaluation. Otherwise, the loan-to-value ratio generally would be based upon the value of the property as determined by the most current appraisal or, if appropriate, the most current evaluation. Subsequent appraisals (or evaluations) of a multifamily property will not be required for the purpose of continuing to include the loan secured by such property in the 50 percent risk category. However, if a subsequent appraisal (or evaluation) is obtained and it indicates that the loan-to-value ratio exceeds the statutory requirements, the loan would have to be reassigned to the 100 percent risk category.

In connection with the loan-to-value ratio criterion, the Board also notes that under the agencies' 1992 real estate lending standards regulations and guidelines, as a general matter, institutions may extend loans to improved property, which includes existing multifamily residential property, with loan-to-value ratios of up to 85 percent. These guidelines, which implement section 304 of FDICIA, became effective on March 19, 1993. While these guidelines permit institutions to make loans secured by existing multifamily property with loan-to-value ratios that exceed 80 percent, such loans would not qualify for the 50 percent risk category. Rather, they should be assigned to the 100 percent risk category.

The final rule provides that securities backed by mortgages on multifamily residential properties may be accorded a 50 percent risk weight if each underlying mortgage satisfies all the criteria for eligibility for the 50 percent risk weight at the time the pool is originated and the structure of the security meets certain technical criteria set forth in the guidelines. This treatment parallels that accorded to securities backed by mortgages on 1- to 4-family residential properties that qualify for a 50 percent risk weight. In light of issues raised by commenters, the Board is clarifying that the final rule does not require monitoring of each loan that has been pooled into a security for continuous compliance with all the qualifying criteria. As a safeguard against deterioration in the underlying assets, however, the final rule stipulates that a security backed by multifamily mortgage loans may be accorded a 50 percent risk weight only as long as principal and interest payments on the security are not more than 30 days past due.

Finally, in order to conform the Board's regulatory language to that of the other agencies, the final rule amends the risk-based capital guidelines for state member banks by clarifying in a footnote that a multifamily housing loan that is sold subject to a pro rata loss sharing arrangement is to be treated by the selling bank as sold (and excluded from the balance sheet assets), to the extent that the sales agreement provides for the purchaser of the loan to share in any loss incurred on the loan on a pro rata basis with the selling bank. This means that, in such a transaction, the portion of the loan that is treated as sold by the selling bank is excluded from the calculation of the risk-based capital ratio.

With regard to bank holding companies, a footnote in the final rule clarifies that multifamily housing loans sold subject to such pro rata loss sharing arrangements, may be treated as sold, for risk-based capital purposes, to the same extent as for banks. The portion that is sold would not be subject to the 100 percent conversion factor normally applied to assets sold with recourse but rather would be excluded from the calculation of the risk-based capital ratio.

The clarifying footnotes also provide guidance on the risk-based capital treatment of sales of multifamily housing loans in which the purchaser of

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a loan shares in any loss incurred on the loan with the selling institution on other than a pro rata basis. These other loss sharing arrangements are taken into account, for purposes of determining the extent to which such loans are treated by the selling banking organization as sold for risk-based capital purposes, and excluded from a bank's balance sheet assets or the credit equivalent amount of a bank holding company's off-balance sheet items, in the same manner as prescribed in the instructions to the Call Report. As noted earlier, these footnotes reflect the existing Call Report and risk-based capital treatment with respect to such assets sold subject to loss sharing arrangements.

In addition, the Board notes that the Board and the other banking agencies, under the auspices of the Federal Financial Institutions Examination Counsel (FFIEC), have been working together to develop revisions to the agencies' risk-based capital standards that will better distinguish between the degrees of risk in loss sharing arrangements involving asset sales in general. In this regard, on December 16, 1993, the Board approved a recommendation from the Federal Financial Institution Examination Council to seek public comment on a Notice of Proposed Rulemaking and an Advanced Notice of Proposed Rulemaking concerning the regulatory treatment of assets sold subject to loss sharing arrangements. To the extent these proposals apply to multifamily housing loans, they would, if adopted, also satisfy the requirements of section 618(b)(3) of RTCRRIA.

Finally, the Board finds, for good cause, that an immediate effective date is necessary in order to serve the public interest, avoid confusion, and expedite the reporting of a capital charge that is commensurate with the risks associated with multifamily housing loans that meet the specified criteria. A December 31, 1993 effective date will enable banking organizations to use the reduced risk weight for multifamily housing loans in their end-of-year regulatory reports. In addition, the Board believes this effective date is appropriate because the revision would reduce, rather than expand, regulatory burden.

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 final rule would reduce certain regulatory burdens on bank holding companies as it would reduce the capital charge on certain transactions. In addition, because the risk-based 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.

List of Subjects

12 CFR Part 208

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

12 CFR Part 225

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

For the reasons set forth in the preamble the Board is amending 12 CFR parts 208 and 225 to read as follows:

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

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

Authority: 12 U.S.C. 36, 248(a) and (c), 321–338, 461, 481–486, 601, 611, 1814, 1823(j), 1831o, 1831p–1, 3906–3909, 3310, 3331–3351; 15 U.S.C. 78b, 78o–4(c)(5), 78q, 78q–1, 78w, 781(b), 781(i), and 1781(g).

2. Appendix A to part 208 is amended by revising the first paragraph of section III.C.3., and Category 3 Item 1. of Attachment III to read as follows:

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

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

* * * * *

C. Risk Weights

* * * * *

3. *Category 3: 50 percent.* This category includes loans fully secured by first liens [34] on 1- to 4-family residential properties, either owner-occupied or rented, or on multifamily residential properties,[35] that meet certain criteria.[36] Loans included in this category must have been made in accordance with prudent underwriting standards;[37] be performing in accordance with their original terms; and not be 90 days or more past due or carried in nonaccrual status. The followin[g] additional criteria must also be applied to a loan secured by a multifamily residential property that is included in this category: all principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or in the case where the existing property owne[r] is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placemen[t] in this category; amortization of the principa[l] and interest must occur over a period of not more than 30 years and the minimum original maturity for repayment of principal must not be less than 7 years; and the annua[l] net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a

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

[35] Loans that qualify as loans secured by 1- to 4-family residential properties or multifamily residential properties are listed in the instructions to the commercial bank Call Report. In addition, for risk-based capital purposes, loans secured by 1- to 4-family residential properties include loans to builders with substantial project equity for the construction of 1- to 4-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest money deposits.

The instructions to the Call Report also discuss the treatment of loans, including multifamily housing loans, that are sold subject to a pro rata lo[ss] sharing arrangement. Such an arrangement should be treated by the selling bank as sold (and exclude[d] from balance sheet assets) to the extent that the sales agreement provides for the purchaser of the loan to share in any loss incurred on the loan on a pro rata basis with the selling bank. In such a transaction, from the standpoint of the selling ban[k] the portion of the loan that is treated as sold is no[t] subject to the risk-based capital standards. In connection with sales of multifamily housing loa[ns] in which the purchaser of a loan shares in any los[s] incurred on the loan with the selling institution o[n] other than a pro rata basis, these other loss sharin[g] arrangements are taken into account for purposes [of] determining the extent to which such loans are treated by the selling bank as sold (and excluded from balance sheet assets) under the risk-based capital framework in the same manner as prescrib[ed] for reporting purposes in the instructions to the C[all] Report.

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

[37] Prudent underwriting standards include a conservative ratio of the current loan balance to t[he] value of the property. In the case of a loan secure[d] by multifamily residential property, the loan-to-value ratio is not conservative if it exceeds 80 percent (75 percent if the loan is based on a floati[ng] interest rate). Prudent underwriting standards als[o] dictate that a loan-to-value ratio used in the case [of] originating a loan to acquire a property would no[t] be deemed conservative unless the value is based on the lower of the acquisition cost of the proper[ty] or appraised (or if appropriate, evaluated) value. Otherwise, the loan-to-value ratio generally woul[d] be based upon the value of the property as determined by the most current appraisal, or if appropriate, the most current evaluation. All appraisals must be made in a manner consistent with the Federal banking agencies' real estate appraisal regulations and guidelines and with th[e] bank's own appraisal guidelines.

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cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in this category are privately-issued mortgage-backed securities provided that

(1) The structure of the security meets the criteria described in section III(B)(3) above;

(2) If the security is backed by a pool of conventional mortgages, on 1- to 4-family residential or multifamily residential properties each underlying mortgage meets the criteria described above in this section for eligibility for the 50 percent risk category at the time the pool is originated;

(3) If the security is backed by privately-issued mortgage-backed securities, *each* underlying security qualifies for the 50 percent risk category; and

(4) If the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due.

Privately-issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

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Attachment III—Summary of Risk Weights and Risk Categories for State Member Banks

* * * * *

Category 3: 50 Percent

1. Loans fully secured by first liens on 1- to 4-family residential properties or on multifamily residential properties that have been made in accordance with prudent underwriting standards, that are performing in accordance with their original terms, that are not past due or in nonaccrual status, and that meet other qualifying criteria, and certain privately-issued mortgage-backed securities representing indirect ownership of such loans. (Loans made for speculative purposes are excluded.)

* * * * *

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

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

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

2. Appendix A to part 225 is amended by revising the first paragraph of section II.C.3., footnote 48 in section III.D.1., and Category 3 Item 1. of Attachment III to read as follows:

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

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

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C. Risk Weights

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3. *Category 3: 50 percent.* This category includes loans fully secured by first liens[37] on 1- to 4-family residential properties, either owner-occupied or rented, or on multifamily residential properties,[38] that meet certain criteria.[39] Loans included in this category must have been made in accordance with prudent underwriting standards;[40] be performing in accordance with their original terms; and not be 90 days or more past due or carried in nonaccrual status. The following additional criteria must also be applied to a loan secured by a multifamily residential property that is included in this category: all principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or in the case where the existing property owner is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; amortization of the principal and interest must occur over a period of not more than 30 years and the minimum original maturity for repayment of principal must not be less than 7 years; and the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in this category are privately-issued mortgage-backed securities provided that:

(1) The structure of the security meets the criteria described in section III(B)(3) above;

(2) if the security is backed by a pool of conventional mortgages, on 1- to 4-family residential or multifamily residential properties, each underlying mortgage meets the criteria described above in this section for eligibility for the 50 percent risk category at the time the pool is originated;

(3) If the security is backed by privately-issued mortgage-backed securities, each underlying security qualifies for the 50 percent risk category; and

(4) If the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due. Privately-issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

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D. Off-Balance Sheet Items

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1. * * * [48]

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Attachment III—Summary of Risk Weights and Risk Categories for Bank Holding Companies

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Category 3: 50 Percent

1. Loans fully secured by first liens on 1- to 4-family residential properties or on multifamily residential properties that have been made in accordance with prudent underwriting standards, that are performing in accordance with their original terms, that are not past due or in nonaccrual status, and that meet other qualifying criteria, and certain privately-issued mortgage-backed securities representing indirect ownership of

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

[38] Loans that qualify as loans secured by 1- to 4-family residential properties or multifamily residential properties are listed in the instructions to the FR Y–9C Report. In addition, for risk-based capital purposes, loans secured by 1- to 4-family residential properties include loans to builders with substantial project equity for the construction of 1- to 4-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest money deposits.

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

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

[48] In regulatory reports and under GAAP, bank holding companies are permitted to treat some asset sales with recourse as "true" sales. For risk-based capital purposes, however, such assets sold with recourse and reported as "true" sales by bank holding companies are converted at 100 percent and assigned to the risk category appropriate to the underlying obligor or, if relevant the guarantor or nature of the collateral, provided that the transactions meet the definition of assets sold with recourse (including assets sold subject to pro rata and other loss sharing arrangements), that is contained in the instructions to the commercial bank Consolidated Reports of Condition and Income (Call Report). This treatment applies to any assets, including the sale of 1- to 4-family and multifamily residential mortgages, sold with recourse. Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of 1- to 4-family residential mortgages, are to be converted at 100 percent and assigned to the risk category appropriate to the obligor, or if relevant, the nature of any collateral or guarantees. The only exception involves transfers of pools of residential mortgages that have been made with insignificant recourse for which a liability or specific non-capital reserve has been established and is maintained for the maximum amount of possible loss under the recourse provision.

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such loans. (Loans made for speculative purposes are excluded.)

* * * * *

Board of Governors of the Federal Reserve System, December 17, 1993.

William W. Wiles,

Secretary of the Board.

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