FEDERAL RESERVE BANK
OF NEW YORK

AT. 10719
June 29, 1994

To All Depository Institutions in the Second Federal Reserve District, and Others Maintaining Sets of Board Regulations:

Enclosed are the following documents issued by the Board of Governors of the Federal Reserve System:

1) Regulation A, "Extensions of Credit by Federal Reserve Banks," as amended effective January 30, 1994; and

2) Capital Adequacy Guidelines, pamphlet dated May 1994:

--"Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure," as amended effective December 31, 1993 (Regulation H, Appendix A);

--"Capital Adequacy Guidelines for State Member Banks: Tier 1 Leverage Measure," as amended effective March 9, 1993 (Regulation H, Appendix B);

--"Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure," as amended effective December 31, 1993 (Regulation Y, Appendix A);

--"Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks: Leverage Measure," as amended effective September 7, 1990 (Regulation Y, Appendix B); and

--"Capital Adequacy Guidelines for Bank Holding Companies: Tier 1 Leverage Measure," as amended effective March 9, 1993 (Regulation Y, Appendix D).

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Board of Governors of the Federal Reserve System

Regulation A
Extensions of Credit
by Federal Reserve Banks

12 CFR 201; as amended effective January 30, 1994

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

May 1994

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Regulation A
Extensions of Credit by Federal Reserve Banks

12 CFR 201; as amended effective January 30, 1994

SECTION 201.1—Authority, Scope and Purpose

(a) *Authority and scope.* This part* is issued under the authority of sections 10A, 10B, 13, 13A, and 19 of the FRA (12 USC 347a, 347b, 343 et seq., 347c, 348 et seq., 374, 374a, and 461), other provisions of the FRA, and section 7(b) of the International Banking Act of 1978 (12 USC 347d) and relates to extensions of credit by Federal Reserve Banks to depository institutions and others.

(b) *Purpose.* This part establishes rules under which Federal Reserve Banks may extend credit to depository institutions and others. Extending credit to depository institutions to accommodate commerce, industry, and agriculture is a principal function of Federal Reserve Banks. While open market operations are the primary means of affecting the overall supply of reserves, the lending function of the Federal Reserve Banks is an effective method of supplying reserves to meet the particular credit needs of individual depository institutions. The lending functions of the Federal Reserve System are conducted with due regard to the basic objectives of monetary policy and the maintenance of a sound and orderly financial system.

SECTION 201.2—Definitions

For purposes of this part, the following definitions shall apply:

(a) *Appropriate federal banking agency* has the same meaning as in section 3 of the FDI Act (12 USC 1813(q)).

(b) *Critically undercapitalized insured depository institution* means any insured depository institution as defined in section 3 of the FDI Act (12 USC 1813(c)(2)) that is deemed to be critically undercapitalized under section 38 of the FDI Act (12 USC 1831o(b)(1)(E)) and the implementing regulations.

(c) (1) *Depository institution* means an institution that maintains reservable transaction accounts or nonpersonal time deposits and is—

(i) an insured bank as defined in section 3 of the FDI Act (12 USC 1813(h)) or a bank which is eligible to make application to become an insured bank under section 5 of such act (12 USC 1815);

(ii) a mutual savings bank as defined in section 3 of the FDI Act (12 USC 1813(f)) or a bank which is eligible to make application to become an insured bank under section 5 of such act (12 USC 1815);

(iii) A savings bank as defined in section 3 of the FDI Act (12 USC 1813(g)) or a bank which is eligible to make application to become an insured bank under section 5 of such act (12 USC 1815);

(iv) An insured credit union as defined in section 101 of the Federal Credit Union Act (12 USC 1752(7)) or a credit union which is eligible to make application to become an insured credit union pursuant to section 201 of such Act (12 USC 1781);

(v) A member as defined in section 2 of the Federal Home Loan Bank Act (12 USC 1422(4)); or

(vi) A savings association as defined in section 3 of the FDI Act (12 USC 1813(b)) which is an insured depository institution as defined in section 3 of the act (12 USC 1813(c)(2)) or is eligible to apply to become an insured depository institution under section 5 of the act (12 USC 1815(a)).

(2) The term *depository institution* does not include a financial institution that is not required to maintain reserves under Regulation D (12 CFR 204) because it is organized solely to do business with other financial institutions, is owned primarily by the financial institutions with which it does

* The words "this part," as used herein, mean Regulation A (Code of Federal Regulations, title 12, chapter II, part 201).

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business, and does not do business with the general public.

(d) *Liquidation loss* means the loss that any deposit insurance fund in the FDIC would have incurred if the FDIC had liquidated the institution—

(1) in the case of an undercapitalized insured depository institution, as of the end of the later of—

(i) 60 days—

(A) in any 120-day period;

(B) during which the institution was an undercapitalized insured depository institution; and

(C) during which advances or discounts were outstanding to the depository institution from any Federal Reserve Bank; or

(ii) the 60-calendar-day period following the receipt by a Federal Reserve Bank of a written certification from the chairman of the Board of Governors or the head of the appropriate federal banking agency that the institution is viable.

(2) in the case of a critically undercapitalized insured depository institution, as of the end of the 5-day period beginning on the date the institution became a critically undercapitalized insured depository institution.

(e) *Increased loss* means the amount of loss to any deposit insurance fund in the FDIC that exceeds the liquidation loss due to—

(1) an advance under section 10B(1)(a) of the FRA that is outstanding to an undercapitalized or critically undercapitalized insured depository institution without payment having been demanded as of the end of the periods specified in paragraphs (d)(1) and (2) of this section; or

(2) an advance under section 10B(1)(a) of the Federal Reserve Act that is made after the end of such periods.

(f) *Excess loss* means the lesser of the increased loss or that portion of the increased loss equal to the lesser of—

(1) the loss the Board of Governors or any Federal Reserve Bank would have incurred on the amount by which advances under section 10B(1)(a) exceed the amount of advances outstanding at the end of the periods specified in paragraphs (d)(1) and (2) of this section if those increased advances had been unsecured; or

(2) the interest received on the amount by which the advances under section 10B(1)(a) exceed the amount of advances outstanding, if any, at the end of the periods specified in paragraphs (d)(1) and (2) of this section.

(g) *Transaction account and nonpersonal time deposit* have the meanings specified in Regulation D (12 CFR 204).

(h) *Undercapitalized insured depository institution* means any insured depository institution as defined in section 3 of the FDI Act (12 USC 1813(c)(2)) that—

(1) is not a critically undercapitalized insured depository institution; and

(2) (i) is deemed to be undercapitalized under section 38 of the FDI Act (12 USC 1831o(b)(1)(C)) and the implementing regulations; or

(ii) has received from its appropriate federal banking agency a composite CAMEL rating of 5 under the Uniform Financial Institutions Rating System (or an equivalent rating by its appropriate federal banking agency under a comparable rating system) as of the most recent examination of such institution.

(i) *Viable,* with respect to a depository institution, means that the Board of Governors or the appropriate federal banking agency has determined, giving due regard to the economic conditions and circumstances in the market in which the institution operates, that the institution is not critically undercapitalized, is not expected to become critically undercapitalized, and is not expected to be placed in conservatorship or receivership. Although there are a number of criteria that may be used to determine viability, the Board of Governors believes that ordinarily an undercapitalized insured depository institution is viable if the appropriate federal banking agency has accepted a capital restoration plan for the depository institution under 12 USC 1831o(e)(2) and the depository institution is complying with that plan.

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SECTION 201.3—Availability and Terms

(a) *Adjustment credit.* Federal Reserve Banks extend adjustment credit on a short-term basis to depository institutions to assist in meeting temporary requirements for funds or to cushion more persistent shortfalls of funds pending an orderly adjustment of a borrowing institution's assets and liabilities. Such credit generally is available only for appropriate purposes and after reasonable alternative sources of funds have been fully used, including credit from special industry lenders such as Federal Home Loan Banks, the National Credit Union Administration's Central Liquidity Facility, and corporate central credit unions. Adjustment credit is usually granted at the basic discount rate, but under certain circumstances a special rate or rates above the basic discount rate may be applied.

(b) *Seasonal credit.* Federal Reserve Banks extend seasonal credit for periods longer than those permitted under adjustment credit to assist smaller depository institutions in meeting regular needs for funds arising from expected patterns of movement in their deposits and loans. A special rate or rates at or above the basic discount rate may be applied to seasonal credit.

(1) Seasonal credit is only available if—

(i) the depository institution's seasonal needs exceed a threshold that the institution is expected to meet from other sources of liquidity (this threshold is calculated as certain percentages, established by the Board of Governors, of the institution's average total deposits in the preceding calendar year);

(ii) the Federal Reserve Bank is satisfied that the institution's qualifying need for funds is seasonal and will persist for at least four weeks; and

(iii) similar assistance is not available from special industry lenders.

(2) The Board may establish special terms for seasonal credit when depository institutions are experiencing unusual seasonal demands for credit in a period of liquidity strain.

(c) *Extended credit.* Federal Reserve Banks extend credit to depository institutions under extended credit arrangements where similar assistance is not reasonably available from other sources, including special industry lenders. Such credit may be provided where there are exceptional circumstances or practices affecting a particular depository institution including sustained deposit drains, impaired access to money market funds, or sudden deterioration in loan-repayment performance. Extended credit may also be provided to accommodate the needs of depository institutions, including those with longer-term asset portfolios, that may be experiencing difficulties adjusting to changing money market conditions over a longer period, particularly at times of deposit disintermediation. A special rate or rates above the basic discount rate may be applied to extended credit.

(d) *Emergency credit for others.* In unusual and exigent circumstances, a Federal Reserve Bank may, after consultation with the Board of Governors, advance credit to individuals, partnerships, and corporations that are not depository institutions if, in the judgment of the Federal Reserve Bank, credit is not available from other sources and failure to obtain such credit would adversely affect the economy. The rate applicable to such credit will be above the highest rate in effect for advances to depository institutions. Where the collateral used to secure such credit consists of assets other than obligations of, or fully guaranteed as to principal and interest by, the United States or an agency thereof, an affirmative vote of five or more members of the Board of Governors is required before credit may be extended.

SECTION 201.4—Limitations on Availability and Assessments

(a) *Advances to or discounts for undercapitalized insured depository institutions.* A Federal Reserve Bank may make or have outstanding advances to or discounts for a depository institution that it knows to be an undercapitalized insured depository institution, only—

(1) if, in any 120-day period, advances or discounts from any Federal Reserve Bank to that depository institution are not outstanding for more than 60 days during

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which the institution is an undercapitalized insured depository institution; or

(2) during the 60 calendar days after the receipt of a written certification from the chairman of the Board of Governors or the head of the appropriate federal banking agency that the borrowing depository institution is viable; or

(3) after consultation with the Board of Governors.[1]

(b) *Advances to or discounts for critically undercapitalized insured depository institutions.* A Federal Reserve Bank may make or have outstanding advances to or discounts for a depository institution that it knows to be a critically undercapitalized insured depository institution only—

(1) during the 5-day period beginning on the date the institution became a critically undercapitalized insured depository institution; or

(2) after consultation with the Board of Governors.[2]

(c) *Assessments.* The Board of Governors will assess the Federal Reserve Banks for any amount that it pays to the FDIC due to any excess loss. Each Federal Reserve Bank shall be assessed that portion of the amount that the Board of Governors pays to the FDIC that is attributable to an extension of credit by that Federal Reserve Bank, up to 1 percent of its capital as reported at the beginning of the calendar year in which the assessment is made. The Board of Governors will assess all of the Federal Reserve Banks for the remainder of the amount it pays to the FDIC in the ratio that the capital of each Federal Reserve Bank bears to the total capital of all Federal Reserve Banks at the beginning of the calendar year in which the assessment is made, provided, however, that if any assessment exceeds 50 percent of the total capital and surplus of all Federal Reserve Banks, whether to distribute the excess over such 50 percent shall be made at the discretion of the Board of Governors.

[1] In unusual circumstances, when prior consultation with the Board is not possible, a Federal Reserve Bank should consult with the Board as soon as possible after extending credit that requires consultation under this paragraph.

[2] See footnote 1 in section 201.4(a)(3).

(d) *Information.* Before extending credit a Federal Reserve Bank should ascertain if an institution is an undercapitalized insured depository institution or a critically undercapitalized insured depository institution.

SECTION 201.5—Advances and Discounts

(a) Federal Reserve Banks may lend to depository institutions either through advances secured by acceptable collateral or through the discount of certain types of paper. Credit extended by the Federal Reserve Banks generally takes the form of an advance.

(b) Federal Reserve Banks may make advances to any depository institution if secured to the satisfaction of the Federal Reserve Bank. Satisfactory collateral generally includes United States government and federal-agency securities, and, if of acceptable quality, mortgage notes covering one- to four-family residences, state and local government securities, and business, consumer, and other customer notes.

(c) If a Federal Reserve Bank concludes that a depository institution will be better accommodated by the discount of paper than by an advance, it may discount any paper endorsed by the depository institution that meets the requirements specified in the FRA.

SECTION 201.6—General Requirements

(a) *Credit for capital purposes.* Federal Reserve credit is not a substitute for capital.

(b) *Compliance with law and regulation.* All credit extended under this part shall comply with applicable requirements of law and of this part. Each Federal Reserve Bank—

(1) shall keep itself informed of the general character and amount of the loans and investments of depository institutions with a view to ascertaining whether undue use is being made of depository-institution credit for the speculative carrying of or trading in securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions; and

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(2) shall consider such information in determining whether to extend credit.

(c) *Information.* A Federal Reserve Bank shall require any information it believes appropriate or desirable to ensure that paper tendered as collateral for advances or for discount is acceptable and that the credit provided is used in a manner consistent with this part.

(d) *Indirect credit for others.* No depository institution shall act as the medium or agent of another depository institution in receiving Federal Reserve credit except with the permission of the Federal Reserve Bank extending credit.

SECTION 201.7—Branches and Agencies

(a) Except as may be otherwise provided, this part shall be applicable to United States branches and agencies of foreign banks subject to reserve requirements under Regulation D (12 CFR 204) in the same manner and to the same extent as depository institutions.

SECTION 201.8—Federal Intermediate Credit Banks

(a) A Federal Reserve Bank may discount for any Federal Intermediate Credit Bank agricultural paper or notes payable to and bearing the endorsement of the Federal Intermediate Credit Bank that cover loans or advances made under subsections (a) and (b) of section 2.3 of the Farm Credit Act of 1971 (12 USC 2074) and that are secured by paper eligible for discount by Federal Reserve Banks. Any paper so discounted shall have a period remaining to maturity at the time of discount of not more than nine months.

SECTION 201.9—No Obligation to Make Advances or Discounts

(a) A Federal Reserve Bank shall have no obligation to make, increase, renew, or extend any advance or discount to any depository institution.

SECTION 201.51—Short-Term Adjustment Credit for Depository Institutions

The rates for short-term adjustment credit provided to depository institutions under section 201.3(a) of Regulation A are:

Federal Reserve Bank	*Rate*	*Effective*
Boston	3.0	July 2, 1992
New York	3.0	July 2, 1992
Philadelphia	3.0	July 2, 1992
Cleveland	3.0	July 6, 1992
Richmond	3.0	July 2, 1992
Atlanta	3.0	July 2, 1992
Chicago	3.0	July 2, 1992
St. Louis	3.0	July 7, 1992
Minneapolis	3.0	July 2, 1992
Kansas City	3.0	July 2, 1992
Dallas	3.0	July 2, 1992
San Francisco	3.0	July 2, 1992

SECTION 201.52—Extended Credit for Depository Institutions

(a) *Seasonal credit.* The rate for seasonal credit extended to depository institutions under section 201.3(b)(1) is a flexible rate that takes into account rates on market sources of funds, but in no case will the rate charged be less than the rate for short-term adjustment credit as set out in section 201.51.

Federal Reserve Bank	*Rate*	*Effective*
Boston	3.0	July 2, 1992
New York	3.0	July 2, 1992
Philadelphia	3.0	July 2, 1992
Cleveland	3.0	July 6, 1992
Richmond	3.0	July 2, 1992
Atlanta	3.0	July 2, 1992
Chicago	3.0	July 2, 1992
St. Louis	3.0	July 7, 1992
Minneapolis	3.0	July 2, 1992
Kansas City	3.0	July 2, 1992
Dallas	3.0	July 2, 1992
San Francisco	3.0	July 2, 1992

(b) *Other extended credit.* The rates for other extended credit provided to depository institutions under sustained liquidity pressures or

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where there are exceptional circumstances or practices involving a particular institution under section 201.3(b)(2) are:

Federal Reserve Bank	*Rate*	*Effective*
Boston	3.0	July 2, 1992
New York	3.0	July 2, 1992
Philadelphia	3.0	July 2, 1992
Cleveland	3.0	July 6, 1992
Richmond	3.0	July 2, 1992
Atlanta	3.0	July 2, 1992
Chicago	3.0	July 2, 1992
St. Louis	3.0	July 7, 1992
Minneapolis	3.0	July 2, 1992
Kansas City	3.0	July 2, 1992
Dallas	3.0	July 2, 1992
San Francisco	3.0	July 2, 1992

These rates apply for the first 30 days of borrowing. For credit outstanding for more than 30 days, a flexible rate will be charged that takes into account rates on market sources of funds, but in no case will the rate charged be less than the rate for short-term adjustment credit, as set out in section 201.51, plus one-half percentage point. Where extended credit provided to a particular depository institution is anticipated to be outstanding for an unusually prolonged period and in relatively large amounts, the 30-day time period may be shortened.

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SECTION 10B*—Advances to Individual Member Banks

(a) Any Federal Reserve Bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, may make advances to any member bank on its time or demand notes having maturities of not more than four months and which are secured to the satisfaction of such Federal Reserve Bank. Notwithstanding the foregoing, any Federal Reserve Bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, may make advances to any member bank on its time notes having such maturities as the Board may prescribe and which are secured by mortgage loans covering a one-to-four family residence. Such advances shall bear interest at a rate equal to the lowest discount rate in effect at such Federal Reserve Bank on the date of such note.

[12 USC 347b(a). As added by act of Feb. 27, 1932 (47 Stat. 56); and amended by acts of Feb. 3, 1933 (47 Stat. 794); March 9, 1933 (48 Stat. 7); Aug. 23, 1935 (49 Stat. 705); Oct. 18, 1974 (88 Stat. 1368); March 31, 1980 (94 Stat. 140); and Dec. 19, 1991 (105 Stat. 2279).]

(b) *Limitations on advances.*

(1) Except as provided in paragraph (2), no advances to any undercapitalized depository institution by any Federal Reserve bank under this section may be outstanding for more than 60 days in any 120-day period.

(2) (A) If—

(i) the head of the appropriate Federal banking agency certifies in advance in writing to the Federal Reserve bank that any depository institution is viable; or

(ii) the Board conducts an examination of any depository institution and the Chairman of the Board certifies in writing to the Federal Reserve bank that the institution is viable,

the limitation contained in paragraph (1) shall not apply during the 60-day period beginning on the date such certification is received.

(B) The 60-day period may be extended for additional 60-day periods upon receipt by the Federal Reserve bank of additional written certifications under subparagraph (A) with respect to each such additional period.

(C) The authority of the head of any agency to issue a written certification of viability under this paragraph may not be delegated to any other person.

(D) Notwithstanding paragraph (1), an undercapitalized depository institution which does not have a certificate of viability in effect under this paragraph may have advances outstanding for more than 60 days in any 120-day period if the Board elects to treat—

(i) such institution as critically undercapitalized under paragraph (3); and

(ii) any such advance as an advance described in subparagraph (A)(i) of paragraph (3).

(3) (A) Notwithstanding any other provision of this section, if—

(i) in the case of any critically undercapitalized depository institution—

(I) any advance under this section to such institution is outstanding without payment having been demanded as of the end of the 5-day period beginning on the date the institution becomes a critically undercapitalized institution; or

(II) any new advance is made to such institution under this section after the end of such period; and

(ii) after the end of that 5-day period, any deposit insurance fund in the Federal Deposit Insurance Corporation incurs a loss exceeding the loss that the Corporation would have incurred if it had liquidated that institution as of the end of that period,

the Board shall, subject to the limitations in subparagraph (B), be liable to the Federal Deposit Insurance Corporation for

* Previously section 10(b), this section was redesignated by act of Dec. 19, 1991 (105 Stat. 2279).

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the excess loss, without regard to the terms of the advance or any collateral pledged to secure the advance.

(B) The liability of the Board under subparagraph (A) shall not exceed the lesser of the following:

(i) The amount of the loss the Board or any Federal Reserve bank would have incurred on the increases in the amount of advances made after the 5-day period referred to in subparagraph (A) if those increased advances had been unsecured.

(ii) The interest received on the increases in the amount of advances made after the 5-day period referred to in subparagraph (A).

(C) The Board shall pay the Federal Deposit Insurance Corporation the amount of any liability of the Board under subparagraph (A).

(D) The Board shall report to the Congress on any excess loss liability it incurs under subparagraph (A), as limited by subparagraph (B)(i), and the reasons therefore, not later than 6 months after incurring the liability.

(4) A Federal Reserve bank shall have no obligation to make, increase, renew, or extend any advance or discount under this Act to any depository institution.

(5) (A) The term "*appropriate Federal banking agency*" has the same meaning as in section 3 of the Federal Deposit Insurance Act.

(B) The term "*critically undercapitalized*" has the same meaning as in section 38 of the Federal Deposit Insurance Act.

(C) The term "*depository institution*" has the same meaning as in section 3 of the Federal Deposit Insurance Act.

(D) The term "*undercapitalized depository institution*" means any depository institution which—

(i) is undercapitalized, as defined in section 38 of the Federal Deposit Insurance Act; or

(ii) has a composite CAMEL rating of 5 under the Uniform Financial Institutions Rating System (or an equivalent rating by any such agency under a comparable rating system) as of the most recent examination of such institution.

(E) A depository institution is "*viable*" if the Board or the appropriate Federal banking agency determines, giving due regard to the economic conditions and circumstances in the market in which the institution operates, that the institution—

(i) is not critically undercapitalized;

(ii) is not expected to become critically undercapitalized; and

(iii) is not expected to be placed in conservatorship or receivership.

[12 USC 347b(b). As added by act of Dec. 19, 1991 (105 Stat. 2279).]

SECTION 13—Powers of Federal Reserve Banks

* * * * *

3. Discounts for Individuals, Partnerships, and Corporations

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve Bank, during such periods as the said Board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve Bank: *Provided,* That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal Reserve Bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

[12 USC 343. As added by act of July 21, 1932 (47 Stat. 715) and amended by acts of Aug. 23, 1935 (49 Stat. 714) and Dec. 19, 1991 (105 Stat. 2386).]

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13. Advances to Individuals, Partnerships, and Corporations on Obligations of United States

Subject to such limitations, restrictions and regulations as the Board of Governors of the Federal Reserve System may prescribe, any Federal Reserve Bank may make advances to any individual, partnership or corporation on the promissory notes of such individual, partnership or corporation secured by direct obligations of the United States or by any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States. Such advances shall be made for periods not exceeding 90 days and shall bear interest at rates fixed from time to time by the Federal Reserve Bank, subject to the review and determination of the Board of Governors of the Federal Reserve System.

[12 USC 347c. As added by act of March 9, 1933 (48 Stat. 7) and amended by act of Sept. 21, 1968 (82 Stat. 856).]

14. Receipt of Deposits from, Discount Paper Endorsed by, and Advances to Foreign Banks

Subject to such restrictions, limitations, and regulations as may be imposed by the Board of Governors of the Federal Reserve System, each Federal Reserve Bank may receive deposits from, discount paper endorsed by, and make advances to any branch or agency of a foreign bank in the same manner and to the same extent that it may exercise such powers with respect to a member bank if such branch or agency is maintaining reserves with such Reserve Bank pursuant to section 7 of the International Banking Act of 1978. In exercising any such powers with respect to any such branch or agency, each Federal Reserve Bank shall give due regard to account balances being maintained by such branch or agency with such Reserve Bank and the proportion of the assets of such branch or agency being held as reserves under section 7 of the International Banking Act of 1978.

[12 USC 347d. As added by act of Sept. 17, 1978 (92 Stat. 621).]

SECTION 19—Bank Reserves

(b) *Reserve requirements*

*   *   *   *   *

(7) *Discount and borrowing.* Any depository institution in which transaction accounts or nonpersonal time deposits are held shall be entitled to the same discount and borrowing privileges as member banks. In the administration of discount and borrowing privileges, the Board and the Federal Reserve banks shall take into consideration the special needs of savings and other depository institutions for access to discount and borrowing facilities consistent with their long-term asset portfolios and the sensitivity of such institutions to trends in the national money markets.

[12 USC 461(b)(7). As amended by acts of Sept. 21, 1966 (80 Stat. 823) and March 31, 1980 (94 Stat. 133).]

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Capital Adequacy Guidelines

12 CFR 208, appendix A; as amended effective December 31, 1993
12 CFR 208, appendix B; as amended effective March 9, 1993
12 CFR 225, appendix A; as amended effective December 31, 1993
12 CFR 225, appendix B; as amended effective September 7, 1990
12 CFR 225, appendix D; as amended effective March 9, 1993

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

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

Regulation H (12 CFR 208), Appendix A; as amended effective December 31, 1993

I. Overview

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

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

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

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

The risk-based capital ratio focuses principally on broad categories of credit risk, although the framework for assigning assets and off-balance-sheet items to risk categories does incorporate elements of transfer risk, as well as limited instances of interest-rate and market risk. The risk-based ratio does not, however, incorporate other factors that can affect a bank's financial condition. These factors include overall interest-rate exposure; liquidity, funding and market risks; the quality and level of earnings; investment or loan-portfolio concentrations; the quality of loans and investments; the effectiveness of loan and investment policies; and management's ability to monitor and control financial and operating risks.

In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of these other factors, including, in particular, the level and severity of problem and classified assets. For this reason, the final supervisory judgment on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio.

The risk-based capital guidelines establish *minimum* ratios of capital to weighted-risk assets. In light of the considerations just discussed, banks generally are expected to operate well above the minimum risk-based ratios. In particular, banks contemplating significant

[1] Supervisory ratios that relate capital to total assets for state member banks are outlined in appendix B of Regulation H (page 29) and in appendix B to part 225 of the Federal Reserve's Regulation Y, 12 CFR 225 (page 59).

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

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

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

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

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

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

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

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

A. The Components of Qualifying Capital

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

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

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

a. *Common stockholders' equity.* Common stockholders' equity includes common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any treasury stock.

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

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

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

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right to defer or eliminate preferred dividends.

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

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

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

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

i. allowance for loan and lease losses (subject to limitations discussed below)

ii. perpetual preferred stock and related surplus (subject to conditions discussed below)

iii. hybrid capital instruments (as defined below) and mandatory convertible debt securities

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

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

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

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

During the transition period, the risk-based capital guidelines provide for reducing the amount of this allowance that may be included in an institution's total capital. Initially, it is unlimited. However, by year-end 1990, the amount of the allowance for loan and lease losses that will qualify as capital will be limited to 1.5 percent of an institution's weighted risk assets. By the end of the transition period, the amount of

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[6] Reserved.

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

[8] The Basle capital framework also provides for the inclusion of "undisclosed reserves" in tier 2. As defined in the framework, undisclosed reserves represent accumulated after-tax retained earnings that are not disclosed on the balance sheet of a bank. Apart from the fact that these reserves are not disclosed publicly, they are essentially of the same quality and character as retained earnings, and, to be included in capital, such reserves must be accepted by the bank's home supervisor. Although such undisclosed reserves are common in some countries, under generally accepted accounting principles (GAAP) and long-standing supervisory practice, these types of reserves are not recognized for state member banks.

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

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the allowance qualifying for inclusion in tier 2 capital may not exceed 1.25 percent of weighted risk assets.[10]

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

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

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

Mandatory convertible debt securities in the form of equity contract notes that meet the criteria set forth in 12 CFR 225, appendix B (page 59) also qualify as unlimited elements of tier 2 capital. In accordance with that appendix, equity commitment notes issued prior to May 15, 1985, also qualify for inclusion in tier 2.

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

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

In the case of subordinated debt, the in-

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

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

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

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

f. *Revaluation reserves.* Such reserves reflect the formal balance sheet restatement or revaluation for capital purposes of asset carrying values to reflect current market values. In the United States, banks, for the most part, follow GAAP when preparing their financial statements, and GAAP generally does not permit the use of marketvalue accounting. For this and other reasons, the federal banking agencies generally have not included unrealized asset values in capital ratio calculations, although they have long taken such values into account as a separate factor in assessing the overall financial strength of a bank.

Consistent with long-standing supervisory practice, the excess of market values over book values for assets held by state member banks will generally not be recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all banks are encouraged to disclose their equivalent of premises (building) and equity revaluation reserves. Such values will be taken into account as additional considerations in assessing overall capital strength and financial condition.

B. *Deductions from Capital and Other Adjustments*

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

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

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

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

1. *Goodwill and other intangible assets*

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

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

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

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b. *Other intangible assets.* The only types of identifiable intangible assets thay 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.

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.

2. *Investments in certain subsidiaries.* The aggregate amount of investments in banking or finance subsidiaries[15] whose financial statements are not consolidated for accounting or

[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 determinng tier 1 capital. However, indentifiable 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.

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

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bank regulatory reporting purposes will be deducted from a bank's total capital components.[16] Generally, investments for this purpose are defined as equity and debt capital investments and any other instruments that are deemed to be capital in the particular subsidiary.

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

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

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

The Federal Reserve will not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies.[17] Nonetheless, the resources invested in these entities, like investments in unconsolidated banking and finance subsidiaries, support assets not consolidated with the rest of the bank's activities and, therefore, may not be generally available to support additional leverage or absorb losses elsewhere in the bank. Moreover, experience has shown that banks stand behind the losses of affiliated institutions, such as joint ventures and associated companies, in order to protect the reputation of the organization as a whole. In some cases, this has led to losses that have exceeded the investments in such organizations.

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

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

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

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

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

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

Reciprocal holdings are cross-holdings resulting from formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other's capital instruments. Generally, deductions will be limited to intentional cross-holdings. At present, the Board does not intend to require banks to deduct nonreciprocal holdings of such capital instruments.[19, 20]

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

A. Procedures

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

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

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

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

[18] See 12 CFR 225, appendix A (page 31) for instruments that qualify as tier 1 and tier 2 capital for bank holding companies.

[19] Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's policy statement on nonvoting equity investments, 12 CFR 225.143 (*Federal Reserve Regulatory Service* 4–172.1). 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.

[20] 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.

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

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risk category, unless some other treatment is explicitly permitted.

B. Collateral, Guarantees, and Other Considerations

1. *Collateral.* The only forms of collateral that are formally recognized by the risk-based capital framework are cash on deposit in the bank; securities issued or guaranteed by the central governments of the OECD-based group of countries,[22] U.S. government agencies, or U.S. government–sponsored agencies; and securities issued by multilateral lending institutions or regional development banks. Claims fully secured by such collateral generally are assigned to the 20 percent risk-weight category. Collateralized transactions meeting all the conditions described in section III.C.1. may be assigned a zero percent risk weight.

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

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

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

3. *Mortgage-backed securities.* Mortgage-backed securities, including pass-throughs and collateralized mortgage obligations (but not stripped mortgage-backed securities), that are *issued* or *guaranteed* by a U.S. government agency or U.S. government–sponsored agency are assigned to the risk-weight category appropriate to the issuer or guarantor. Generally, a privately issued mortgage-backed security meeting certain criteria set forth in the accompanying footnote[23] is treated as essentially an

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

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

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indirect holding of the underlying assets, and assigned to the same risk category as the underlying assets, but in no case to the zero percent risk category. Privately issued mortgage-backed securities whose structures do not qualify them to be regarded as indirect holdings of the underlying assets are assigned to the 100 percent risk category. During the examination process, privately issued mortgage-backed securities that are assigned to a lower risk-weight category will be subject to examiner review to ensure that they meet the appropriate criteria.

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

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

C. Risk Weights

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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3. *Category 3: 50 percent.* This category includes loans fully secured by first liens[34] on one- to four-family residential properties, either owner-occupied or rented, or on multifamily residential properties,[35] that meet certain criteria.[36] Loans included in this category must have been made in accordance with prudent underwriting standards;[37] be performing in accordance with their original terms; and not be 90 days or more past due or carried in nonaccrual status. The following additional criteria must also be applied to a loan secured by a multifamily residential property that is included in this category: all principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or in the case where the existing property owner is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; amortization of the principal and interest must occur over a period of not more that 30 years and the minimum original maturity for repayment of principal must not be less than 7 years; and the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in this category are privately issued mortgage-backed securities provided that (1) the structure of the security meets the criteria described in section III(B)(3) above; (2) if the security is backed by a pool of conventional mortgages, on one- to four-family residential or multifamily residential properties, *each* underlying mortgage meets the criteria described above in this section for eligibility for the 50 percent risk category at the time the pool is originated; (3) if the security is backed by privately issued mortgage-backed securities, *each* underlying security qualifies for the 50 percent risk category; and (4) if the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due. Privately issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

Also assigned to this category are *revenue* (nongeneral obligation) bonds or similar obligations, including loans and leases, that are obligations of states or other political subdivisions of the U.S. (for example, municipal rev-

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

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

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

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

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

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enue bonds) or other countries of the OECD-based group, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds.

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

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

This category includes long-term claims on, or guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[38] This category also includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding involving standard risk claims;[39] investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans for residential property that qualify for a lower risk weight); mortgage-backed securities that do not meet criteria for assignment to a lower risk weight (including any classes of mortgage-backed securities that can absorb more than their pro rata share of loss without the whole issue being in default); and all stripped mortgage-backed and similar securities.

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

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

D. Off-Balance-Sheet Items

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

1. *Items with a 100 percent conversion factor.* A 100 percent conversion factor applies to direct credit substitutes, which include guarantees, or equivalent instruments, backing financial claims, such as outstanding securities, loans, and other financial liabilities, or that back off-balance-sheet items that require capital under the risk-based capital framework. Direct credit substitutes include, for example,

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

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

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

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financial standby letters of credit, or other equivalent irrevocable undertakings or surety arrangements, that guarantee repayment of financial obligations such as commercial paper, tax-exempt securities, commercial or individual loans or debt obligations, or standby or commercial letters of credit. Direct credit substitutes also include the acquisition of risk participations in banker's acceptances and standby letters of credit, since both of these transactions, in effect, constitute a guarantee by the acquiring bank that the underlying account party (obligor) will repay its obligation to the originating, or issuing, institution.[41] (Standby letters of credit that are performance-related are discussed below and have a credit conversion factor of 50 percent.)

The full amount of a direct credit substitute is converted at 100 percent and the resulting credit-equivalent amount is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor or the nature of the collateral. In the case of a direct credit substitute in which a risk participation[42] has been conveyed, the full amount is still converted at 100 percent. However, the credit-equivalent amount that has been conveyed is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after giving effect to any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation. Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the portion of a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the risk category appropriate to claims guaranteed by those institutions, that is, the 20 percent risk category.[43] This approach recognizes that such conveyances replace the originating bank's exposure to the obligor with an exposure to the institutions acquiring the risk participations.[44]

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

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

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

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

Sale and repurchase agreements and asset sales with recourse (to the extent not included on the balance sheet) and forward agreements also are converted at 100 percent. The risk-based capital definition of the sale of assets

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

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

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

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

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with recourse, including the sale of one- to four-family residential mortgages, is the same as the definition contained in the instructions to the commercial bank call report. Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of one- to four-family residential mortgages, are to be converted at 100 percent and assigned to the risk weight appropriate to the obligor, or if relevant, the nature of any collateral or guarantees. The 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. So-called loan strips (that is, short-term advances sold under long-term commitments without direct recourse) are defined in the instructions to the commercial bank call report and for risk-based capital purposes as assets sold with recourse.

Forward agreements are legally binding contractual obligations to purchase assets with *certain* drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[45] and partly paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign-exchange contracts.

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

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

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

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

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

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

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

Facilities that are unconditionally cancellable (without cause) at any time by the bank are not deemed to be commitments, provided the bank makes a separate credit decision before each drawing under the facility. Commitments with an original maturity of one year or less are deemed to involve low risk and, therefore, are not assessed a capital charge. Such short-term commitments are defined to include the unused portion of lines of credit on retail credit cards and related plans (as defined in the instructions to the commercial bank call report) if the bank has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

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

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

3. *Items with a 20 percent conversion factor.* Short-term, self-liquidating trade-related contingencies which arise from the movement of goods are converted at 20 percent. Such contingencies generally include commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

4. *Items with a zero percent conversion factor.* These include unused portions of commitments with an original maturity of one year or less,[48] or which are unconditionally cancellable at any time, provided a separate credit decision is made before each drawing under the facility. Unused portions of lines of credit on retail credit cards and related plans are deemed to be short-term commitments if the bank has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

E. Interest-Rate and Foreign-Exchange-Rate Contracts

1. *Scope.* Credit equivalent amounts are computed for each of the following off-balance-sheet interest-rate and foreign-exchange-rate instruments:

I. Interest-Rate Contracts
  A. Single-currency interest-rate swaps
  B. Basis swaps
  C. Forward-rate agreements
  D. Interest-rate options purchased (including caps, collars, and floors purchased)
  E. Any other instrument that gives rise to similar credit risks (including when-

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

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issued securities and forward forward deposits accepted)

II. Exchange-Rate Contracts
   A. Cross-currency interest-rate swaps
   B. Forward foreign-exchange contracts
   C. Currency options purchased
   D. Any other instrument that gives rise to similar credit risks

Exchange-rate contracts with an original maturity of 14 calendar days or less and instruments traded on exchanges that require daily payment of variation margin are excluded from the risk-based ratio calculation. Over-the-counter options purchased, however, are included and treated in the same way as the other interest-rate and exchange-rate contracts.

2. *Calculation of credit-equivalent amounts.* Credit-equivalent amounts are calculated for each individual contract of the types listed above. To calculate the credit-equivalent amount of its off-balance-sheet interest-rate and exchange-rate instruments, a bank sums these amounts:

1. the mark-to-market value[49] positive values only) of each contract (that is, the current exposure) and
2. an estimate of the potential future credit exposure over the remaining life of each contract.

The potential future credit exposure on a contract, including contracts with negative mark-to-market values, is estimated by multiplying the notional principal amount by one of the following credit conversion factors, as appropriate:

Remaining maturity	*Interest-rate contracts*	*Exchange-rate contracts*
One year or less	-0-	1.0%
Over one year	0.5%	5.0%

Examples of the calculation of credit-equivalent amounts for these instruments are contained in attachment V.

Because exchange-rate contracts involve an exchange of principal upon maturity, and exchange rates are generally more volatile than interest rates, higher conversion factors have been established for foreign-exchange contracts than for interest-rate contracts.

No potential future credit exposure is calculated for single-currency interest-rate swaps in which payments are made based upon two floating rate indices, so-called floating/floating or basis swaps; the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

3. *Risk weights.* Once the credit-equivalent amount for interest-rate and exchange-rate instruments has been determined, that amount is assigned to the risk-weight category appropriate to the counterparty, or, if relevant, the nature of any collateral or guarantees.[50] However, the maximum weight that will be applied to the credit-equivalent amount of such instruments is 50 percent.

4. *Avoidance of double-counting.* In certain cases, credit exposures arising from the interest-rate and exchange instruments covered by these guidelines may already be reflected, in part, on the balance sheet. To avoid double-counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the types of instruments covered by these guidelines may need to be excluded from balance-sheet assets in calculating banks' risk-based capital ratios.

5. *Netting.* Netting of swaps and similar contracts is recognized for purposes of calculating the risk-based capital ratio *only* when accomplished through netting by novation.[51] While the Federal Reserve encourages any reasonable arrangements designed to reduce the risks inherent in these transactions, other types of netting arrangements are not recognized for

[49] Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in both interest rates and counterparty credit quality.

[50] For interest- and exchange-rate contracts, sufficiency of collateral or guarantees is determined by the market value of the collateral or the amount of the guarantee in relation to the credit-equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III(B).

[51] Netting by novation, for this purpose, is a written bilateral contract between two counterparties under which any obligation to each other to deliver a given currency on a given date is automatically amalgamated with all other obligations for the same currency and value date, *legally* substituting one single net amount for the previous gross obligations.

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purposes of calculating the risk-based ratio at this time.

IV. Minimum Supervisory Ratios and Standards

The interim and final supervisory standards set forth below specify *minimum* supervisory ratios based primarily on broad credit-risk considerations. As noted above, the risk-based ratio does not take explicit account of the quality of individual asset portfolios or the range of other types of risks to which banks may be exposed, such as interest-rate, liquidity, market, or operational risks. For this reason, banks are generally expected to operate with capital positions above the minimum ratios.

Institutions with high or inordinate levels of risk are expected to operate well above minimum capital standards. Banks experiencing or anticipating significant growth are also expected to maintain capital, including tangible capital positions, well above the minimum levels. For example, most such institutions generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banks. In all cases, banks should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

Upon adoption of the risk-based framework, any bank that does not meet the interim or final supervisory ratios, or whose capital is otherwise considered inadequate, is expected to develop and implement a plan acceptable to the Federal Reserve for achieving an adequate level of capital consistent with the provisions of these guidelines or with the special circumstances affecting the individual institution. In addition, such banks should avoid any actions, including increased risk-taking or unwarranted expansion, that would lower or further erode their capital positions.

A. Minimum Risk-Based Ratio After Transition Period

As reflected in attachment VI, by year-end 1992, all state member banks should meet a minimum ratio of qualifying total capital to weighted-risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of tier 1 capital. For purposes of section IV.A., tier 1 capital is defined as the sum of core capital elements less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix. The maximum amount of supplementary capital elements that qualifies as tier 2 capital is limited to 100 percent of tier 1 capital. The maximum amount of supplementary capital elements that qualifies as tier 2 capital is limited to 100 percent of tier 1 capital. In addition, the combined maximum amount of subordinated debt and intermediate-term preferred stock that qualifies as tier 2 capital is limited to 50 percent of tier 1 capital. The maximum amount of the allowance for loan and lease losses that qualifies as tier 2 capital is limited to 1.25 percent of gross weighted-risk assets. Allowances for loan and lease losses in excess of this limit may, of course, be maintained, but would not be included in a bank's total capital. The Federal Reserve will continue to require banks to maintain reserves at levels fully sufficient to cover losses inherent in their loan portfolios.

Qualifying total capital is calculated by adding tier 1 capital and tier 2 capital (limited to 100 percent of tier 1 capital) and then deducting from this sum certain investments in banking or finance subsidiaries that are not consolidated for accounting or supervisory purposes, reciprocal holdings of banking organization capital securities, or other items at the direction of the Federal Reserve. These deductions are discussed above in section II(B).

B. Transition Arrangements

The transition period for implementing the risk-based capital standard ends on December 31, 1992.[52] Initially, the risk-based capital

[52] The Basle capital framework does not establish an initial minimum standard for the risk-based capital ratio before the end of 1990. However, for the purpose of calculating a risk-based capital ratio prior to year-end 1990, no sublimit is placed on the amount of the allowance for loan and lease losses includable in tier 2. In addition, this framework permits, under temporary transition arrangements, a certain percentage of a bank's tier 1 capital to be made up

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guidelines do not establish a minimum level of capital. However, by year-end 1990, banks are expected to meet a minimum interim target ratio for qualifying total capital to weightedrisk assets of 7.25 percent, at least one-half of which should be in the form of tier 1 capital. For purposes of meeting the 1990 interim target, the amount of loan-loss reserves that may be included in capital is limited to 1.5 percent of weighted-risk assets and up to 10 percent of a bank's tier 1 capital may consist of supplementary capital elements. Thus, the 7.25 percent interim target ratio implies a minimum ratio of tier 1 capital to weighted-risk assets of 3.6 percent (one-half of 7.25) and a minimum ratio of core capital elements to weighted-risk assets ratio of 3.25 percent (nine-tenths of the tier 1 capital ratio).

Through year-end 1990, banks have the option of complying with the minimum 7.25 percent year-end 1990 risk-based capital standard, in lieu of the minimum 5.5 percent primary and 6 percent total capital to total assets capital ratios set forth in appendix B to part 225 of the Federal Reserve's Regulation Y (page 59). In addition, as more fully set forth in appendix B to Regulation H (page 29), banks are expected to maintain a minimum ratio of tier 1 capital to total assets during this transition period.

Continued
of supplementary capital elements. In particular, supplementary elements may constitute 25 percent of a bank's tier 1 capital (before the deduction of goodwill) up to the end of 1990; from year-end 1990 up to the end of 1992, this allowable percentage of supplementary elements in tier 1 declines to 10 percent of tier 1 (before the deduction of goodwill). Beginning on December 31, 1992, supplementary elements may not be included in tier 1. The amount of subordinated debt and intermediate-term preferred stock temporarily included in tier 1 under these arrangements will not be subject to the sublimit on the amount of such instruments includable in tier 2 capital. Goodwill must be deducted from the sum of a bank's permanent core capital elements (that is, common equity, noncumulative perpetual preferred stock, and minority interest in the equity of unconsolidated subsidiaries) plus supplementary items that may temporarily qualify as tier 1 elements for the purpose of calculating tier 1 (net of goodwill), tier 2, and total capital.

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Attachment I—Sample Calculation of Risk-Based Capital Ratio for State Member Banks

Example of a bank with $6,000 in total capital and the following assets and off-balance-sheet items.

Balance-sheet assets	
Cash	$ 5,000
U.S. Treasuries	20,000
Balances at domestic banks	5,000
Loans secured by first liens on 1- to 4-family residential properties	5,000
Loans to private corporations	65,000
Total Balance-Sheet Assets	$ 100,000
Off-balance-sheet items	
Standby letters of credit (SLCs) backing general-obligation debt issues of U.S. municipalities (GOs)	$ 10,000
Long-term legally binding commitments to private corporations	20,000
Total Off-Balance-Sheet Items	$ 30,000

This bank's total capital to *total* assets (leverage) ratio would be:

($6,000/$100,000) = 6.00%.

To compute the bank's weighted-risk assets—

1. Compute the credit-equivalent amount of each off-balance-sheet (OBS) item.

OBS item	*Face value*		*Conversion factor*		*Credit-equivalent amount*
SLCs backing municipal GOs	$ 10,000	×	1.00	=	$ 10,000
Long-term commitments to private corporations	$ 20,000	×	0.50	=	$ 10,000

Attachment I continued, next page

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2. Multiply each balance-sheet asset and the credit-equivalent amount of each OBS item by the appropriate risk weight.

OBS item	*Face value*		*Conversion factor*		*Credit-equivalent amount*
0% category					
Cash	$ 5,000				
U.S. Treasuries	20,000				
	$25,000	×	0	=	0
20% category					
Balances at domestic banks	$ 5,000				
Credit-equivalent amounts of SLCs backing GOs of U.S. municipalities	10,000				
	$15,000	×	0.20	=	$ 3,000
50% category					
Loans secured by first liens on 1- to 4-family residential properties	$ 5,000	×	0.50	=	$ 2,500
100% category					
Loans to private corporations	$65,000				
Credit-equivalent amounts of long-term commitments to private corporations	10,000				
	$75,000	×	1.00	=	$75,000
Total Risk-Weighted Assets					$80,500

This bank's ratio of total capital to weighted-risk assets (risk-based capital ratio) would be:

($6,000/$80,500) = 7.45%

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

Using the Year-End 1992 Standards

Components	*Minimum requirements after transition period*
CORE CAPITAL (tier 1)	Must equal or exceed 4% of weighted-risk assets
Common stockholders' equity	No limit
Qualifying noncumulative perpetual preferred stock	No limit; banks should avoid undue reliance on preferred stock in tier 1
Minority interest in equity accounts of consolidated subsidiaries	Banks should avoid using minority interests to introduce elements not otherwise qualifying for tier 1 capital
Less: Goodwill and other intangible assets required to be deducted from capital[1]	
SUPPLEMENTARY CAPITAL (tier 2)	Total of tier 2 is limited to 100% of tier 1[2]
Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets[2]
Perpetual preferred stock	No limit within tier 2
Hybrid capital instruments and equity-contract notes	No limit within tier 2
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more)	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1;[3] amortized for capital purposes as they approach maturity
Revaluation reserves (equity and building)	Not included; banks encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making an overall assessment of capital
DEDUCTIONS (from sum of tier 1 and tier 2)	
Investments in unconsolidated subsidiaries	
Reciprocal holdings of banking organizations' capital securities	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority	On a case-by-case basis or as a matter of policy after formal rulemaking
TOTAL CAPITAL (tier 1 + tier 2 − Deductions)	Must equal or exceed 8% of weighted-risk assets

*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.

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

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

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

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

Category 1: Zero Percent

1. Cash (domestic and foreign) held in the bank or in transit

2. Balances due from Federal Reserve Banks (including Federal Reserve Bank stock) and central banks in other OECD countries

3. Direct claims on, and the portions of claims that are unconditionally guaranteed by, the U.S. Treasury and U.S. government agencies[1] and the central governments of other OECD countries, and local currency claims on, and the portions of local currency claims that are unconditionally guaranteed by, the central governments of non-OECD countries (including the central banks of non-OECD countries), to the extent that the bank has liabilities booked in that currency

4. Gold bullion held in the bank's vaults or in another's vaults on an allocated basis, to the extent offset by gold bullion liabilities

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

Category 2: 20 Percent

1. Cash items in the process of collection

2. All claims (long- or short-term) on, and the portions of claims (long- or short-term) that are guaranteed by, U.S. depository institutions and OECD banks

3. Short-term claims (remaining maturity of one year or less) on, and the portions of short-term claims that are guaranteed by, non-OECD banks

4. The portions of claims that are conditionally guaranteed by the central governments of OECD countries and U.S. government agencies, and the portions of local currency claims that are conditionally guaranteed by the central governments of non-OECD countries, to the extent that the bank has liabilities booked in that currency

5. Claims on, and the portions of claims that are guaranteed by, U.S. government–sponsored agencies[2]

6. General obligation claims on, and the portions of claims that are guaranteed by the full faith and credit of, local governments and political subdivisions of the U.S. and other OECD local governments

7. Claims on, and the portions of claims that are guaranteed by, official multilateral lending institutions or regional development banks

8. The portions of claims that are collateralized[3] by cash on deposit in the bank or by securities issued or guaranteed by the U.S. Treasury, the central governments of other OECD countries, and U.S. government agencies that do not qualify for the zero percent risk-weight category, or that are collateralized by securities issued or guaranteed by U.S. government–sponsored agencies

9. The portions of claims that are collateralized[3] by securities issued by official multilateral lending institutions or regional development banks

10. Certain privately issued securities representing indirect ownership of mortgage-backed U.S. government agency or U.S. government–sponsored agency securities

11. Investments in shares of a fund whose portfolio is permitted to hold only securities

[1] For the purpose of calculating the risk-based capital ratio, a U.S. government agency is defined as an instrumentality of the U.S. government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government.

[2] For the purpose of calculating the risk-based capital ratio, a U.S. government–sponsored agency is defined as an agency originally established or chartered to serve public purposes specified by the U.S. Congress but whose obligations are not *explicitly* guaranteed by the full faith and credit of the U.S. government.

[3] The extent of collateralization is determined by current market value.

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that would qualify for the zero or 20 percent risk categories

Category 3: 50 Percent

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

2. Revenue bonds or similar claims that are obligations of U.S. state or local governments, or other OECD local governments, but for which the government entity is committed to repay the debt only out of revenues from the facilities financed

3. Credit-equivalent amounts of interest rate– and foreign exchange rate–related contracts, except for those assigned to a lower risk category

Category 4: 100 Percent

1. All other claims on private obligors

2. Claims on, or guaranteed by, non-OECD foreign banks with a remaining maturity exceeding one year

3. Claims on, or guaranteed by, non-OECD central governments that are not included in item 3 of category 1 or item 4 of category 2; all claims on non-OECD state or local governments

4. Obligations issued by U.S. state or local governments, or other OECD local governments (including industrial-development authorities and similar entities), repayable solely by a private party or enterprise

5. Premises, plant, and equipment; other fixed assets; and other real estate owned

6. Investments in any unconsolidated subsidiaries, joint ventures, or associated companies—if not deducted from capital

7. Instruments issued by other banking organizations that qualify as capital—if not deducted from capital

8. Claims on commercial firms owned by a government

9. All other assets, including any intangible assets that are not deducted from capital

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Attachment IV—Credit-Conversion Factors for Off-Balance-Sheet Items for State Member Banks

100 Percent Conversion Factor

1. Direct credit substitutes (These include general guarantees of indebtedness and all guarantee-type instruments, including standby letters of credit backing the financial obligations of other parties.)

2. Risk participations in banker's acceptances and direct credit substitutes, such as standby letters of credit

3. Sale and repurchase agreements and assets sold with recourse that are not included on the balance sheet

4. Forward agreements to purchase assets, including financing facilities, on which drawdown is *certain*

5. Securities lent for which the bank is at risk

50 Percent Conversion Factor

1. Transaction-related contingencies (These include bid bonds, performance bonds, warranties, and standby letters of credit backing the nonfinancial performance of other parties.)

2. Unused portions of commitments with an original maturity[1] exceeding one year, including underwriting commitments and commercial credit lines

3. Revolving underwriting facilities (RUFs), note-issuance facilities (NIFs), and similar arrangements

20 Percent Conversion Factor

1. Short-term, self-liquidating, trade-related contingencies, including commercial letters of credit

Zero Percent Conversion Factor

1. Unused portions of commitments with an original maturity[1] of one year or less, or which are unconditionally cancellable at any time, provided a separate credit decision is made before each drawing

Credit Conversion for Interest-Rate and Foreign-Exchange Contracts

The total replacement cost of contracts (obtained by summing the positive mark-to-market values of contracts) is added to a measure of future potential increases in credit exposure. This future potential exposure measure is calculated by multiplying the total notional value of contracts by one of the following credit-conversion factors, as appropriate:

Remaining maturity	*Interest-rate contracts*	*Exchange-rate contracts*
One year or less	0	1.0%
Over one year	0.5%	5.0%

No potential exposure is calculated for single-currency interest-rate swaps in which payments are made based upon two floating rate indices, that is, so-called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-market value. Exchange-rate contracts with an original maturity of 14 days or less are excluded. Instruments traded on exchanges that require daily payments of variation margin are also excluded. The only form of netting recognized is netting by novation.

[1] Remaining maturity may be used until year-end 1992.

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Attachment V—Calculation of Credit-Equivalent Amounts

Interest Rate– and Foreign Exchange Rate–Related Transactions for State Member Banks

	Potential Exposure			+ *Current Exposure*		= *Credit-Equivalent Amount (dollars)*
Type of contract (remaining maturity)	*Notional principal (dollars)*	× *Potential-exposure conversion factor*	= *Potential exposure (dollars)*	*Replacement cost*[1]	*Current exposure (dollars)*[2]	
(1) 120-day forward foreign exchange	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 120-day forward foreign exchange	6,000,000	.01	60,000	−120,000	-0-	60,000
(3) 3-year single-currency fixed/floating interest-rate swap	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 3-year single-currency fixed/floating interest-rate swap	10,000,000	.005	50,000	−250,000	-0-	50,000
(5) 7-year cross-currency floating/floating interest-rate swap	20,000,000	.05	1,000,000	−1,300,000	-0-	1,000,000
TOTAL	**$51,000,000**					**$1,510,000**

[1] These numbers are purely for illustration.
[2] The larger of zero or a positive mark-to-market value.

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Attachment VI

SUMMARY OF:

	Transitional Arrangements for State Member Banks		*Final Arrangement*
	Initial	*Year-end 1990*	*Year-end 1992*
1. Minimum standard of total capital to weighted-risk assets	None	7.25%	8.0%
2. Definition of tier 1 capital	Common equity, qualifying noncumulative perpetual preferred stock, minority interests, *plus* supplementary elements[1] *less* goodwill	Common equity, qualifying noncumulative perpetual preferred stock, minority interests, *plus* supplementary elements[2] *less* goodwill	Common equity, qualifying noncumulative perpetual preferred stock, and minority interest *less* goodwill and other intangible assets required to be deducted from capital[3]
3. Minimum standard of tier 1 capital to weighted-risk assets	None	3.625%	4.0%
4. Minimum standard of stockholders' equity to weighted-risk assets	None	3.25%	4.0%
5. Limitations on supplementary capital elements			
a. Allowance for loan and lease losses	No limit within tier 2	1.5% of weighted-risk assets	1.25% of weighted-risk assets
b. Qualifying perpetual preferred stock	No limit within tier 2	No limit within tier 2	No limit within tier 2
c. Hybrid capital instruments and equity contract notes	No limit within tier 2	No limit within tier 2	No limit within tier 2
d. Subordinated debt and intermediate-term preferred stock	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1
e. Total qualifying tier 2 capital	May not exceed tier 1 capital	May not exceed tier 1 capital	May not exceed tier 1 capital
6. Definition of total capital	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries

[1] Supplementary elements may be included in tier 1 up to 25% of the sum of tier 1 plus goodwill.

[2] Supplementary elements may be included in tier 1 up to 10% of the sum of tier 1 plus goodwill.

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

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Capital Adequacy Guidelines for State Member Banks: Tier 1 Leverage Measure

Regulation H (12 CFR 208), Appendix B; as amended effective March 9, 1993

I. Overview

The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of state member banks.[1] The principal objective of this measure is to place a constraint on the maximum degree to which a state member bank can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

The guidelines apply to all state member banks on a consolidated basis and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

II. The Tier 1 Leverage Ratio

The Board has established a *minimum* level of tier 1 capital to total assets of 3 percent. An institution operating at or near these levels is expected to have well-diversified risk, including no undue interest-rate risk exposure; excellent asset quality; high liquidity; and good earnings; and in general be considered a strong banking organization, rated composite 1 under the CAMEL rating system of banks. Institutions not meeting these characteristics, as well as institutions with supervisory, financial, or operational weaknesses, are expected to operate well above minimum capital standards. Institutions experiencing or anticipating significant growth also are expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. For example, most such banks generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banks. Thus, for all but the most highly rated banks meeting the conditions set forth above, the minimum tier 1 leverage ratio is to be 3 percent plus an additional cushion of at least 100 to 200 basis points. In all cases, banking institutions should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.

A bank's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital for year-end 1992 as set forth in the risk-based capital guidelines contained in appendix A of this part will be used.[2] As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income (call report), less goodwill; amounts of 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]

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[1] Supervisory risk-based capital ratios that relate capital to weighted-risk assets for state member banks are outlined in appendix A to Regulation H (page 1).

[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 Regulation H (page 1).

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Whenever appropriate, including when a bank is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual bank's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and practice with regard to leverage guidelines. Banks experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

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Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure

Regulation Y (12 CFR 225), Appendix A; as amended effective December 31, 1993

I. Overview

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

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

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

The risk-based guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $150 million or more. For bank holding companies with less than $150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless (a) the parent bank holding company is engaged in nonbank activity involving significant leverage;[4] or (b) the parent company has a significant amount of outstanding debt that is held by the general public.

The risk-based guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. Thus, in considering an application filed by a bank holding company, the Federal Reserve will take into account the organization's risk-based capital ratio, the reasonableness of its capital plans, and the degree of progress it has demonstrated toward meeting the interim and final risk-based capital standards.

The risk-based capital ratio focuses principally on broad categories of credit risk, although the framework for assigning assets and off-balance-sheet items to risk categories does incorporate elements of transfer risk, as well as limited instances of interest-rate and market risk. The risk-based ratio does not, however, incorporate other factors that can affect an organization's financial condition. These factors include overall interest-rate exposure; liquidity, funding, and market risks; the quality and level of earnings; investment or loan portfolio concentrations; the quality of loans and investments; the effectiveness of loan and investment policies; and management's ability to monitor and control financial and operating risks.

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[1] Supervisory ratios that relate capital to total assets for bank holding companies are outlined in appendixes B and D of Regulation Y (pages 59 and 67).

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

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

[4] A parent company that is engaged in significant off-balance-sheet activities would generally be deemed to be engaged in activities that involve significant leverage.

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In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of these other factors, including, in particular, the level and severity of problem and classified assets. For this reason, the final supervisory judgment on an organization's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of the organization's risk-based capital ratio.

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

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

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

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

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

Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Consequently, an organization considering such a step should consult with the Federal Reserve before redeeming any equity or debt capital instrument (prior to maturity) if such redemption could have a material effect on the level or composition of the organization's capital base.[5]

A. *The Components of Qualifying Capital*

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

i. common stockholders' equity
ii. qualifying noncumulative perpetual preferred stock (including related surplus)
iii. minority interest in the equity accounts of consolidated subsidiaries, subject to certain limitations described below
iv. minority interest in the equity accounts of consolidated subsidiaries

Tier 1 capital is generally defined as the sum of the core capital elements[6] less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix.

a. *Common stockholders' equity.* Common stockholders' equity includes: common

[5] Consultation would not ordinarily be necessary if an instrument were redeemed with the proceeds of, or replaced by, a like amount of a similar or higher-quality capital instrument and the organization's capital position is considered fully adequate by the Federal Reserve. In the case of limited-life tier 2 instruments, consultation would generally be obviated if the new security is of equal or greater maturity than the one it replaces.

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

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stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any treasury stock.

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

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

For bank holding companies, both cumulative and noncumulative perpetual preferred stock qualify for inclusion in tier 1. However, the aggregate amount of cumulative perpetual preferred stock that may be included in a holding company's tier 1 is limited to one-third of the sum of core capital elements, excluding the perpetual preferred stock (that is, items i, ii, and iv above). Stated differently, the aggregate amount may not exceed 25 percent of the sum of all core capital elements, including cumulative perpetual preferred stock (that is, items i, ii, iii and iv above). Any cumulative perpetual preferred stock outstanding in excess of this limit may be included in tier 2 capital without any sublimits within that tier (see discussion below).

While the guidelines allow for the inclusion of noncumulative perpetual preferred stock and limited amounts of cumulative perpetual preferred stock in tier 1, it is desirable from a supervisory standpoint that voting common equity remain the dominant form of tier 1 capital. Thus, bank holding companies should avoid overreliance on preferred stock or nonvoting equity elements within tier 1.

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

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

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

The maximum amount of tier 2 capital that may be included in an organization's qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill and other intan-

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

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

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

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

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

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

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

1. The instrument must be unsecured; fully paid up; and subordinated to general creditors. If issued by a bank, it must also be subordinated to claims of depositors.
2. The instrument must not be redeemable at the option of the holder prior to maturity, except with the prior approval of the Federal Reserve. (Consistent with the Board's criteria for perpetual debt and mandatory convertible securities, this requirement implies that holders of such instruments may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.)
3. The instrument must be available to participate in losses while the issuer is operating as a going concern. (Term subordinated debt would not meet this requirement.) To satisfy this requirement, the instrument must convert to common or perpetual preferred stock in the event that the accumulated losses exceed the sum of the retained earnings and capital surplus accounts of the issuer.
4. The instrument must provide the option

[8] The Basle capital framework also provides for the inclusion of "undisclosed reserves" in tier 2. As defined in the framework, undisclosed reserves represent accumulated after-tax retained earnings that are not disclosed on the balance sheet of a banking organization. Apart from the fact that these reserves are not disclosed publicly, they are essentially of the same quality and character as retained earnings, and, to be included in capital, such reserves must be accepted by the banking organization's home supervisor. Although such undisclosed reserves are common in some countries, under generally accepted accounting principles (GAAP) and long-standing supervisory practice, these types of reserves are not recognized for banking organizations in the United States. Foreign banking organizations seeking to make acquisitions or conduct business in the United States would generally be expected to disclose publicly at least the degree of reliance on such reserves in meeting supervisory capital requirements.

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

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

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

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for the issuer to defer interest payments if (a) the issuer does not report a profit in the preceding annual period (defined as combined profits for the most recent four quarters) *and* (b) the issuer eliminates cash dividends on common and preferred stock.

Perpetual debt and mandatory convertible debt securities that meet the criteria set forth in 12 CFR 225, appendix B (page 59), also qualify as unlimited elements of tier 2 capital for bank holding companies.

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

Subordinated debt and intermediate-term preferred stock must have an original weighted average maturity of at least five years to qualify as supplementary capital.[12] (If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing banking organization.)

In the case of subordinated debt, the instrument must be unsecured and must clearly state on its face that it is not a deposit and is not insured by a federal agency. Bank holding company debt must be subordinated in right of payment to all senior indebtedness of the company.

e. *Discount of supplementary capital instruments.* As a limited-life capital instrument approaches maturity it begins to take on characteristics of a short-term obligation. For this reason, the outstanding amount of term subordinated debt and any long- or intermediate-life, or term, preferred stock eligible for inclusion in tier 2 is reduced, or discounted, as these instruments approach maturity: one-fifth of the original amount, less any redemptions, is excluded each year during the instrument's last five years before maturity.[13]

f. *Revaluation reserves.* Such reserves reflect the formal balance-sheet restatement or revaluation for capital purposes of asset carrying values to reflect current market values. In the United States, banking organizations, for the most part, follow GAAP when preparing their financial statements, and GAAP generally does not permit the use of market-value accounting. For this and other reasons, the federal banking agencies generally have not included unrealized asset values in capital-ratio calculations, although they have long taken such values into account as a separate factor in assessing the overall financial strength of a banking organization.

Consistent with long-standing supervisory practice, the excess of market values over book values for assets held by bank holding companies will generally not be recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all banking organizations are encouraged to disclose their equivalent of premises (building) and equity revaluation reserves. Such values will be taken into account as additional considerations in assess-

[12] Unsecured term debt issued by bank holding companies prior to March 12, 1988, and qualifying as secondary capital at the time of issuance would continue to qualify as an element of supplementary capital under the risk-based framework, subject to the 50 percent of tier 1 capital limitation. Bank holding company term debt issued on or after March 12, 1988, must be subordinated in order to qualify as capital.

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

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ing overall capital strength and financial condition.

B. Deductions from Capital and Other Adjustments

Certain assets are deducted from an organization's capital for the purpose of calculating the risk-based capital ratio.[14] These assets include—

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

ii. investments in banking and finance subsidiaries that are not consolidated for accounting or supervisory purposes, and investments in other designated subsidiaries or associated companies at the discretion of the Federal Reserve—deducted from total capital components (as described in greater detail below)

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

1. *Goodwill and other intangible assets.*
   a. *Goodwill.* Goodwill is an intangible asset that represents the excess of the purchase price over the fair market value of identifiable assets acquired less liabilities assumed in acquisitions accounted for under the purchase method of accounting. Any goodwill carried on the balance sheet of a bank holding company after December 31, 1992, will be deducted from the sum of core capital elements in determining tier 1 capital for ratio-calculation purposes. Any goodwill in existence before March 12, 1988, is grandfathered during the transition period and is not deducted from core capital elements until after December 31, 1992. However, bank holding company goodwill acquired as a result of a merger or acquisition that was consummated on or after March 12, 1988, is deducted immediately.

   b. *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 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

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

[15] Amounts of 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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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.

2. *Investments in certain subsidiaries.*

a. *Unconsolidated banking or finance subsidiaries.* The aggregate amount of investments in banking or finance subsidiaries[16] whose financial statements are not consolidated for accounting or regulatory-reporting purposes, regardless of whether the investment is made by the parent bank holding company or its direct or indirect subsidiaries, will be deducted from the consolidated parent banking organization's total capital components.[17] Generally, investments for this purpose are defined as equity and debt capital investments and any other instruments that are deemed to be capital in the particular subsidiary.

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

Inasmuch as the assets of unconsolidated banking and finance subsidiaries are not fully reflected in a banking organization's consolidated total assets, such assets may be viewed as the equivalent of off-balance-sheet exposures since the operations of an unconsolidated subsidiary could expose the parent organization and its affiliates to considerable risk. For this reason, it is generally appropriate to view the capital resources invested in these unconsolidated

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

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

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entities as primarily supporting the risks inherent in these off-balance-sheet assets, and not generally available to support risks or absorb losses elsewhere in the organization.

b. *Other subsidiaries and investments.* The deduction of investments, regardless of whether they are made by the parent bank holding company or by its direct or indirect subsidiaries, from a consolidated banking organization's capital will also be applied in the case of any subsidiaries, that, while consolidated for accounting purposes, are not consolidated for certain specified supervisory or regulatory purposes, such as to facilitate functional regulation. For this purpose, aggregate capital investments (that is, the sum of any equity or debt instruments that are deemed to be capital) in these subsidiaries will be deducted from the consolidated parent banking organization's total capital components.[18]

Advances (that is, loans, extensions of credit, guarantees, commitments, or any other forms of credit exposure) to such subsidiaries that are not deemed to be capital will generally not be deducted from capital. Rather, such advances will normally be included in the parent banking organization's consolidated assets and assigned to the 100 percent risk category, unless such obligations are backed by recognized collateral or guarantees, in which case they will be assigned to the risk category appropriate to such collateral or guarantees. These advances may, however, be deducted from the consolidated parent banking organization's capital if, in the judgment of the Federal Reserve, the risks stemming from such advances are comparable to the risks associated with capital investments or if such advances involve other risk factors that warrant such an adjustment to capital for supervisory purposes. These other factors could include, for example, the absence of collateral support.[19]

In general, when investments in a consolidated subsidiary are deducted from a consolidated parent banking organization's capital, the subsidiary's assets will also be excluded from the consolidated assets of the parent banking organization in order to assess the latter's capital adequacy.[20]

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

The Federal Reserve will not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies.[21] Nonetheless, the resources invested in these entities, like investments in unconsolidated banking and finance subsidiaries, support assets not consolidated with the rest of the banking organization's activities and, therefore, may not be generally available to support additional leverage or absorb losses elsewhere in the banking organization. Moreover, experience has shown that banking organizations stand behind the losses of affiliated institutions, such as joint ventures and associated companies, in order to protect the reputation of the organization as a whole. In some cases, this has led to losses

[18] Investments in unconsolidated subsidiaries will be deducted from both tier 1 and tier 2 capital. As a general rule, one-half (50 percent) of the aggregate amount of capital investments will be deducted from the bank holding company's tier 1 capital and one-half (50 percent) from its tier 2 capital. However, the Federal Reserve may, on a case-bycase basis, deduct a proportionately greater amount from tier 1 if the risks associated with the subsidiary so warrant. If the amount deductible from tier 2 capital exceeds actual tier 2 capital, the excess would be deducted from tier 1 capital. Bank holding companies' risk-based capital ratios, net of these deductions, must exceed the minimum standards set forth in section IV.

[19] In assessing the overall capital adequacy of a banking organization, the Federal Reserve may also consider the organization's fully consolidated capital position.

[20] If the subsidiary's assets are consolidated with the parent banking organization for financial-reporting purposes, this adjustment will involve excluding the subsidiary's assets on a line-by-line basis from the consolidated parent organization's assets. The parent banking organization's capital ratio will then be calculated on a consolidated basis with the exception that the assets of the excluded subsidiary will not be consolidated with the remainder of the parent banking organization.

[21] The definition of such entities is contained in the instructions to the Consolidated Financial Statements for Bank Holding Companies. Under regulatory-reporting procedures, associated companies and joint ventures generally are defined as companies in which the banking organization owns 20 to 50 percent of the voting stock.

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that have exceeded the investments in such organizations.

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

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

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

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

Reciprocal holdings are cross-holdings resulting from formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other's capital instruments. Generally, deductions will be limited to intentional cross-holdings. At present, the Board does not intend to require banking organizations to deduct nonreciprocal holdings of such capital instruments.[22, 23]

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

A. *Procedures*

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

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

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

[22] Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's policy statement on nonvoting equity investments, 12 CFR 225.143 (*Federal Reserve Regulatory Service* 4–172.1). 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.

[23] 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.

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percent risk weight appropriate to U.S. municipal revenue bonds.[24]

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

B. Collateral, Guarantees, and Other Considerations

1. *Collateral.* The only forms of collateral that are formally recognized by the risk-based capital framework are cash on deposit in a subsidiary lending institution; securities issued or guaranteed by the central governments of the OECD-based group of countries,[25] U.S. government agencies, or U.S. government–sponsored agencies; and securities issued by multilateral lending institutions or regional development banks. Claims fully secured by such collateral generally are assigned to the 20 percent risk category. Collateralized transactions meeting all the conditions described in section III.C.1. may be assigned a zero percent risk weight.

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

2. *Guarantees.* Guarantees of the OECD and non-OECD central governments, U.S. government agencies, U.S. government–sponsored agencies, state and local governments of the OECD-based group of countries, multilateral lending institutions and regional development banks, U.S. depository institutions, and foreign banks are also recognized. If a claim is partially guaranteed, that is, coverage of the guarantee is less than the face amount of a balance-sheet asset or an off-balance-sheet item, the portion that is not fully covered by the guarantee is assigned to the risk category

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

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

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appropriate to the obligor or, if relevant, to any collateral. The face amount of a claim covered by two types of guarantees that have different risk weights, such as a U.S. government guarantee and a state guarantee, is to be apportioned between the two risk categories appropriate to the guarantors.

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

3. *Mortgage-backed securities.* Mortgage-backed securities, including pass-throughs and collateralized mortgage obligations (but not stripped mortgage-backed securities), that are *issued* or *guaranteed* by a U.S. government agency or U.S. government–sponsored agency are assigned to the risk-weight category appropriate to the issuer or guarantor. Generally, a privately issued mortgage-backed security meeting certain criteria set forth in the accompanying footnote[26] is treated as essentially an indirect holding of the underlying assets, and is assigned to the same risk category as the underlying assets, but in no case to the zero percent risk category. Privately issued mortgage-backed securities whose structures do not qualify them to be regarded as indirect holdings of the underlying assets are assigned to the 100 percent risk category. During the inspection process, privately issued mortgage-backed securities that are assigned to a lower risk-weight category will be subject to examiner review to ensure that they meet the appropriate criteria.

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

4. *Maturity.* Maturity is generally not a factor in assigning items to risk categories with the exception of claims on non-OECD banks, commitments, and interest-rate and foreign-exchange-rate contracts. Except for commitments, short-term is defined as one year or less *remaining* maturity and long-term is defined as over one year *remaining* maturity. In the case of commitments, short-term is defined as one year or less *original* maturity and long-term is defined as over one year *original* maturity.[27]

C. Risk Weights

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

1. *Category 1: zero percent.* This category includes cash (domestic and foreign) owned and held in all offices of subsidiary depository institu-

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

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

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tions or in transit and gold bullion held in either a subsidiary depository institution's own vaults or in another's vaults on an allocated basis, to the extent it is offset by gold bullion liabilities.[28] The category also includes all direct claims (including securities, loans, and leases) on, and the portions of claims that are directly and unconditionally guaranteed by, the central governments[29] of the OECD countries and U.S. government agencies,[30] as well as all direct local currency claims on, and the portions of local currency claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that subsidiary depository institutions have liabilities booked in that currency. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. government or its agencies that are actively traded in financial markets, such as GNMA securities, are considered to be unconditionally guaranteed.

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

2. *Category 2: 20 percent.* This category includes cash items in the process of collection, both foreign and domestic; short-term claims (including demand deposits) on, and the portions of short-term claims that are guaranteed by,[31] U.S. depository institutions[32] and foreign banks;[33] and long-term claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions and OECD banks.[34]

This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. government agencies, as well as the portions of local currency claims that are conditionally guaranteed by non-OECD central governments, to the extent that subsidiary depository institutions have liabilities booked in that currency.

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

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

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

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

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

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

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

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In addition, this category also includes claims on, and the portions of claims that are guaranteed by, U.S. government–sponsored agencies[35] and claims on, and the portions of claims guaranteed by, the International Bank for Reconstruction and Development (World Bank), the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. General obligation claims on, or portions of claims guaranteed by the full faith and credit of, states or other political subdivisions of the United States or other countries of the OECD-based group are also assigned to this category.[36]

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

3. *Category 3: 50 percent.* This category includes loans fully secured by first liens[37] on one- to four-family residential properties, either owner-occupied or rented, or on multifamily residential properties,[38] that meet certain criteria.[39] Loans included in this category must have been made in accordance with prudent underwriting standards;[40] be performing in accordance with their original terms; and not be 90 days or more past due or carried in nonaccrual status. The following additional criteria must also be applied to a loan secured by a multifamily residential property that is included in this category: all principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or in the case where the existing property owner is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; amortization of the principal and interest may occur over a period of not more than 30 years and the minimum original maturity for repayment of principal must not be less than 7

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

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

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

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

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

[40] Prudent underwriting standards include a conservative ratio of the current loan balance to the value of the property. In the case of a loan secured by multifamily residential property, the loan-to-value ratio is not conservative if it 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.

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

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

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

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

This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[41] This category also includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding involving standard risk claims;[42] investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans for residential property that qualify for a lower risk weight); mortgage-backed securities that do not meet criteria for assignment to a lower risk weight (including any classes of mortgage-backed securities that can absorb more than their pro rata share of loss without the whole issue being in default); and all stripped mortgage-backed and similar securities.

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

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

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

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countries that do not belong to the OECD-based group.

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

D. Off-Balance-Sheet Items

The face amount of an off-balance-sheet item is incorporated into the risk-based capital ratio by multiplying it by a credit-conversion factor. The resultant credit-equivalent amount is assigned to the appropriate risk category according to the obligor, or, if relevant, the guarantor or the nature of the collateral.[43] Attachment IV sets forth the conversion factors for various types of off-balance-sheet items.

1. *Items with a 100 percent conversion factor.* A 100 percent conversion factor applies to direct credit substitutes, which include guarantees, or equivalent instruments, backing financial claims, such as outstanding securities, loans, and other financial liabilities, or that back off-balance-sheet items that require capital under the risk-based capital framework. Direct credit substitutes include, for example, financial standby letters of credit, or other equivalent irrevocable undertakings or surety arrangements, that guarantee repayment of financial obligations such as commercial paper, tax-exempt securities, commercial or individual loans or debt obligations, or standby or commercial letters of credit. Direct credit substitutes also include the acquisition of risk participations in banker's acceptances and standby letters of credit, since both of these transactions, in effect, constitute a guarantee by the acquiring banking organization that the underlying account party (obligor) will repay its obligation to the originating, or issuing, institution.[44] (Standby letters of credit that are performance-related are discussed below and have a credit-conversion factor of 50 percent.)

The full amount of a direct credit substitute is converted at 100 percent and the resulting credit-equivalent amount is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor or the nature of the collateral. In the case of a direct credit substitute in which a risk participation[45] has been conveyed, the full amount is still converted at 100 percent. However, the credit-equivalent amount that has been conveyed is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after giving effect to any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation. Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the portion of a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the risk category appropriate to claims guaranteed by those institutions, that is, the 20 percent risk category.[46] This approach recognizes that such conveyances replace the originating banking organization's exposure to the obligor with an exposure to the institutions acquiring the risk participations.[47]

In the case of direct credit substitutes that take the form of a syndication, that is, where each banking organization is obligated only for its pro rata share of the risk and there is no recourse to the originating banking organization, each banking organization will only include its pro rata share of the direct credit substitute in its risk-based capital calculation.

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

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

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

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

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

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

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

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

Sale and repurchase agreements and asset sales with recourse (to the extent not included on the balance sheet) and forward agreements also are converted at 100 percent.[48] So-called "loan strips" (that is, short-term advances sold under long-term commitments without direct recourse) are treated for risk-based capital purposes as assets sold with recourse and, accordingly, are also converted at 100 percent.

Forward agreements are legally binding contractual obligations to purchase assets with *certain* drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[49] and partly paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign-exchange contracts.

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

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

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

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

The unused portion of commitments with an *original* maturity exceeding one year,[50] including underwriting commitments, and commercial and consumer credit commitments also are converted at 50 percent. Original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which (1) the banking organization can, at its option, unconditionally (without cause) cancel the commitment[51] and (2) the banking organization is scheduled to (and as a normal practice actually does) review the facility to determine whether or not it should be extended. Such reviews must continue to be conducted at least annually for such a facility to qualify as a short-term commitment.

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

Facilities that are unconditionally cancellable (without cause) at any time by the banking organization are not deemed to be commitments, provided the banking organization makes a separate credit decision before each drawing under the facility. Commitments with an original maturity of one year or less are deemed to involve low risk and, therefore, are not assessed a capital charge. Such short-term commitments are defined to include the unused portion of lines of credit on retail credit cards and related plans (as defined in the instructions to the FR Y-9C Report) if the banking organization has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

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

Revolving underwriting facilities (RUFs), note-issuance facilities (NIFs), and other similar arrangements also are converted at 50 percent regardless of maturity. These are facilities under which a borrower can issue on a revolving basis short-term paper in its own name, but for which the underwriting organi-

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

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

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zations have a legally binding commitment either to purchase any notes the borrower is unable to sell by the rollover date or to advance funds to the borrower.

3. *Items with a 20 percent conversion factor.* Short-term, self-liquidating, trade-related contingencies which arise from the movement of goods are converted at 20 percent. Such contingencies generally include commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

4. *Items with a zero percent conversion factor.* These include unused portions of commitments with an original maturity of one year or less,[52] or which are unconditionally cancellable at any time, provided a separate credit decision is made before each drawing under the facility. Unused portions of lines of credit on retail credit cards and related plans are deemed to be short-term commitments if the banking organization has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

E. Interest-Rate and Foreign-Exchange-Rate Contracts

1. *Scope.* Credit-equivalent amounts are computed for each of the following off-balance-sheet interest-rate and foreign-exchange-rate instruments:

- I. Interest-rate contracts
  - A. Single-currency interest-rate swaps
  - B. Basis swaps
  - C. Forward-rate agreements
  - D. Interest-rate options purchased (including caps, collars, and floors purchased)
  - E. Any other instrument that gives rise to similar credit risks (including when-issued securities and forward forward deposits accepted)
- II. Exchange-rate contracts
  - A. Cross-currency interest rate swaps
  - B. Forward foreign-exchange contracts
  - C. Currency options purchased
  - D. Any other instrument that gives rise to similar credit risks

Exchange-rate contracts with an original maturity of 14 calendar days or less and instruments traded on exchanges that require daily payment of variation margin are excluded from the risk-based ratio calculation. Over-the-counter options purchased, however, are included and treated in the same way as the other interest-rate and exchange-rate contracts.

2. *Calculation of credit-equivalent amounts.* Credit-equivalent amounts are calculated for each individual contract of the types listed above. To calculate the credit-equivalent amount of its off-balance-sheet interest-rate and exchange-rate instruments, a banking organization sums these amounts:

1. the mark-to-market value[53] (positive values only) of each contract (that is, the current exposure); and
2. an estimate of the potential future credit exposure over the remaining life of each contract.

The potential future credit exposure on a contract, including contracts with negative mark-to-market values, is estimated by multiplying the notional principal amount by one of the following credit conversion factors, as appropriate:

Remaining maturity	*Interest-rate contracts*	*Exchange-rate contracts*
One year or less	-0-	1.0%
Over one year	0.5%	5.0%

Examples of the calculation of credit-equivalent amounts for these instruments are contained in attachment V.

Because exchange-rate contracts involve an exchange of principal upon maturity, and exchange rates are generally more volatile than interest rates, higher conversion factors have been established for foreign-exchange contracts than for interest-rate contracts.

No potential future credit exposure is calculated for single-currency interest-rate swaps in which payments are made based upon two

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

[53] Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in both interest rates and counterparty credit quality.

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floating rate indices, so-called floating/floating or basis swaps; the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

3. *Risk weights.* Once the credit-equivalent amount for interest-rate and exchange-rate instruments has been determined, that amount is assigned to the risk-weight category appropriate to the counterparty, or, if relevant, the nature of any collateral or guarantees.[54] However, the maximum weight that will be applied to the credit-equivalent amount of such instruments is 50 percent.

4. *Avoidance of double-counting.* In certain cases, credit exposures arising from the interest-rate and exchange instruments covered by these guidelines may already be reflected, in part, on the balance sheet. To avoid double-counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the types of instruments covered by these guidelines may need to be excluded from balance-sheet assets in calculating banking organizations' risk-based capital ratios.

5. *Netting.* Netting of swaps and similar contracts is recognized for purposes of calculating the risk-based capital ratio *only* when accomplished through netting by novation.[55] While the Federal Reserve encourages any reasonable arrangements designed to reduce the risks inherent in these transactions, other types of netting arrangements are not recognized for purposes of calculating the risk-based ratio at this time.

IV. Minimum Supervisory Ratios and Standards

The interim and final supervisory standards set forth below specify *minimum* supervisory ratios based primarily on broad credit-risk considerations. As noted above, the risk-based ratio does not take explicit account of the quality of individual asset portfolios or the range of other types of risks to which banking organizations may be exposed, such as interest-rate, liquidity, market, or operational risks. For this reason, banking organizations are generally expected to operate with capital positions well above the minimum ratios. Institutions with high or inordinate levels of risk are expected to operate well above minimum capital standards. Banking organizations experiencing or anticipating significant growth are also expected to maintain capital, including tangible capital positions, well above the minimum levels. For example, most such organizations generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. In all cases, organizations should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

Upon adoption of the risk-based framework, any organization that does not meet the interim or final supervisory ratios, or whose capital is otherwise considered inadequate, is expected to develop and implement a plan acceptable to the Federal Reserve for achieving an adequate level of capital consistent with the provisions of these guidelines or with the special circumstances affecting the individual organization. In addition, such organizations should avoid any actions, including increased risk-taking or unwarranted expansion, that would lower or further erode their capital positions.

A. Minimum Risk-Based Ratio After Transition Period

As reflected in attachment VI, by year-end 1992, all bank holding companies[56] should

[54] For interest- and exchange-rate contracts, sufficiency of collateral or guarantees is determined by the market value of the collateral or the amount of the guarantee in relation to the credit-equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III(B).

[55] Netting by novation, for this purpose, is a written bilateral contract between two counterparties under which any obligation to each other to deliver a given currency on a given date is automatically amalgamated with all other obligations for the same currency and value date, *legally* substituting one single net amount for the previous gross obligations.

[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.

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meet a minimum ratio of qualifying total capital to weighted-risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of tier 1 capital. For purposes of section IV.A., tier 1 capital is defined as the sum of core capital elements less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix. The maximum amount of supplementary capital elements that qualifies as tier 2 capital is limited to 100 percent of tier 1 capital. In addition, the combined maximum amount of subordinated debt and intermediate-term preferred stock that qualifies as tier 2 capital is limited to 50 percent of tier 1 capital. The maximum amount of the allowance for loan and lease losses that qualifies as tier 2 capital is limited to 1.25 percent of gross weighted-risk assets. Allowances for loan and lease losses in excess of this limit may, of course, be maintained, but would not be included in an organization's total capital. The Federal Reserve will continue to require bank holding companies to maintain reserves at levels fully sufficient to cover losses inherent in their loan portfolios.

Qualifying total capital is calculated by adding tier 1 capital and tier 2 capital (limited to 100 percent of tier 1 capital) and then deducting from this sum certain investments in banking or finance subsidiaries that are not consolidated for accounting or supervisory purposes, reciprocal holdings of banking organizations' capital securities, or other items at the direction of the Federal Reserve. The conditions under which these deductions are to be made and the procedures for making the deductions are discussed above in section II(B).

B. Transition Arrangements

The transition period for implementing the risk-based capital standard ends on December 31, 1992.[57] Initially, the risk-based capital guidelines do not establish a minimum level of capital. However, by year-end 1990, banking organizations are expected to meet a minimum interim target ratio for qualifying total capital to weighted-risk assets of 7.25 percent, at least one-half of which should be in the form of tier 1 capital. For purposes of meeting the 1990 interim target, the amount of loan-loss reserves that may be included in capital is limited to 1.5 percent of weighted-risk assets and up to 10 percent of an organization's tier 1 capital may consist of supplementary capital elements. Thus, the 7.25 percent interim target ratio implies a minimum ratio of tier 1 capital to weighted-risk assets of 3.6 percent (one-half of 7.25) and a minimum ratio of core capital elements to weighted-risk assets ratio of 3.25 percent (nine-tenths of the tier 1 capital ratio).

Through year-end 1990, banking organizations have the option of complying with the minimum 7.25 percent year-end 1990 riskbased capital standard, in lieu of the minimum 5.5 percent primary and 6 percent total capital to total assets ratios set forth in appendix B of Regulation Y (page 59). In addition, as more fully set forth in appendix D to Regulation Y (page 67), banking organizations are expected to maintain a minimum ratio or tier 1 capital to total assets during this transition period.

[57] The Basle capital framework does not establish an initial minimum standard for the risk-based capital ratio before the end of 1990. However, for the purpose of calculating a risk-based capital ratio prior to year-end 1990, no sublimit is placed on the amount of the allowance for loan and lease losses includable in tier 2. In addition, this framework permits, under temporary transition arrangements, a certain percentage of an organization's tier 1 capital to be made up of supplementary capital elements. In particular, supplementary elements may constitute 25 percent of an organization's tier 1 capital (before the deduction of goodwill) up to the end of 1990; from year-end 1990 up to the end of 1992, this allowable percentage of supplementary elements in tier 1 declines to 10 percent of tier 1 (before the deduction of goodwill). Beginning on December 31, 1992, supplementary elements may not be included in tier 1. The amount of subordinated debt and intermediate-term preferred stock temporarily included in tier 1 under these arrangements will not be subject to the sublimit on the amount of such instruments includable in tier 2 capital. While the transitional arrangements allow an organization to include supplementary elements in tier 1 on a temporary basis, the amount of perpetual preferred stock that may be included in a bank holding company's tier 1—both during and after the transition period—is, as described in section II(A), based solely upon a specified percentage of the organization's permanent core capital elements (that is, common equity, perpetual preferred stock, and minority interest in the equity of consolidated subsidiaries), not upon total tier 1 elements that temporarily include tier 2 items. Once the amount of supplementary items that may temporarily qualify as tier 1 elements is determined, goodwill must be deducted from the sum of this amount and the amount of the organization's permanent core capital elements for the purpose of calculating tier 1 (net of goodwill), tier 2, and total capital.

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Attachment I—Sample Calculation of Risk-Based Capital Ratio for Bank Holding Companies

Example of a banking organization with $6,000 in total capital and the following assets and off-balance-sheet items:

Balance-sheet assets	
Cash	$ 5,000
U.S. Treasuries	20,000
Balances at domestic banks	5,000
Loans secured by first liens on 1- to 4-family residential properties	5,000
Loans to private corporations	65,000
Total Balance-Sheet Assets	$100,000

Off-balance-sheet items	
Standby letters of credit (SLCs) backing general-obligation debt issues of U.S. municipalities (GOs)	$ 10,000
Long-term legally binding commitments to private corporations	20,000
Total Off-Balance-Sheet Items	$ 30,000

This bank holding company's total capital to *total* assets (leverage ratio) would be:

($6,000/$100,000) = 6.00%.

To compute the bank holding company's weighted-risk assets:

1. Compute the credit-equivalent amount of each off-balance-sheet (OBS) item.

OBS item	*Face value*		*Conversion factor*		*Credit-equivalent amount*
SLCs backing municipal GOs	$10,000	×	1.00	=	$10,000
Long-term commitments to private corporations	$20,000	×	0.50	=	$10,000

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2. Multiply each balance-sheet asset and the credit-equivalent amount of each OBS item by the appropriate risk weight.

OBS item	*Face value*		*Conversion factor*		*Credit-equivalent amount*
0% category					
Cash	$ 5,000				
U.S. Treasuries	20,000				
	$25,000	×	0	=	0
20% category					
Balances at domestic banks	$ 5,000				
Credit-equivalent amounts of SLCs backing GOs of U.S. municipalities	10,000				
	$15,000	×	0.20	=	$ 3,000
50% category					
Loans secured by first liens on 1- to 4-family residential properties	$ 5,000	×	0.50	=	$ 2,500
100% category					
Loans to private corporations	$65,000				
Credit-equivalent amounts of long-term commitments to private corporations	10,000				
	$75,000	×	1.00	=	$75,000
Total Risk-Weighted Assets					$80,500

This bank holding company's ratio of total capital to weighted-risk assets (risk-based capital ratio) would be:

($6,000/$80,500) = 7.45%

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

Using the Year-End 1992 Standards

Components	*Minimum requirements after transition period*
CORE CAPITAL (tier 1)	Must equal or exceed 4% of weighted-risk assets
Common stockholders' equity	No limit
Qualifying noncumulative perpetual preferred stock	No limit
Qualifying cumulative perpetual preferred stock	Limited to 25% of the sum of common stock, qualifying perpetual preferred stock, and minority interests
Minority interest in equity accounts of consolidated subsidiaries	Organizations should avoid using minority interests to introduce elements not otherwise qualifying for tier 1 capital
Less: Goodwill and other intangible assets required to be deducted from capital[1]	
SUPPLEMENTARY CAPITAL (tier 2)	Total of tier 2 is limited to 100% of tier 1[2]
Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets[2]
Perpetual preferred stock	No limit within tier 2
Hybrid capital instruments, perpetual debt, and mandatory convertible securities	No limit within tier 2
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more)	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1;[3] amortized for capital purposes as they approach maturity
Revaluation reserves (equity and building)	Not included; organizations encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making an overall assessment of capital
DEDUCTIONS (from sum of tier 1 and tier 2)	
Investments in unconsolidated subsidiaries	As a general rule, one-half of the aggregate investments will be deducted from tier 1 capital and one-half from tier 2 capital[4]
Reciprocal holdings of banking organizations' capital securities	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority	On a case-by-case basis or as a matter of policy after formal rulemaking
TOTAL CAPITAL (tier 1 + tier 2 − Deductions)	Must equal or exceed 8% of weighted-risk assets

* 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.

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

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

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

[4] A proportionately greater amount may be deducted from tier 1 capital if the risks associated with the subsidiary so warrant.

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

Category 1: Zero Percent

1. Cash (domestic and foreign) held in subsidiary depository institutions or in transit

2. Balances due from Federal Reserve Banks (including Federal Reserve Bank stock) and central banks in other OECD countries

3. Direct claims on, and the portions of claims that are unconditionally guaranteed by, the U.S. Treasury and U.S. government agencies[1] and the central governments of other OECD countries, and local currency claims on, and the portions of local currency claims that are unconditionally guaranteed by, the central governments of non-OECD countries (including the central banks of non-OECD countries), to the extent that subsidiary depository institutions have liabilities booked in that currency

4. Gold bullion held in the vaults of a subsidiary depository institution or in another's vaults on an allocated basis, to the extent offset by gold bullion liabilities

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

Category 2: 20 Percent

1. Cash items in the process of collection

2. All claims (long- or short-term) on, and the portions of claims (long- or short-term) that are guaranteed by, U.S. depository institutions and OECD banks

3. Short-term claims (remaining maturity of one year or less) on, and the portions of short-term claims that are guaranteed by, non-OECD banks

4. The portions of claims that are conditionally guaranteed by the central governments of OECD countries and U.S. government agencies, and the portions of local currency claims that are conditionally guaranteed by the central governments of non-OECD countries, to the extent that subsidiary depository institutions have liabilities booked in that currency

5. Claims on, and the portions of claims that are guaranteed by, U.S. government-sponsored agencies[2]

6. General obligation claims on, and the portions of claims that are guaranteed by the full faith and credit of, local governments and political subdivisions of the U.S. and other OECD local governments

7. Claims on, and the portions of claims that are guaranteed by, official multilateral lending institutions or regional development banks

8. The portions of claims that are collateralized[3] by cash on deposit in the subsidiary lending institution or by securities issued or guaranteed by the U.S. Treasury, the central governments of other OECD countries, and U.S. government agencies that do not qualify for the zero percent risk-weight category, or that are collateralized by securities issued or guaranteed by U.S. government–sponsored agencies.

9. The portions of claims that are collateralized[3] by securities issued by official multilateral lending institutions or regional development banks

10. Certain privately issued securities representing indirect ownership of mortgage-backed U.S. government agency or U.S. government–sponsored agency securities

[1] For the purpose of calculating the risk-based capital ratio, a U.S. government agency is defined as an instrumentality of the U.S. government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government.

[2] For the purpose of calculating the risk-based capital ratio, a U.S. government–sponsored agency is defined as an agency originally established or chartered to serve public purposes specified by the U.S. Congress but whose obligations are not *explicitly* guaranteed by the full faith and credit of the U.S. government.

[3] The extent of collateralization is determined by current market value.

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11. Investments in shares of a fund whose portfolio is permitted to hold only securities that would qualify for the zero or 20 percent risk categories

Category 3: 50 Percent

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

2. Revenue bonds or similar claims that are obligations of U.S. state or local governments, or other OECD local governments, but for which the government entity is committed to repay the debt only out of revenues from the facilities financed

3. Credit-equivalent amounts of interest rate–and foreign exchange rate–related contracts, except for those assigned to a lower risk category

Category 4: 100 Percent

1. All other claims on private obligors

2. Claims on, or guaranteed by, non-OECD foreign banks with a remaining maturity exceeding one year

3. Claims on, or guaranteed by, non-OECD central governments that are not included in item 3 of category 1 or item 4 of category 2; all claims on non-OECD state or local governments

4. Obligations issued by U.S. state or local governments, or other OECD local governments (including industrial-development authorities and similar entities), repayable solely by a private party or enterprise

5. Premises, plant, and equipment; other fixed assets; and other real estate owned

6. Investments in any unconsolidated subsidiaries, joint ventures, or associated companies—if not deducted from capital

7. Instruments issued by other banking organizations that qualify as capital—if not deducted from capital

8. Claims on commercial firms owned by a government

9. All other assets, including any intangible assets that are not deducted from capital

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Attachment IV—Credit-Conversion Factors for Off-Balance-Sheet Items for Bank Holding Companies

100 Percent Conversion Factor

1. Direct credit substitutes (These include general guarantees of indebtedness and all guarantee-type instruments, including standby letters of credit backing the financial obligations of other parties.)

2. Risk participations in banker's acceptances and direct credit substitutes, such as standby letters of credit

3. Sale and repurchase agreements and assets sold with recourse that are not included on the balance sheet

4. Forward agreements to purchase assets, including financing facilities, on which drawdown is *certain*

5. Securities lent for which the banking organization is at risk

50 Percent Conversion Factor

1. Transaction-related contingencies (These include bid bonds, performance bonds, warranties, and standby letters of credit backing the nonfinancial performance of other parties.)

2. Unused portions of commitments with an original maturity[1] exceeding one year, including underwriting commitments and commercial credit lines

3. Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and similar arrangements

20 Percent Conversion Factor

1. Short-term, self-liquidating, trade-related contingences, including commercial letters of credit

Zero Percent Conversion Factor

1. Unused portions of commitments with an original maturity[1] of one year or less, or which are unconditionally cancellable at any time, provided a separate credit decision is made before each drawing

Credit Conversion for Interest-Rate and Foreign-Exchange Contracts

The total replacement cost of contracts (obtained by summing the positive mark-to-market values of contracts) is added to a measure of future potential increases in credit exposure. This future potential exposure measure is calculated by multiplying the total notional value of contracts by one of the following credit conversion factors, as appropriate:

Remaining maturity	*Interest-rate contracts*	*Exchange-rate contracts*
One year or less	0	1.0%
Over one year	0.5%	5.0%

No potential exposure is calculated for single-currency interest-rate swaps in which payments are made based upon two floating rate indices, that is, so-called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-market value. Exchange-rate contracts with an original maturity of 14 days or less are excluded. Instruments traded on exchanges that require daily payment of variation margin are also excluded. The only form of netting recognized is netting by novation.

[1] Remaining maturity may be used until year-end 1992.

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Attachment V—Calculation of Credit-Equivalent Amounts

Interest Rate– and Foreign Exchange Rate–Related Transactions for Bank Holding Companies

	Potential Exposure			+ *Current Exposure*		= *Credit-Equivalent Amount (dollars)*
Type of contract (remaining maturity)	*Notional principal (dollars)* ×	*Potential exposure conversion factor*	= *Potential exposure (dollars)*	*Replacement cost*[1]	*Current exposure (dollars)*[2]	
(1) 120-day forward foreign exchange	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 120-day forward foreign exchange	6,000,000	.01	60,000	−120,000	–0–	60,000
(3) 3-year single-currency fixed/ floating interest-rate swap	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 3-year single-currency fixed/ floating interest-rate swap	10,000,000	.005	50,000	−250,000	–0–	50,000
(5) 7-year cross-currency floating/ floating interest-rate swap	20,000,000	.05	1,000,000	−1,300,000	–0–	1,000,000
TOTAL	**$51,000,000**					**$1,510,000**

[1] These numbers are purely for illustration.

[2] The larger of zero or a positive mark-to-market value.

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Attachment VI

SUMMARY OF:

	Transitional Arrangements for Bank Holding Companies		*Final Arrangement*
	Initial	*Year-end 1990*	*Year-end 1992*
1. Minimum standard of total capital to weighted-risk assets	None	7.25%	8.0%
2. Definition of tier 1 capital	Common equity, qualifying cumulative perpetual preferred stock,[1] and minority interests, *plus* supplementary elements,[2] *less* goodwill[3]	Common equity, qualifying cumulative and noncumulative perpetual preferred stock,[1] and minority interests, *plus* supplementary elements,[4] *less* goodwill[3]	Common equity, qualifying noncumulative and cumulative perpetual preferred stock,[1] and minority interest *less* goodwill and other intangible assets required to be deducted from capital[3]
3. Minimum standards of tier 1 capital to weighted-risk assets	None	3.625%	4.0%
4. Minimum standard of stockholders' equity to weighted-risk assets	None	3.25%	4.0%
5. Limitations on supplementary capital elements			
a. Allowance for loan and lease losses	No limit within tier 2	1.5% of weighted-risk assets	1.25% of weighted-risk assets
b. Perpetual preferred stock	No limit within tier 2	No limit within tier 2	No limit within tier 2
c. Hybrid capital instruments, perpetual debt, and mandatory convertibles	No limit within tier 2	No limit within tier 2	No limit within tier 2
d. Subordinated debt and intermediate-term preferred stock	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1
e. Total qualifying tier 2 capital	May not exceed tier 1 capital	May not exceed tier 1 capital	May not exceed tier 1 capital
6. Definition of total capital	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries[5]	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries[5]	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries[5]

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

[2] Supplementary elements may be included in tier 1 up to 25% of the sum of tier 1 plus goodwill.

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

[4] Supplementary elements may be included in tier 1 up to 10% of the sum of tier 1 plus goodwill.

[5] As a general rule, one-half (50%) of the aggregate amount of investments will be deducted from tier 1 capital and one-half (50%) from tier 2 capital. A proportionally greater amount may be deducted from tier 1 capital if the risks associated with the subsidiary so warrant.

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Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks: Leverage Measure

Regulation Y (12 CFR 225), Appendix B; as amended effective September 7, 1990

The Board of Governors of the Federal Reserve System has adopted minimum capital ratios and guidelines to provide a framework for assessing the adequacy of the capital of bank holding companies and state member banks (collectively "banking organizations"). The guidelines generally apply to all state member banks and bank holding companies regardless of size and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board of Governors will review the guidelines from time to time for possible adjustments commensurate with changes in the economy, financial markets, and banking practices. In this regard, the Board has determined that during the transition period through year-end 1990 for implementation of the risk-based capital guidelines contained in appendix A to part 225 (page 31) and in appendix A to part 208 (page 1), a banking organization may choose to fulfill the requirements of the guidelines relating capital to total assets contained in this appendix in one of two manners. Until year-end 1990, a banking organization may choose to conform to either the 5.5 percent and 6 percent minimum primary and total capital standards set forth in this appendix, or the 7.25 percent year-end 1990 minimum risk-based capital standard set forth in appendix A to this part and appendix A to part 208. Those organizations that choose to conform during this period to the 7.25 percent year-end 1990 risk-based capital standard will be deemed to be in compliance with the capital adequacy guidelines set forth in this appendix.

Two principal measurements of capital are used—the primary capital ratio and the total capital ratio. The definitions of primary and total capital for banks and bank holding companies and formulas for calculating the capital ratios are set forth below in the definitional sections of these guidelines.

Capital Guidelines

The Board has established a minimum level of primary capital to total assets of 5.5 percent and a minimum level of total capital to total assets of 6.0 percent. Generally, banking organizations are expected to operate above the minimum primary and total capital levels. Those organizations whose operations involve or are exposed to high or inordinate degrees of risk will be expected to hold additional capital to compensate for these risks.

In addition, the Board has established the following three zones for total capital for banking organizations of all sizes:

	Total Capital Ratio
Zone 1	Above 7.0%
Zone 2	6.0% to 7.0%
Zone 3	Below 6.0%

The capital guidelines assume adequate liquidity and a moderate amount of risk in the loan and investment portfolios and in off-balance-sheet activities. The Board is concerned that some banking organizations may attempt to comply with the guidelines in ways that reduce their liquidity or increase risk. Banking organizations should avoid the practice of attempting to meet the guidelines by decreasing the level of liquid assets in relation to total assets. In assessing compliance with the guidelines, the Federal Reserve will take into account liquidity and the overall degree of risk associated with an organization's operations, including the volume of assets exposed to risk.

The Federal Reserve will also take into account the sale of loans or other assets with recourse and the volume and nature of all off-balance-sheet risk. Particularly close attention will be directed to risks associated with standby letters of credit and participation in joint-venture activities. The Federal Reserve will review the relationship of all on- and off-balance-sheet risks to capital and will require; those institutions with high or inordinate levels of risk to hold additional primary capital. In addition, the Federal Reserve will continue to review the need for more explicit procedures for factoring on- and off-balance-sheet risks into the assessment of capital adequacy.

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The capital guidelines apply to both banks and bank holding companies on a consolidated basis.[1] Some banking organizations are engaged in significant nonbanking activities that typically require capital ratios higher than those of commercial banks alone. The Board believes that, as a matter of both safety and soundness and competitive equity, the degree of leverage common in banking should not automatically extend to nonbanking activities. Consequently, in evaluating the consolidated capital positions of banking organizations, the Board is placing greater weight on the building-block approach for assessing capital requirements. This approach generally provides that nonbank subsidiaries of a banking organization should maintain levels of capital consistent with the levels that have been established by industry norms or standards, by federal or state regulatory agencies for similar firms that are not affiliated with banking organizations, or that may be established by the Board after taking into account risk factors of a particular industry. The assessment of an organization's consolidated capital adequacy must take into account the amount and nature of all nonbank activities, and an institution's consolidated capital position should at least equal the sum of the capital requirements of the organization's bank and nonbank subsidiaries as well as those of the parent company.

Supervisory Action

The nature and intensity of supervisory action will be determined by an organization's compliance with the required minimum primary capital ratio as well as by the zone in which the company's total capital ratio falls. Banks and bank holding companies with primary capital ratios below the 5.5 percent minimum will be considered undercapitalized unless they can demonstrate clear extenuating circumstances. Such banking organizations will be required to submit an acceptable plan for achieving compliance with the capital guidelines and will be subject to denial of applications and appropriate supervisory enforcement actions.

The zone into which an organization's total capital ratio falls will normally trigger the following supervisory responses, subject to qualitative analysis:

- For institutions operating in zone 1, the Federal Reserve will consider that capital is generally adequate if the primary capital ratio is acceptable to the Federal Reserve and is above the 5.5 percent minimum.
- For institutions operating in zone 2, the Federal Reserve will pay particular attention to financial factors, such as asset quality, liquidity, off-balance-sheet risk, and interest-rate risk, as they relate to the adequacy of capital. If these areas are deficient and the Federal Reserve concludes capital is not fully adequate, the Federal Reserve will intensify its monitoring and take appropriate supervisory action.
- For institutions operating in zone 3, the Federal Reserve will—
  - —consider that the institution is undercapitalized, absent clear extenuating circumstances;
  - —require the institution to submit a comprehensive capital plan, acceptable to the Federal Reserve, that includes a program for achieving compliance with the required minimum ratios within a reasonable time period; and
  - —institute appropriate supervisory and/or administrative enforcement action, which may include the issuance of a capital directive or denial of applications, unless a capital plan acceptable to the Federal Reserve has been adopted by the institution.

Treatment of Intangible Assets for Purpose of Assessing Capital Adequacy

In considering the treatment of intangible assets for the purpose of assessing capital adequacy, the Federal Reserve recognizes that the determination of the future benefits and useful lives of certain intangible assets may involve

[1] The guidelines will apply to bank holding companies with less than $150 million in consolidated assets on a bank-only basis unless (1) the holding company or any nonbank subsidiary is engaged directly or indirectly in any nonbank activity involving significant leverage or (2) the holding company or any nonbank subsidiary has outstanding significant debt held by the general public. Debt held by the general public is defined to mean debt held by parties other than financial institutions, officers, directors, and controlling shareholders of the banking organization or their related interests.

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a degree of uncertainty that is not normally associated with other banking assets. Supervisory concern over intangible assets derives from this uncertainty and from the possibility that, in the event an organization experiences financial difficulties, such assets may not provide the degree of support generally associated with other assets. For this reason, the Federal Reserve will carefully review the level and specific character of intangible assets in evaluating the capital adequacy of state member banks and bank holding companies.

The Federal Reserve recognizes that intangible assets may differ with respect to predictability of any income stream directly associated with a particular asset, the existence of a market for the asset, the ability to sell the asset, or the reliability of any estimate of the asset's useful life. Certain intangible assets have predictable income streams and objectively verifiable values and may contribute to an organization's profitability and overall financial strength. The value of other intangibles, such as goodwill, may involve a number of assumptions and may be more subject to changes in general economic circumstances or to changes in an individual institution's future prospects. Consequently, the value of such intangible assets may be difficult to ascertain. Consistent with prudent banking practices and the principle of the diversification of risks, banking organizations should avoid excessive balance-sheet concentration in any category or related categories of intangible assets.

Bank Holding Companies

While the Federal Reserve will consider the amount and nature of all intangible assets, those holding companies with aggregate intangible assets in excess of 25 percent of tangible primary capital (i.e., stated primary capital less all intangible assets) or those institutions with lesser, although still significant, amounts of goodwill will be subject to close scrutiny. For the purpose of assessing capital adequacy, the Federal Reserve may, on a case-by-case basis, make adjustments to an organization's capital ratios based upon the amount of intangible assets in excess of the 25 percent threshold level or upon the specific character of the organization's intangible assets in relation to its overall financial condition. Such adjustments may require some organizations to raise additional capital.

The Board expects banking organizations (including state member banks) contemplating expansion proposals to ensure that pro forma capital ratios exceed the minimum capital levels without significant reliance on intangibles, particularly goodwill. Consequently, in reviewing acquisition proposals, the Board will take into consideration both the stated primary capital ratio (that is, the ratio without any adjustment for intangible assets) and the primary capital ratio after deducting intangibles. In acting on applications, the Board will take into account the nature and amount of intangible assets and will, as appropriate, adjust capital ratios to include certain intangible assets on a case-by-case basis.

State Member Banks

State member banks with intangible assets in excess of 25 percent of tangible primary capital will be subject to close scrutiny. In addition, for the purpose of calculating capital ratios of state member banks, the Federal Reserve will deduct goodwill from primary capital and total capital. The Federal Reserve may, on a case-by-case basis, make further adjustments to a bank's capital ratios based on the amount of intangible assets (aside from goodwill) in excess of the 25 percent thresh old level or on the specific character of the bank's intangible assets in relation to its overall financial condition. Such adjustments may require some banks to raise additional capital.

In addition, state member banks and bank holding companies are expected to review periodically the value at which intangible assets are carried on their balance sheets to determine whether there has been any impairment of value or whether changing circumstances warrant a shortening of amortization periods. Institutions should make appropriate reductions in carrying values and amortization periods in light of this review, and examiners will evaluate the treatment of intangible assets during on-site examinations.

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Definition of Capital to Be Used in Determining Capital Adequacy

Primary Capital Components

The components of primary capital are—

- common stock,
- perpetual preferred stock (preferred stock that does not have a stated maturity date and that may not be redeemed at the option of the holder),
- surplus (excluding surplus relating to limited-life preferred stock),
- undivided profits,
- contingency and other capital reserves,
- mandatory convertible instruments,[2]
- allowance for possible loan and lease losses (exclusive of allocated transfer risk reserves),
- minority interest in equity accounts of consolidated subsidiaries, and
- perpetual debt instruments (for bank holding companies but not for state member banks).

Limits on Certain Forms of Primary Capital

Bank holding companies. The maximum composite amount of mandatory convertible securities, perpetual debt, and perpetual preferred stock that may be counted as primary capital for bank holding companies is limited to 33.3 percent of all primary capital, including these instruments. Perpetual preferred stock issued prior to November 20, 1985, (or determined by the Federal Reserve to be in the process of being issued prior to that date) shall continue to be included as primary capital.

The maximum composite amount of mandatory convertible securities and perpetual debt that may be counted as primary capital for bank holding companies is limited to 20 percent of all primary capital, including these instruments. The maximum amount of equity commitment notes (a form of mandatory convertible securities) that may be counted as primary capital for a bank holding company is limited to 10 percent of all primary capital, including mandatory convertible securities. Amounts outstanding in excess of these limitations may be counted as secondary capital provided they meet the requirements of secondary capital instruments.

State member banks. The composite limitations on the amount of mandatory convertible securities and perpetual preferred stock (perpetual debt is not primary capital for state member banks) that may serve as primary capital for bank holding companies shall not be applied formally to state member banks, although the Board shall determine appropriate limits for these forms of primary capital on a case-by-case basis.

The maximum amount of mandatory convertible securities that may be counted as primary capital for state member banks is limited to 16⅔ percent of all primary capital, including mandatory convertible securities. Equity commitment notes, one form of mandatory convertible securities, shall not be included as primary capital for state member banks except that notes issued by state member banks prior to May 15, 1985, will continue to be included in primary capital. Amounts of mandatory convertible securities in excess of these limitations may be counted as secondary capital if they meet the requirements of secondary capital instruments.

Secondary Capital Components

The components of secondary capital are—

- limited-life preferred stock (including related surplus) and
- bank subordinated notes and debentures and unsecured long-term debt of the parent company and its nonbank subsidiaries.

Restrictions Relating to Capital Components

To qualify as primary or secondary capital, a capital instrument should not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices. Examples of such terms are those regarded as unduly interfering with the ability of the bank or holding company to conduct normal banking operations or those resulting in significantly higher dividends or interest payments in the event of a deterioration in the financial condition of the issuer.

[2] See the definitional section below that lists the criteria for mandatory convertible instruments to qualify as primary capital.

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The secondary components must meet the following conditions to qualify as capital:

- The instrument must have an original weighted-average maturity of at least seven years.
- The instrument must be unsecured.
- The instrument must clearly state on its face that it is not a deposit and is not insured by a federal agency.
- Bank debt instruments must be subordinated to claims of depositors.
- For banks only, the aggregate amount of limited-life preferred stock and subordinate debt qualifying as capital may not exceed 50 percent of the amount of the bank's primary capital.

As secondary capital components approach maturity, the banking organization must plan to redeem or replace the instruments while maintaining an adequate overall capital position. Thus, the remaining maturity of secondary capital components will be an important consideration in assessing the adequacy of total capital.

Capital Ratios

The primary and total capital ratios for bank holding companies are computed as follows:

Primary capital ratio:

$$\frac{\text{Primary capital components}}{\text{Total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)}}$$

Total capital ratio:

$$\frac{\text{Primary capital components + Secondary capital components}}{\text{Total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)}}$$

The primary and total capital ratios for state member banks are computed as follows:

Primary capital ratio:

$$\frac{\text{Primary capital components} - \text{Goodwill}}{\text{Average total assets + Allownce for loan and lease losses (exclusive of allocated transfer risk reserves)} - \text{Goodwill}}$$

Total capital ratio:

$$\frac{\text{Primary capital components + Secondary capital components} - \text{Goodwill}}{\text{Average total assets + Allownce for loan and lease losses (exclusive of allocated transfer risk reserves)} - \text{Goodwill}}$$

Generally, period-end amounts will be used to calculate bank holding company ratios. However, the Federal Reserve will discourage temporary balance-sheet adjustments or any other "window dressing" practices designed to achieve transitory compliance with the guidelines. Banking organizations are expected to maintain adequate capital positions at all times. Thus, the Federal Reserve will, on a case-by-case basis, use average total assets in the calculation of bank holding company capital ratios whenever this approach provides a more meaningful indication of an individual holding company's capital position.

For the calculation of bank capital ratios, "average total assets" will generally be defined as the quarterly average total assets figure reported on the bank's Report of Condition. If warranted, however, the Federal Reserve may calculate bank capital ratios based upon total assets as of period-end. All other components of the bank's capital ratios will be based upon period-end balances.

Criteria for Determining Primary Capital Status of Mandatory Convertible Securities

Mandatory convertible securities are subordinated debt instruments that are eventually transformed into common or perpetual preferred stock within a specified period of time, not to exceed 12 years. To be counted as primary capital, mandatory convertible securities must meet the criteria set forth below. These criteria cover the two basic types of mandatory convertible securities: equity contract notes (securities that obligate the holder to take common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal) and equity commitment notes (securities that are redeemable only with the proceeds from the sale of common or perpetual

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preferred stock). Both equity commitment notes and equity contract notes qualify as primary capital for bank holding companies, but only equity contract notes qualify as primary capital for banks.

Criteria Applicable to Both Types of Mandatory Convertible Securities

a. The securities must mature in 12 years or less.

b. The issuer may redeem securities prior to maturity only with the proceeds from the sale of common or perpetual preferred stock of the bank or bank holding company. Any exception to this rule must be approved by the Federal Reserve. The securities may not be redeemed with the proceeds of another issue of mandatory convertible securities. Nor may the issuer repurchase or acquire its own mandatory convertible securities for resale or reissuance.

c. Holders of the securities may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.

d. The securities must be subordinate in right of payment to all senior indebtedness of the issuer. In the event that the proceeds of the securities are reloaned to an affiliate, the loan must be subordinated to the same degree as the original issue.

e. An issuer that intends to dedicate the proceeds of an issue of common or perpetual preferred stock to satisfy the funding requirements of an issue of mandatory convertible securities (i.e. the requirement to retire or redeem the notes with the proceeds from the issuance of common or perpetual preferred stock) generally must make such a dedication during the quarter in which the new common or preferred stock is issued.[3] As a general rule, if the dedication is not made within the prescribed period, then the securities issued may not at a later date be dedicated to the retirement or redemption of the mandatory convertible securities.[4]

Additional Criteria Applicable to Equity Contract Notes

a. The note must contain a contractual provision (or must be issued with a mandatory stock purchase contract) that requires the holder of the instrument to take the common or perpetual stock of the issuer in lieu of cash in satisfaction of the claim for principal repayment. The obligation of the holder to take the common or perpetual preferred stock of the issuer may be waived if, and to the extent that, prior to the maturity date of the obligation, the issuer sells new common or perpetual preferred stock and dedicates the proceeds to the retirement or redemption of the notes. The dedication generally must be made during the quarter in which the new common or preferred stock is issued.

b. A stock purchase contract may be separated from a security only if (1) the holder of the contract provides sufficient collateral[5] to the issuer, or to an independent trustee for the benefit of the issuer, to ensure performance under the contract and (2) the stock purchase contract requires the purchase of common or perpetual preferred stock.

[3] Common or perpetual preferred stock issued under dividend reinvestment plans or issued to finance acquisitions, including acquisitions of business entities, may be dedicated to the retirement or redemption of the mandatory convertible securities. Documentation certified by an authorized agent of the issuer showing the amount of common stock or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.

[4] The dedication procedure is necessary to ensure that the primary capital of the issuer is not overstated. For each dollar of common or perpetual preferred proceeds dedicated to the retirement or redemption of the notes, there is a corresponding reduction in the amount of outstanding mandatory securities that may qualify as primary capital. De minimis amounts (in relation to primary capital) of common or perpetual preferred stock issued under arrangements in which the amount of stock issued is not predictable, such as dividend reinvestment plans and employee stock option plans (but excluding public stock offerings and stock issued in connection with acquisitions), should be dedicated by no later than the company's fiscal year-end.

[5] Collateral is defined as (1) cash or certificates of deposit; (2) U.S. government securities that will mature prior to or simultaneous with the maturity of the equity contract and that have a par or maturity value at least equal to the amount of the holder's obligation under the stock purchase contract; (3) standby letters of credit issued by an insured U.S. bank that is not an affiliate of the issuer; or (4) other collateral as may be designated from time to time by the Federal Reserve.

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Additional Criteria Applicable to Equity Commitment Notes

a. The indenture or note agreement must contain the following two provisions:

1. The proceeds of the sale of common or perpetual preferred stock will be the sole source of repayment for the notes, and the issuer must dedicate the proceeds for the purpose of repaying the notes. (Documentation certified by an authorized agent of the issuer showing the amount of common or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.)

2. By the time that one-third of the life of the securities has run, the issuer must have raised and dedicated an amount equal to one-third of the original principal of the securities. By the time that two-thirds of the life of the securities has run, the issuer must have raised and dedicated an amount equal to two-thirds of the original principal of the securities. At least 60 days prior to the maturity of the securities, the issuer must have raised and dedicated an amount equal to the entire original principal of the securities. Proceeds dedicated to redemption or retirement of the notes must come only from the sale of common or perpetual preferred stock.[6]

b. If the issuer fails to meet any of these periodic funding requirements, the Federal Reserve immediately will cease to treat the unfunded securities as primary capital and will take appropriate supervisory action. In addition, failure to meet the funding requirements will be viewed as a breach of a regulatory commitment and will be taken into consid eration by the Board in acting on statutory applications.

c. If a security is issued by a subsidiary of a bank or bank holding company, any guarantee of the principal by that subsidiary's parent bank or bank holding company must be subordinate to the same degree as the security issued by the subsidiary and limited to repayment of the principal amount of the security at its final maturity.

[6] The funded portions of the securities will be deducted from primary capital to avoid double counting.

Criteria for Determining the Primary Capital Status of Perpetual Debt Instruments of Bank Holding Companies

a. The instrument must be unsecured and, if issued by a bank, must be subordinated to the claims of depositors.

b. The instrument may not provide the noteholder with the right to demand repayment of principal except in the event of bankruptcy, insolvency, or reorganization. The instrument must provide that nonpayment of interest shall not trigger repayment of the principal of the perpetual debt note or any other obligation of the issuer, nor shall it constitute prima facie evidence of insolvency or bankruptcy.

c. The issuer shall not voluntarily redeem the debt issue without prior approval of the Federal Reserve, except when the debt is converted to, exchanged for, or simultaneously replaced in like amount by an issue of common or perpetual preferred stock of the issuer or the issuer's parent company.

d. If issued by a bank holding company, a bank subsidiary, or a subsidiary with substantial operations, the instrument must contain a provision that allows the issuer to defer interest payments on the perpetual debt in the event of, and at the same time as the elimination of dividends on all outstanding common or preferred stock of the isssuer (or in the case of a guarantee by a parent company at the same time as the elimination of the dividends of the parent company's common and preferred stock). In the case of a nonoperating subsidiary (a funding subsidiary or one formed to issue securities), the deferral of interest payments must be triggered by elimination of dividends by the parent company.

e. If issued by a bank holding company or a subsidiary with substantial operations, the instrument must convert automatically to common or perpetual preferred stock of the issuer when the issuer's retained earnings and surplus accounts become negative. If an operating subsidiary's perpetual debt is guaranteed by its parent, the debt may convert to the

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shares of the issuer or guarantor and such conversion may be triggered when the issuer's or parent's retained earnings and surplus accounts become negative. If issued by a nonoperating subsidiary of a bank holding company or bank, the instrument must convert automatically to common or preferrred stock of the issuer's parent when the retained earnings and surplus accounts of the issuer's parent become negative.

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Capital Adequacy Guidelines for Bank Holding Companies: Tier 1 Leverage Measure

Regulation Y (12 CFR 225), Appendix D; as amended effective March 9, 1993

I. Overview

The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of bank holding companies ("banking organizations").[1] The principal objectives of this measure is to place a constraint on the maximum degree to which a banking organization can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

The guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $150 million or more. For bank holding companies with less than $150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless (a) the parent bank holding company is engaged in nonbank activity involving significant leverage. [2] or (b) the parent company has a significant amount of outstanding debt that is held by the general public.

The tier 1 leverage guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

II. The Tier 1 Leverage Ratio

The Board has established a *minimum* level of tier 1 capital to total assets of 3 percent. A banking organization operating at or near these levels is expected to have well-diversified risk, including no undue interest-rate risk exposure; excellent asset quality; high liquidity; and good earnings; and in general be considered a strong banking organization, rated composite 1 under the BOPEC rating system for bank holding companies. Organizations not meeting these characteristics, as well as institutions with supervisory, financial, or operational weaknesses, are expected to operate well above minimum capital standards. Organizations experiencing or anticipating significant growth also are expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. For example, most such organizations generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. Thus, for all but the most highly rated organizations meeting the conditions set forth above, the minimum tier 1 leveraged ratio is to be 3 percent plus an additional cushion of at least 100 to 200 basis points. In all cases, banking organizations should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.

A banking organization's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated on the basis of period-end assets, whenever necessary on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital for year-end 1992 as set forth in the risk-based capital guidelines contained in appendix A to Regulation Y (page 31) will be used.[3] As a general matter, average total consolidated

[1] Supervisory ratios that relate capital to total assets for state member banks are outlined in appendix B of Regulation Y (page 59).

[2] A parent company that is engaged in signific off balance sheet activities would generally be deemed to be engaged in activities that involve significant leverage

[3] At the end of 1992, tier 1 capital for 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.

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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 determines should be deducted from tier 1 capital.[4]

[4] Deductions from tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A to Regulation Y (page 31).

Whenever appropriate, including when an organization is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual organization's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and practice with regard to leverage guidelines. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

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