FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 10751
December 28, 1994]

RISK-BASED CAPITAL GUIDELINES

— Netting Arrangements

— Net Unrealized Gains/Losses on Securities Available for Sale

— Concentration of Credit Risk; Risks of Nontraditional Activities

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

The Board of Governors of the Federal Reserve System has adopted amendments to its risk-based capital guidelines, effective December 31, 1994, (a) to allow institutions to net the mark-to-market of interest and exchange rate contracts subject to qualifying bilateral netting contracts, and (b) to direct institutions not to include in Tier 1 capital net unrealized gains and losses on securities available for sale. Also, effective January 17, 1995, concentrations of credit risk and risks posed by nontraditional activities, as well as an institution's ability to manage these risks, will be explicitly identified as important factors in assessing capital adequacy. Printed below are the texts of the Board's announcements.

Netting arrangements

The Federal Reserve Board has issued amendments to its risk-based capital guidelines for state member banks and bank holding companies to recognize the risk-reducing benefits of netting arrangements.

The amendments are effective December 31, 1994.

Under the amendments, institutions will be permitted to net, for risk-based capital purposes, the mark-to-market of interest and exchange rate contracts subject to qualifying bilateral netting contracts.

The amendments will allow state member banks and bank holding companies to net positive and negative mark-to-market values of rate contracts in determining the current exposure portion of the credit equivalent amount of such contracts to be included in risk-weighted assets.

These amendments implement a recent revision to the Basle Accord that allow the recognition of such netting arrangements.

Securities available for sale

The Federal Reserve Board has issued final amendments to its risk-based capital guidelines for state member banks and bank holding companies.

The amendments are effective December 31, 1994.

Under this final rule, institutions are generally directed not to include in Tier 1 capital the component of common stockholders equity (net unrealized holding gains and losses on securities available for sale).

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This component was created by the Financial Accounting Standards Board (FASB) Statement No. 115, "Accounting for Certain Investments in Debt Equity Securities."

Net unrealized losses on marketable equity securities (equity securities with readily determinable fair values), however, will continue to be deducted from Tier 1 capital. This rule has the general effect of valuing available-for-sale securities at amortized cost (based on historical cost), rather than at fair value (generally at market value), for purposes of calculating the risk-based and leverage capital ratios.

Concentration of risk; risks of nontraditional activities

The Federal Reserve Board has issued amendments to the Board's risk-based capital guidelines for state member banks regarding concentration of credit risk and risks of nontraditional activities.

The amendments are effective January 17, 1995.

The amendments implement Section 305 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) which directs each Federal banking agency to revise its risk-based capital standards to ensure that the standards take adequate account of these risks.

As amended, the risk-based capital guidelines explicitly identify concentrations of credit risk and an institution's ability to manage them as important factors in assessing an institution's overall capital adequacy.

The amendments also identify an institution's ability to adequately manage the risks posed by nontraditional activities as an important factor to consider in assessing an institution's overall capital adequacy.

The Board initially approved these amendments on August 3, 1994. Publication of the joint final rule was delayed to reach interagency agreement.

Enclosed — for state member banks, bank holding companies, and others who maintain sets of the Board's regulations — are the texts of the official notices of these changes, as published in the *Federal Register*; copies will be furnished to others upon request directed to the Circulars Division of this Bank (Tel. No. 212-720-5215 or 5216). In addition, copies can be obtained at this Bank (33 Liberty Street) from the Issues Division on the first floor. Questions on these amendments may be directed to our Bank Analysis Department (Tel. No. 212-720-6710).

William J. McDonough,
President.

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federal register

Wednesday December 7, 1994 Vol. 59, No. 234 Pp. 62987-62995	Thursday December 8, 1994 Vol. 59, No. 235 Pp. 63241-63245	Thursday December 15, 1994 Vol. 59, No. 240 Pp. 64561-64564

RISK-BASED CAPITAL GUIDELINES (Regs. H & Y)

- Netting Arrangements
  Docket No. R-0837
  Effective December 31, 1994
- Securities Available for Sale
  Docket No. R-0823
  Effective December 31, 1994
- Concentration of Credit Risk;
  Risks of Nontraditional Activities
  Docket No. R-0764
  Effective January 17, 1994

[Enc. Cir. 10751]

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FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R-0837]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is amending its risk-based capital guidelines to recognize the risk-reducing benefits of qualifying bilateral netting contracts. This final rule implements a recent revision to the Basle Accord permitting the recognition of such netting arrangements. The effect of the final rule is that state member banks and bank holding companies (banking organizations, institutions) may net positive and negative mark-to-market values of interest and exchange rate contracts in determining the current exposure portion of the credit equivalent amount of such contracts to be included in risk-weighted assets.

EFFECTIVE DATE: December 31, 1994.

FOR FURTHER INFORMATION CONTACT: Roger Cole, Deputy Associate Director (202/452-2618), Norah Barger, Manager (202/452-2402), Robert Motyka, Supervisory Financial Analyst (202)/452-3621), Barbara Bouchard, Supervisory Financial Analyst (202/452-3072), Division of Banking Supervision and Regulation; or Stephanie Martin, Senior Attorney (202/452-3198), Legal Division. For the hearing impaired only, Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544), 20th and C Streets, N.W., Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION:

Background

The Basle Accord [1] established a risk-based capital framework which was implemented for state member banks and bank holding companies by the Board in 1989. Under this framework, off-balance-sheet interest rate and exchange rate contracts (rate contracts) are incorporated into risk weighted assets by converting each contract into a credit equivalent amount. This amount is then assigned to the appropriate credit risk category according to the identity of the obligor or counterparty or, if relevant, the guarantor or the nature of the collateral. The credit equivalent amount of an interest or exchange rate contract can be assigned to a maximum credit risk category of 50 percent.

The credit equivalent amount of a rate contract is determined by adding together the current replacement cost (current exposure) and an estimate of the possible increase in future replacement cost in view of the volatility of the current exposure over the remaining life of the contract (potential future exposure, also referred to as the add-on).[2]

For risk-based capital purposes, a rate contract with a positive mark-to-market value has a current exposure equal to that market value. If the mark-to-market value of a rate contract is zero or negative, then there is no replacement cost associated with the contract and the current exposure is zero. The original Basle Accord and the Board's guidelines provided that current exposure would be determined individually for each rate contract entered into by a banking organization; institutions generally were not permitted to offset, that is, net, positive and negative market values of multiple rate contracts with a single counterparty to determine one current credit exposure relative to that counterparty.[3]

In April 1993 the Basle Supervisors' Committee proposed a revision to the Basle Accord, endorsed by the G-10 Governors in July 1994, that permits institutions to net positive and negative market values of rate contracts subject to a qualifying, legally enforceable, bilateral netting arrangement. Under the revision, institutions with a qualifying netting arrangement may calculate a single net current exposure for purposes of determining the credit equivalent amount for the included contracts.[4] If the net market value of the contracts included in such a netting arrangement is positive, then that market value equals the current exposure for the netting contract. If the net market value is zero or negative, then the current exposure is zero.

The Board's Proposal

On May 20, 1994, the Board and the Office of the Comptroller of the Currency (OCC) issued a joint proposal to amend their respective risk-based capital standards (59 FR 26456) in accordance with the Basle Supervisors' Committee's April 1993 proposal.[5] The joint proposal provided that for capital purposes institutions regulated by the Board and the OCC could net the positive and negative market values of interest and exchange rate contracts subject to a qualifying, legally enforceable, bilateral netting contract to calculate one current exposure for that netting contract (sometimes referred to as the master netting contract).

The proposal provided that the net current exposure would be determined by adding together all positive and negative market values of individual contracts subject to the netting contract. The net current exposure would equal the sum of the market values if that sum is a positive value, or zero if the sum of

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

[2] This method of determining credit equivalent amounts for rate contracts is identified in the Basle Accord as the current exposure method, which is used by most international banks.

[3] It was noted in the Accord that the legal enforceability of certain netting arrangements was unclear in some jurisdictions. The legal status of netting by novation, however, was determined to be settled and this limited type of netting was recognized. Netting by novation is accomplished under a written bilateral contract providing that any obligation to deliver a given currency on a given date is automatically amalgamated with all other obligations for the same currency and value date. The previously existing contracts are extinguished and a new contract for the single net amount, in effect, legally replaces the amalgamated gross obligations.

[4] The revision to the Accord notes that national supervisors must be satisfied about the legal enforceability of a netting arrangement under the laws of each jurisdiction relevant to the arrangement. The Accord also states that, if any supervisor is dissatisfied about enforceability under its own laws, the netting arrangement does not satisfy this condition and neither counterparty may obtain supervisory benefit.

[5] The Office of Thrift Supervision (OTS) issued a similar netting proposal on June 14, 1994 and the Federal Deposit Insurance Corporation (FDIC) issued its netting proposal on July 25, 1994.

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the market values is zero or a negative value. The proposals did not alter the calculation method for potential future exposure.[6]

Under the proposal, institutions would be able to net for risk-based capital purposes only with a written bilateral netting contract that creates a single legal obligation covering all included individual rate contracts and does not contain a walkaway clause.[7] The proposal required an institution to obtain a written and reasoned legal opinion(s) stating that under the master netting contract the institution would have a claim to receive, or an obligation to pay, only the net amount of the sum of the positive and negative market values of included individual contracts if a counterparty failed to perform due to default, insolvency, bankruptcy, liquidation, or similar circumstances.

The proposal indicated that the legal opinion must normally cover: (i) The law of the jurisdiction in which the counterparty is chartered, or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, the law of the jurisdiction in which the branch is located; (ii) the law that governs the individual contracts covered by the netting contract; and (iii) the law that governs the netting contract.

The proposal provided that an institution must maintain in its files documentation adequate to support the bilateral netting contract. Documentation would typically include a copy of the bilateral netting contract, legal opinions and any related translations. In addition, the proposal required an institution to establish and maintain procedures to ensure that the legal characteristics of netting contracts would be kept under review.

Under the proposal, the Federal Reserve could disqualify any or all contracts from netting treatment for risk-based capital purposes if the requirements of the proposal were not satisfied. In the event of disqualification, the affected contracts would be treated as though they were not subject to the master netting contract. The proposal indicated that outstanding netting by novation arrangements would not be grandfathered, that is, such arrangements would have to meet all of the proposed requirements for qualifying bilateral netting contracts.

The proposal requested general comments as well as specific comments on the nature of collateral arrangements and the extent to which collateral might be recognized in conjunction with bilateral netting contracts.

Comments Received

The Board received nineteen public comments on the proposed amendment. Eleven comments were from banking organizations and five were from industry trade associations and organizations. In addition, there were three comments from law firms. All commenters supported the expanded recognition of bilateral netting contracts for risk-based capital purposes. Several commenters encouraged recognition of such contracts as quickly as possible. Many of the commenters concurred with one of the principal underlying tenets of the proposal, that is, that legally enforceable bilateral netting contracts can provide an efficient and desirable means for institutions to reduce or control credit exposure. A few commenters noted that, in their view, the recognition of bilateral netting contracts would create an incentive for market participants to use such arrangements and would encourage lawmakers to clarify the legal status of netting arrangements in their jurisdictions. One commenter noted that the expanded recognition of bilateral netting contracts would help keep U.S. banking organizations competitive in global derivatives markets.

While generally expressing their endorsement for the expanded recognition of bilateral netting contracts, nearly all commenters offered suggestions or requested clarification regarding details of the proposals. In particular, the commenters raised issues concerning specifics of the required legal opinions, the treatment of collateral, and the grandfathering of walkaway clauses and novation agreements.

Legal Opinions

Almost all commenters addressed the proposed requirement that institutions obtain legal opinions concluding that their bilateral netting contracts would be enforceable in all relevant jurisdictions. Commenters did not object to the general requirement that they secure legal opinions, rather they raised a number of questions about the form and substance of an acceptable opinion.

Form. Several commenters requested clarification as to the specific form of the legal opinion. Commenters wanted to know if a memorandum of law would satisfy the requirement or if a legal *opinion* would be required. They questioned whether a memorandum or opinion could be addressed to, or obtained by, an industry group, and whether a generic opinion or memorandum relating to a standardized netting contract would satisfy the legal opinion requirement.

Several commenters suggested that an opinion secured on behalf of the banking industry by an organization should be sufficient so long as the individual institution's counsel concurs with the opinion and concludes that the opinion applies directly to the institution's specific netting contract and to the individual contracts subject to it. A few commenters requested confirmation that legal opinions would not have to follow a predetermined format.

Scope. Several commenters identified two possible interpretations of the proposed language with regard to the scope of the legal opinions. They asked for clarification as to whether the opinions would be required to discuss only whether all relevant jurisdictions would recognize the contractual choice of law, or whether they must also discuss the enforceability of netting in bankruptcy or other instances of default. One commenter suggested deleting the requirement for a choice of law analysis.

A number of commenters objected to the proposed requirement that the legal opinion for a multibranch netting contract (that is, a netting contract between multinational banks that includes contracts with branches of the parties located in various jurisdictions) address the enforceability of netting under the law of the jurisdiction where each branch is located. These commenters stated that it should be sufficient for the legal opinion to conclude that netting would be enforced in the jurisdiction of the counterparty's home office if the master netting contract provides that all transactions are considered obligations of the home office and the branch jurisdictions recognize that provision.

Severability. Several commenters expressed concern about the proposed treatment for netting contracts that include contracts with branches in jurisdictions where the enforceability of netting is unclear. In such circumstances, commenters asserted, unenforceability or uncertainty in one

[6] Potential future exposure is estimated by multiplying the effective notional amount of a contract by a credit conversion factor which is based on the type of contract and the remaining maturity of the contract. Under the Board/OCC proposal, a potential future exposure amount would be calculated for each individual contract subject to the netting contract. The individual potential future exposures would then be added together to arrive at one total add-on amount.

[7] A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

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jurisdiction should not invalidate the entire netting contract for risk-based capital netting treatment. These commenters contended that contracts with branches of a counterparty in jurisdictions that recognize netting arrangements should be netted and contracts with branches in jurisdictions where the enforceability of netting is not supported by legal opinions should, for risk-based capital purposes, be severed, or removed from the master netting contract and treated as though they were not subject to that contract. These commenters noted that this treatment should only be available to the extent it is supported by legal opinion.

Conclusions. The proposal required a legal opinion to conclude that "relevant court and administrative authorities would find" the netting to be effective. Many commenters that discussed this aspect of the proposal expressed concern that this standard was too high. They suggested, instead, that the opinions be required to conclude that netting "should" be effective.

A few commenters requested clarification regarding the proposed requirement that the netting contract must create a single legal obligation.

Collateral

Twelve commenters addressed the proposal's specific request for comment on the nature of collateral and the extent to which collateral might be recognized in conjunction with bilateral netting contracts. All of these commenters believed collateral should be recognized as a means of reducing credit exposure. A few commenters noted that collateral arrangements are increasingly being used with derivative transactions.

Several commenters stated that for netting contracts that call for the use of collateral, the amount of required collateral is determined from the net mark-to-market value of the master netting contract. A few commenters added that mark-to-market collateral often is used in conjunction with a collateral "add-on" based on such things as the notional amount of the underlying contracts, the maturities of the contracts, the credit quality of the counterparty, and volatility levels.

A number of commenters offered their opinions as to how collateral should be recognized for risk-based capital purposes. Some suggested that the existing method of recognizing collateral for purposes of assigning credit equivalent amounts to risk categories is applicable to derivative transactions as well. Other commenters expressed the view that collateral should be recognized when assigning risk weights to the extent it is legally available to cover the total credit exposure for the bilateral netting contract in the event of default and that this availability should be addressed in the legal opinions.

Several other commenters suggested separating the net current exposure and potential future exposure of bilateral netting contracts for determining collateral coverage and appropriate risk weights. One commenter favored recognizing collateral for capital purposes by allowing an institution to offset net current exposure by the amount of the collateral to further reduce the credit equivalent amount.

Two commenters requested clarification that contracts subject to qualifying netting contracts could be eligible for a zero percent risk weight if the transaction is properly collateralized in accordance with the Board's collateralized transactions rule.[8]

Walkaway Clauses

Several commenters addressed the proposed prohibition against walkaway clauses in contracts qualifying for netting for risk-based capital purposes. While most of these commenters agreed that, ultimately, walkaway clauses should be eliminated from master netting contracts, they favored a phase-out period, during which outstanding bilateral netting contracts containing walkaway clauses could qualify for capital netting treatment. Several commenters contended that if a defaulter is a net debtor under the contract, the existence of a walkaway clause would not affect the amount owed to the non-defaulting creditor.

Novation

A few commenters expressed concern that the proposal did not grandfather outstanding novation agreements. These commenters suggested a phase-in period during which novation agreements would not be required to be supported by legal opinions.

Other Issues

One commenter requested greater detail on the nature and extent of examination review procedures. Two commenters stated that in some situations obtaining translations might be burdensome. Another commenter suggested assurance that the Federal Reserve would not disqualify netting contracts in an unreasonable manner.

Approximately one-half of the commenters expressed concern that the proposal specifically was limited to interest rate and exchange rate contracts. All of these opposed limiting the range of products that could be included under qualifying netting contracts. In this regard, one commenter noted that where there is sufficient legal support confirming the enforceability of cross-product netting, such netting should be recognized for capital purposes.

A number of commenters used the proposal as an opportunity to discuss the manner in which the add-on for potential future exposure is calculated. They suggested netting contracts should be recognized not only as a way to reduce the current exposure to a counterparty, but also the effects of such netting contracts should be taken into account to reduce the amount of capital organizations must hold against the potential future exposure to the counterparty.

Final Rule

After considering the public comments received and further deliberating the issues involved, the Board is adopting a final rule recognizing, for capital purposes, qualifying bilateral netting contracts. This final rule is substantially the same as proposed.

Legal Opinions

Form. The final rule requires that institutions obtain a written and reasoned legal opinion(s) concluding that the netting contract is enforceable in all relevant jurisdictions. This requirement is aimed at ensuring there is a substantial legal basis supporting the legal enforceability of a netting contract before reducing a banking organization's capital requirement based on that netting contract. A legal opinion, as generally recognized by the legal community in the United States, can provide such a legal basis. A memorandum of law may be an acceptable alternative as long as it addresses all of the relevant issues in a credible manner.

As discussed in the proposal, the legal opinions may be prepared by either an outside law firm or an institution's in-house counsel. The salient requirements for an acceptable legal opinion are that it: (i) Addresses all relevant jurisdictions; and (ii) concludes with a high degree of certainty that in the event of a legal challenge the banking

[8] In December 1992 the Board issued an amendment to its risk-based capital guidelines permitting certain collateralized transactions to qualify for a zero percent risk weight (57 FR 62180, December 30, 1992). In order to qualify for a zero percent risk weight, an institution must maintain a positive margin of qualifying collateral at all times. Thus, the collateral arrangement should provide for immediate liquidation of the claim in the event that a positive margin of collateral is not maintained. The OCC has issued a similar proposal (58 FR 43822, August 18, 1993).

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organization's claim or obligation would be determined by the relevant court or administrative authority to be the net sum of the positive and negative mark-to-market values of all individual contracts subject to the bilateral netting contract. The subject matter and complexity of required legal opinions will vary.

To some extent, institutions may use general, standardized opinions to help support the legal enforceability of their bilateral netting contracts. For example, a banking organization may have obtained a memorandum of law addressing the enforceability of netting provisions in a particular foreign jurisdiction. This opinion may be used as the basis for recognizing netting generally in that jurisdiction. However, with regard to an individual master netting contract, the general opinion would need to be supplemented by an opinion that addresses issues such as the enforceability of the underlying contracts, choice of law, and severability.

For example, the Board does not believe that a generic opinion prepared for a trade association with respect to the effectiveness of netting under the standard form agreement issued by the trade association, by itself, is adequate to support a netting contract. Banking organizations using such general opinions would need to supplement them with a review of the terms of the specific netting contract that the institution is executing.

Scope. With regard to the scope of the legal opinions, that is, what areas of analysis must be covered, the Board is of the opinion that legal opinions must address the validity and enforceability of the entire netting contract. The opinion must conclude that under the applicable state or other jurisdictional law the netting contract is a legal, valid, and binding contract, enforceable in accordance with its terms, even in the event of insolvency, bankruptcy, or similar proceedings. Opinions provided on the law of jurisdictions outside of the U.S. should include a discussion and conclusion that netting provisions do not violate the public policy or the law of that jurisdiction.

The Board has further determined that one of the most critical aspects of a qualifying netting contract is the contract's enforceability in any jurisdiction whose law would likely be applied in an enforcement action, as well as the jurisdiction where the counterparty's assets reside. In this regard, and in light of the policy in some countries to liquidate branches of foreign banking organizations independent of the head office, the Board is retaining its proposed requirement that legal opinions address the netting contract's enforceability under: (i) The law of the jurisdiction in which the counterparty is chartered, or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, the law of the jurisdiction in which the branch is located; (ii) the law that governs the individual contracts subject to the bilateral netting contract; and (iii) the law that governs the netting contract.

Severability. The Board recognizes that for some multibranch netting contracts an organization may not be able to obtain a legal opinion(s) concluding that netting would be enforceable in every jurisdiction where branches covered under the master netting contract are located. The Board concurs with commenters that in such situations it may be inefficient to require institutions to renegotiate netting contracts to ensure they cover only those jurisdictions where netting is clearly enforceable. The Board has determined that, in certain circumstances for capital purposes, banking institutions may use master bilateral netting contracts that include contracts with branches across all jurisdictions. Banking institutions should calculate their net current exposure for the contracts in those jurisdictions where netting clearly is enforceable as supported by legal opinion(s). The remaining contracts subject to the netting contract should be severed from the netting contract and treated as though they were not subject to the netting contract for capital and credit purposes. This approach of essentially dividing contracts subject to the netting contact into two categories—those that clearly may be netted and those that may not—is acceptable provided that the banking organization's legal opinions conclude that the contracts that do not qualify for netting treatment are legally severable from the master netting contract and that such severance will not undermine the enforceability of the netting contract for the remaining qualifying contracts.

Conclusions. The Board has retained the proposed language that legal opinions must represent that netting would be enforceable in all relevant jurisdictions. In response to commenters' assertions that the standard for this type of legal opinion is too high, the Board notes that use of the word "would" in the capital rules does not necessarily mean that the legal opinions must also use the word "would" or that enforceability must be determined to be an absolute certainty. The intent, rather, is for banking organizations to secure a legal opinion concluding that there is a high degree of certainty that the netting contract will survive a legal challenge in any applicable jurisdiction. The degree of certainty should be apparent from the reasoning set out in the opinion.

The Board notes that the requirement for legal opinions to conclude that netting contracts must create a single legal obligation applies only to those individual contracts that are covered by, and included under, the netting contract for capital purposes. As discussed above, a netting contract may include individual contracts that do not qualify for netting treatment, provided that these individual contracts are legally severable from the contracts to be netted for capital purposes.

Institutions generally must include all contracts covered by a qualifying netting contract in calculating the current exposure of that netting contract. In the event a netting contract covers transactions that are normally excluded from the risk-based ratio calculation—for example, exchange rate contracts with an original maturity of fourteen calendar days or less or instruments traded on exchanges that require daily payment of variation margin—an institution may choose to either include or exclude all mark-to-market values of such contracts when determining net current exposure, but this choice must be followed consistently.

Collateral

The final rule permits, subject to certain conditions, institutions to take into account qualifying collateral when assigning the credit equivalent amount of a netting contract to the appropriate risk weight category in accordance with the procedures and requirements currently set forth in the Board's risk-based capital guidelines. The Board has added language to the final rule clarifying that collateral must be legally available to cover the credit exposure of the netting contract in the event of default. For example, the collateral may not be pledged solely against one individual contract subject to the master netting contract. The legal availability of the collateral must be addressed in the legal opinions.

Walkaway Clauses

The Board has considered the suggestion made by some commenters of a phase-out period for outstanding contracts with walkaway clauses. The Board continues to believe that walkaway clauses do not reduce credit risk. Accordingly, the final rule retains the provision that bilateral netting contracts with walkaway clauses are no'

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eligible for netting treatment for risk-based capital purposes and does not provide for a phase-out period.

Novation

The proposal required all netting contracts, including netting by novation agreements, to be supported by written legal opinions. The Board does not agree with commenters that a grandfathering period for outstanding novation agreements is needed. Rather, the Board continues to believe that all netting contracts must be held to the same standards in order to promote certainty as to the legal enforceability of the contracts and to decrease the risks faced by counterparties in the event of default. Under the final rule, a netting by novation agreement must meet the requirements for a qualifying bilateral netting contract.

Other Issues

The Board has considered all of the other issues raised by commenters. With regard to documentation, the Board reiterates that, as with all provisions of risk-based capital, a banking organization must maintain in its files appropriate documentation to support any particular capital treatment including netting of rate contracts. Appropriate documentation typically would include a copy of the bilateral netting contract, supporting legal opinions, and any related translations. The documentation should be available to examiners for their review.

The Board recognizes commenters' concerns that the proposed rule was limited specifically to interest and exchange rate contracts. The Board notes that both the Basle Accord and the Board's risk-based capital guidelines currently do not address derivatives contracts other than rate contracts. This final rule does not attempt to go beyond the scope of the existing risk-based capital framework and applies only to netting contracts encompassing interest rate and foreign exchange rate contracts. The Board, however, notes that the Basle Supervisors' Committee issued a proposal for public comment in July 1994 to amend the Basle Accord that explicitly would set forth the risk-based capital treatment for other types of derivative transactions, such as commodity, precious metal, and equity contracts. In this regard, the Board issued a similar proposal, based on the Basle Supervisors' Committee proposal, to amend its risk-based capital guidelines (59 FR 43508, August 24, 1994).

Until the Basle Accord has been revised and the Board's risk-based capital rules have been amended to encompass commodity, precious metal, and equity derivative contracts, the Board, rather than automatically disqualifying from capital netting treatment an entire netting contract that includes non-rate-related transactions, will permit institutions to apply the following treatment. In determining the current exposure of otherwise qualifying netting contracts that include non-rate-related contracts, institutions will be permitted to net the positive and negative mark-to-market values of the included interest and exchange rate contracts, while severing the non-rate-related contracts and treating them for risk-based capital purposes as individual contracts that are not subject to the master netting contract. (This treatment is similar to the treatment applied to a netting contract that includes contracts in jurisdictions where the enforceability of netting is not supported by legal opinion. With non-rate-related contracts, however, legal opinions on severability are not required.)

The Board notes that the regulatory language with regard to the calculation of potential future exposure remains essentially the same as that proposed. The Board has clarified an underlying premise of the current exposure method for calculating credit exposure as set forth in the Basle Accord, that is, the add-on for potential future exposure must be calculated based on the effective, rather than the apparent, notional principal amount and the notional amount an institution uses will be subject to examiner review.[9]

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board hereby certifies that this final rule will not have a significant impact on a substantial number of small business entities. Accordingly, a regulatory flexibility analysis is not required.

Paperwork Reduction Act and Regulatory Burden

The Board has determined that this final rule will not increase the regulatory paperwork burden of banking organizations pursuant to the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*).

Section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Pub. L. 103–325, 108 Stat. 2160) provides that the federal banking agencies must consider the administrative burdens and benefits of any new regulation that imposes additional requirements on insured depository institutions. Section 302 also requires such a rule to take effect on the first day of the calendar quarter following final publication of the rule, unless the agency, for good cause, determines an earlier effective date is appropriate.

The new capital rule imposes certain requirements on depository institutions that wish to net the current exposures of their rate contracts for purposes of calculating their risk-based capital requirements. For these institutions, any burden of complying with the requirements of netting under a legally enforceable netting contract and obtaining the necessary legal opinions should be outweighed by the benefits associated with a lower capital requirement. The new rule will not affect institutions that do not wish to net for capital purposes. For these reasons, the Board has determined that an effective date of December 31, 1994 is appropriate, in order to allow banking organizations to take advantage of netting in their year-end statements, if they so desire. For these same reasons, in accordance with 5 U.S.C. 553(d)(3) the Board finds there is good cause not to follow the 30-day notice requirements of 5 U.S.C. 553(d) and to make the rule effective on December 31, 1994.

List of Subjects

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Branches, Capital adequacy, Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities, State member banks.

12 CFR Part 225

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

Authority and Issuance

For the reasons set out in the preamble, parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations are amended as set forth below.

[9] The notional amount is, generally, a stated reference amount of money used to calculate payment streams between the counterparties. In the event that the effect of the notional amount is leveraged or enhanced by the structure of the transaction, institutions must use the actual, or effective, notional amount when determining potential future exposure.

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

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

Authority: 12 U.S.C. 36, 248(a) and 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1823(j), 1828(o), 1831o, 1831p-1, 3105, 3310, 3331–3351 and 3906–3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o-4(c)(5), 78q, 78q-1 and 78w; 31 U.S.C. 5318.

2. Appendix A to part 208 is amended by revising:

a. Section III.E.2.;

b. Section III.E.3;

c. Section III.E.5.;

d. The last heading and two subsequent paragraphs of Attachment IV; and

e. Attachment V.

The revisions read as follows:

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

* * * * *

III. * * *

E. * * *

12. *Calculation of credit equivalent amounts. a.* The credit equivalent amount of an off-balance-sheet rate contract that is not subject to a qualifying bilateral netting contract in accordance with section III.E.5. of this appendix A is equal to the sum of (i) the current exposure (sometimes referred to as the replacement cost) of the contract; and (ii) an estimate of the potential future credit exposure over the remaining life of the contract.

b. The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in the relevant rates, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit conversion factor. Banks should, subject to examiner review, use the effective rather than the apparent or stated notional amount in this calculation. The conversion factors are:

Remaining maturity	Interest rate contracts (percent)	Exchange rate contracts (percent)
One year or less	0	1.0
Over one year	0.5	5.0

d. Examples of the calculation of credit equivalent amounts for these instruments are contained in Attachment V of this appendix A.

e. 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 rate contracts than for interest rate contracts.

f. 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 an interest rate or exchange rate contract has been determined, that amount is assigned to the risk weight category appropriate to the counterparty, or, if relevant, to the guarantor or the nature of any collateral.[49] However, the maximum weight that will be applied to the credit equivalent amount of such instruments is 50 percent.

* * * * *

5. *Netting.* a. For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values in the determination of a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of rate contracts is recognized for purposes of calculating the credit equivalent amount provided that:

i. The netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the bank would have a claim to receive, or obligation to pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to any of the following events: Default, insolvency, liquidation, or similar circumstances.

ii. The bank obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the bank's exposure to be such a net amount under:

1. The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

2. The law that governs the individual contracts covered by the netting contract; and

3. The law that governs the netting contract.

iii. The bank establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law.

iv. The bank maintains in its files documentation adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.[50]

c. By netting individual contracts for the purpose of calculating its credit equivalent amount, a bank represents that it has met the requirements of this appendix A and all the appropriate documents are in the bank's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a bank's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable under any one of the bodies of law described in paragraph 5.a.ii.*1.* through 5.a.ii.*3.* of section III of this appendix A. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

d. The credit equivalent amount of rate contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract, and (ii) the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract, estimated in accordance with section III.E.2. of this appendix A.[51]

e. The current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the current exposure of the netting contract is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure of the netting contract is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts may not qualify. In such instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

f. In the event a netting contract covers contracts that are normally excluded from the

[49] 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. of this appendix A. Collateral held against a netting contract is not recognized for capital purposes unless it is legally available to support the single legal obligation created by the netting contract.

[50] A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

[51] For purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency. The reason for this is that offsetting contracts in the same currency maturing on the same date will have lower potential future exposure as well as lower current exposure.

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risk-based ratio calculation—for example, exchange rate contracts with an original maturity of fourteen calendar days or less, or instruments traded on exchanges that require daily payment of variation margin—an institution may elect to consistently either include or exclude all mark-to-market values of such contracts when determining net current exposure.

g. An example of the calculation of the credit equivalent amount for rate contracts subject to a qualifying netting contract is contained in Attachment V of this appendix A.

* * * * *

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

* * * * *

Credit Conversion for Interest Rate and Exchange Rate Contracts

1. The credit equivalent amount of a rate contract is the sum of the current credit exposure of the contract and an estimate of potential future increases in credit exposure. The current exposure is the positive mark-to-market value of the contract (or zero if the mark-to-market value is zero or negative). For rate contracts that are subject to a qualifying bilateral netting contract the current exposure is, generally, the net sum of the positive and negative mark-to-market values of the contracts included in the netting contract (or zero if the net sum of the mark-to-market values is zero or negative). The potential future exposure is calculated by multiplying the effective notional amount of a contract by one of the following credit conversion factors, as appropriate:

Remaining maturity	Interest rate contracts (percent)	Exchange rate contracts (percent)
One year or less	0	1.0
Over one year	0.5	5.0

2. No potential future exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating 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 fourteen days or less are excluded. Instruments traded on exchanges that require daily payment of variation margin are also excluded.

ATTACHMENT V—CALCULATION OF CREDIT EQUIVALENT AMOUNTS FOR INTEREST RATE AND EXCHANGE RATE-RELATED TRANSACTIONS FOR STATE MEMBER BANKS

Type of contract (remaining maturity)	Potential exposure	+		Current exposure	=	Credit equivalent amount
	Notional principal (dollars)	Conversion factor	Potential exposure (dollars)	Mark-to-market value	Current exposure (dollars)	
(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 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			1,210,000		300,000	1,510,000

If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

	Potential future exposure (from above)	+	Net current exposure [1]	=	Credit equivalent amount
(1)	50,000				
(2)	60,000				
(3)	50,000				
(4)	50,000				
(5)	1,000,0000				
Total	1,210,000		0		1,210,000

[1] The total of the mark-to-market values from above is −1,370,000. Since this is a negative amount, the net current exposure is zero.

* * * * *

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

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

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

2. Appendix A to part 225 is amended by revising:

a. Section III.E.2.;

b. Section III.E.3.;

c. Section III.E.5.;

d. The last heading and subsequent two paragraphs of Attachment IV; and

e. Attachment V.

The revisions read as follows:

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

* * * * *

III. * * *

E. * * *

2. *Calculation of credit equivalent amounts. a.* The credit equivalent amount of an off-balance sheet rate contract that is not subject to a qualifying bilateral netting contract in accordance with section III.E.5. of this appendix A is equal to the sum of (i) the current exposure (sometimes referred to as the replacement cost) of the contract; and an (ii) estimate of the potential future credit exposure over the remaining life of the contract.

b. The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and

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should reflect changes in the relevant rates, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit conversion factors. Banking organizations should, subject to examiner review, use the effective rather than the apparent or stated notional amount in this calculation. The conversion factors are:

Remaining maturity	Interest rate contracts (percent)	Exchange rate contracts (percent)
One year or less	0	1.0
Over one year	0.5	5.0

d. Examples of the calculation of credit equivalent amounts for these instruments are contained in Attachment V of this appendix A.

e. 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 exchange rate contracts than for interest rate contracts.

f. 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 an interest rate or exchange rate contract has been determined, that amount is assigned to the risk weight category appropriate to the counterparty or, if relevant, to the guarantor or the nature of any collateral.[53] However, the maximum weight that will be applied to the credit equivalent amount of such instruments is 50 percent.

* * * * *

5. *Netting*. a. For purposes of this appendix A, netting refers to the offsetting of positive and negative mark to-market values in the determination of a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of rate contracts is recognized for purposes of calculating the credit equivalent amount provided that:

i. The netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the organization would have a claim to receive, or obligation to receive or pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to any of the following events: default, bankruptcy, liquidation, or similar circumstances.

ii. The banking organization obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge—including one resulting from default, bankruptcy, liquidation, or similar circumstances—the relevant court and administrative authorities would find the banking organization's exposure to be such a net amount under:

1. The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

2. The law that governs the individual contracts covered by the netting contract; and

3. The law that governs the netting contract.

iii. The banking organization establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law.

iv. The banking organization maintains in its files documentation adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.[54]

c. By netting individual contracts for the purpose of calculating its credit equivalent amount, a banking organization represents that it has met the requirements of this appendix A and all the appropriate documents are in the organization's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a banking organization's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable under any one of the bodies of law described in paragraph 5.a.ii.*1.* through 5.a.ii.*3.* of section III of this appendix A. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

d. The credit equivalent amount of rate contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract, and (ii) the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract, estimated in accordance with section III.E.2. of this appendix A.[55]

e. The current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the current exposure of the netting contract is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure of the netting contract is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts may not qualify. In such instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

f. In the event a netting contract covers contracts that are normally excluded from the risk-based ratio calculation—for example, exchange rate contracts with an original maturity of fourteen calendar days or less, or instruments traded on exchanges that require daily payment of variation margin—an institution may elect to consistently either include or exclude all mark-to-market values of such contracts when determining net current exposure.

g. An example of the calculation of the credit equivalent amount for rate contracts subject to a qualifying netting contract is contained in Attachment V of this appendix A.

* * * * *

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

* * * * *

Credit Conversion for Interest Rate and Exchange Rate Contracts

1. The credit equivalent amount of a rate contract is the sum of the current credit exposure of the contract and an estimate of potential future increases in credit exposure. The current exposure is the positive mark-to-market value of the contract (or zero if the mark-to-market value is zero or negative). For rate contracts that are subject to a qualifying bilateral netting contract the current exposure is the net sum of the positive and negative mark-to-market values of the contracts included in the netting contract (or zero if the net sum of the mark-to-market values is zero or negative). The potential future exposure is calculated by multiplying the effective notional amount of a contract by one of the following credit conversion factors, as appropriate:

[53] 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. of this appendix A. Collateral held against a netting contract is not recognized for capital purposes unless it is legally available to support the single legal obligation created by the netting contract.

[54] A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter even if the defaulter or the estate of the defaulter is a net creditor under the contract.

[55] For purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency. The reason for this is that offsetting contracts in the same currency maturing on the same date will have lower potential future exposure as well as lower current exposure.

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Remaining maturity	Interest rate contracts (percent)	Exchange rate contracts (percent)
One year or less	0	1.0
Over one year	0.5	5.0

2. No potential future exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating 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 fourteen days or less are excluded. Instruments traded on exchanges that require daily payment of variation margin are also excluded.

ATTACHMENT V.—CALCULATION OF CREDIT EQUIVALENT AMOUNTS FOR INTEREST RATE AND EXCHANGE RATE-RELATED TRANSACTIONS FOR BANK HOLDING COMPANIES

Type of contract (remaining maturity)	Potential exposure		+	Current exposure	=	Credit equivalent amount
	Notional principal (dollars)	Conversion Factor	Potential exposure (dollars)	Mark-to-market value	Current exposure (dollars)	
(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			1,210,000		300,000	1,510,000

If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

	Potential future exposure (from above)	+	Net current exposure [1]	=	Credit equivalent amount
(1)	50,000				
(2)	60,000				
(3)	50,000				
(4)	50,000				
(5)	1,000,000				
Total	1,210,000		0		1,210,000

[1] The total of the mark-to-market values from above is −1,370,000. Since this is a negative amount, the net current exposure is zero.

* * * * *

By order of the Board of Governors of the Federal Reserve System, December 1, 1994.

William W. Wiles,

Secretary of the Board.

[FR Doc. 94–30040 Filed 12–6–94; 8:45 am]

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Rules and Regulations

Federal Register

Vol. 59, No. 235

Thursday, December 8, 1994

This section of the FEDERAL REGISTER contains regulatory documents having general applicability and legal effect, most of which are keyed to and codified in the Code of Federal Regulations, which is published under 50 titles pursuant to 44 U.S.C. 1510.

The Code of Federal Regulations is sold by the Superintendent of Documents. Prices of new books are listed in the first FEDERAL REGISTER issue of each week.

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R-0823]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System is amending its risk-based capital guidelines for state member banks and bank holding companies. Under this final rule, institutions are generally directed to not include in regulatory capital the "net unrealized holding gains (losses) on securities available for sale," the new common stockholders' equity account created by Statement of Financial Accounting Standards Number 115 (FAS 115), *Accounting for Certain Investments in Debt and Equity Securities.* Net unrealized losses on marketable equity securities (i.e., equity securities with readily determinable fair values), however, will continue to be deducted from Tier 1 capital. This rule has the general effect of valuing available-for-sale securities at amortized cost (i.e., based on historical cost), rather than at fair value (i.e., generally at market value), for purposes of calculating the risk-based and leverage capital ratios.

EFFECTIVE DATE: December 31, 1994.

FOR FURTHER INFORMATION CONTACT: Rhoger H Pugh, Assistant Director (202/728-5883), Norah M. Barger, Manager (202/452-2402), Arleen E. Lustig, Supervisory Financial Analyst (202/452-2987), and John M. Frech, Supervisory Financial Analyst (202/452-2275), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets NW, Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

On December 28, 1993, the Board of Governors issued for public comment a proposal to amend its risk-based capital guidelines [1] for state member banks and bank holding companies to include in Tier 1 capital the "net unrealized holding gains and losses on securities available for sale" (58 FR 68563, December 28, 1993). The proposal would have had the effect of valuing securities available for sale at market value for purposes of calculating the risk-based and leverage capital ratios. In its proposal, the Board offered several alternative treatments, one of which was to not include such net unrealized gains and losses in the calculation of regulatory capital. It is this alternative treatment that the Board is adopting as a final rule. The comment period ended on January 21, 1994.

The proposal was in response to the issuance of FAS 115 on May 31, 1993, which established "net unrealized holding gains (losses) on securities available for sale" as a new element of common stockholders' equity. All banking organizations were required to adopt FAS 115, for both generally accepted accounting principles (GAAP) and regulatory reporting purposes, as of January 1, 1994, or the beginning of their first fiscal year thereafter, if later. Earlier adoption was permitted.

Since the final capital treatment of such net unrealized gains and losses on available-for-sale securities was not in effect by year-end 1993, the Board directed state member banks and bank holding companies to continue calculating the risk-based and leverage capital ratios on a pre-FAS 115 basis. Accordingly, the net unrealized holding gains and losses on available-for-sale debt securities were not included in regulatory capital, and the amortized cost rather than the fair value of available-for-sale debt securities generally continued to be used in the calculation of both capital ratios. Moreover, equity securities with readily determinable fair values continued to be valued at the lower of cost or fair value for regulatory capital purposes. Both the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) followed this interim capital treatment.

FAS 115

FAS 115 divides securities held by banking organizations among three categories: (1) Securities held to maturity; (2) trading account securities; and (3) securities available for sale.

Under FAS 115, trading securities are defined as those securities that an institution buys and holds principally for the purpose of selling in the near term. As under earlier accounting standards, these securities are to be reported at fair value (i.e., generally at market value), with net unrealized changes in their value reported directly in the income statement as part of an institution's earnings.

Under FAS 115, securities held to maturity are to be recorded at amortized cost. However, FAS 115 states that a banking organization may include a security in the held-to-maturity category only if management has "the positive intent and ability to hold the security to maturity."

Securities meeting the definition of the available-for-sale category (i.e., all securities not held for trading that an institution cannot justify categorizing as held-to-maturity) are to be reported at fair value. Changes in the fair value of securities available for sale are to be reported, net of tax effects, directly in a separate component of common stockholders' equity. Consequently, any unrealized appreciation or depreciation in the value of securities in the available-for-sale category has no impact on the reported earnings of an institution, but affects its GAAP equity capital position.

Initial Proposal

In late December 1993, the Board proposed amending the capital adequacy guidelines for state member banks and bank holding companies to

[1] The Board's risk-based capital guidelines implement, for state member banks and bank holding companies, the international bank capital standards as set forth in the Basle Accord. The Basle Accord is a risk-based capital framework that was proposed by the Basle Committee on Banking Regulations and Supervisory Practices and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Committee is comprised of representatives of the central banks and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.

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reflect the provisions of FAS 115 (58 FR 68563, December 28, 1993). Under the proposed amendment, the net amount of unrealized gains and losses, adjusted for the effects of income taxes, on securities held in the available-for-sale account would be included in Tier 1 capital[2] and such securities would be booked at fair value rather than at amortized cost for purposes of calculating the risk-based and leverage capital ratios.

The Board proposed inclusion of net unrealized gains and losses on available-for-sale securities in Tier 1 capital because it would make the definition of Tier 1 capital more equivalent to the GAAP definition of equity capital. In addition, the proposed Tier 1 capital treatment for unrealized changes in the value of securities available for sale could be viewed as an extension of the capital treatment currently applied to net unrealized gains and losses on trading securities, which are recognized in Tier 1 capital. This recognition has long been viewed as consistent with the Basle Accord. Thus, it could be argued that inclusion of unrealized gains and losses on securities available for sale in Tier 1 capital is also consistent with the Basle Accord.

The Board also noted in its initial proposal that the inclusion of net unrealized changes in the value of securities available for sale in Tier 1 capital would affect the calculation of capital for purposes of a number of laws and regulations that are based, in part, on the institution's capital levels. Such laws and regulations include prompt corrective action (12 CFR part 208, Subpart B), brokered deposit restrictions (12 CFR 337.6), and the risk-related insurance premium system (12 CFR part 327).

While proposing Tier 1 capital treatment for net unrealized gains and losses on available-for-sale securities, the Board also sought public comment on several alternative treatments. The other options included:

(a) Excluding from regulatory capital all changes in the value of securities available for sale, which would have the same effect as valuing these securities on an amortized cost basis;

(b) Including losses in Tier 1 capital, while not recognizing any gains for capital purposes, which would have the effect of valuing securities available for sale on lower of cost or market basis;

(c) Including both the gains and losses in Tier 2 capital; and

(d) Including losses in Tier 1 capital, while including gains in Tier 2 capital.

[2] The Board's risk-based capital guidelines set forth a definition of Tier 1 capital that includes common stockholders' equity. These guidelines further state that common stockholders' equity includes: (1) Common stock; (2) related surplus; and (3) retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of treasury stock.

Comments Received

The Federal Reserve received letters from 59 public commenters. Comments were received from 17 multinational and large regional banking organizations, 24 community banking organizations, seven foreign banks, six banking trade associations, two state banking supervisors, two consultants, and one law firm. Twenty-one of the public commenters supported the proposal to include "net unrealized holding gains (losses) on securities available for sale," in Tier 1 capital, while 38 opposed the proposal, including all seven foreign banks.

Public commenters opposed to the proposal included 18 out of the 24 community banks, 5 out of the 17 multinational and large regional banking organizations, all seven foreign banking organizations, three banking trade associations, two state banking supervisory organizations, two consultants, and one law firm. Some of the common reasons cited for opposing the proposal included:

(1) The additional volatility to capital resulting from marking-to-market the available-for-sale securities and consequent fluctuations for some institutions in their single borrower lender limits;

(2) The potential for temporary changes in interest rates to have an adverse effect on the risk-based and leverage capital ratios that would result in a lower prompt corrective action category or higher FDIC risk-based insurance premiums;

(3) The distorting effect of applying market value accounting to some items on only one side of the institution's balance sheet, particularly since interest rate changes that cause changes in asset values often give rise to offsetting changes to the value of the deposit base, which existing accounting standards do not recognize; and

(4) The potential for organizations to become critically undercapitalized and subject to closure as a result of temporary changes in the market values of securities that the banking organization has no intention of selling.

All seven foreign banks that commented on the proposal opposed the inclusion of the net unrealized gains and losses on available-for-sale securities in Tier 1 on the grounds that such treatment for the new equity account is inconsistent with the Basle Accord. In their view, this account is more comparable to securities revaluation reserves, which, under the Accord, are substantially discounted and accorded Tier 2 status, rather than disclosed reserves, which receive an unlimited Tier 1 treatment under the Accord.

Twelve of the 17 multinational and large regional banking organizations commented favorably on the proposal, as did three banking trade associations. However, five multinational and large regional banking organizations opposed the proposal citing concerns similar to those given by smaller institutions. The 21 commenters favoring the proposal gave two main reasons for their support:

(1) The proposed Tier 1 treatment of the new account would parallel the GAAP equity treatment for unrealized gains and losses and, thus, institutions could avoid having to maintain two sets of accounting records for available-for-sale securities; and

(2) Tier 1 treatment would be consistent with the intent of section 121 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which stipulates that regulatory accounting standards be no less stringent than GAAP.

In its proposal, the Board asked for specific comment on six issues. Ten public commenters commented on the first issue, which concerned the extent to which FAS 115 may permit an institution to sell securities from the held-to-maturity account without calling into question the institution's intent or ability to continue to hold other securities reported in that account All 10 commenters stated that FAS 115 provides a specific set of circumstances under which banking organizations can sell securities from the held-to-maturity account without tainting the remaining securities in that account.

Seven banking institutions commented on the second issue, which concerned requests for examples of isolated, nonrecurring, and unusual events involving demands for liquidity that would permit the sale or transfer of held-to-maturity securities under FAS 115. The most common examples cited were changes in tax law, deterioration in the credit-worthiness of a security issuer, and natural disasters.

The third issue concerned alternatives to the proposed Tier 1 capital treatment. Twenty-three organizations commented on the alternatives included in the Board's request for public comment. These alternatives included: Excluding all such changes from capital; deducting losses from Tier 1 capital, and either not recognizing any gains for capital purposes or including them in Tier 2

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capital; and including both the gains and losses in Tier 2 capital.

Of the 23 commenters, six were multinational or large regional banking organizations that supported the proposal. Generally, these organizations did not favor any of the alternatives. However, 13 commenters, including the seven foreign banks that opposed the proposal, stated that they preferred Tier 2 treatment for net unrealized gains and losses on available-for sale securities over Tier 1 treatment. Four commenters preferred not including the net unrealized gains and losses on available-for-sale securities in regulatory capital.

The fourth issue concerned the extent to which the above alternatives might create an incentive for banking organizations to sell securities that have appreciated to realize the gains in Tier 1 capital, while holding securities that have depreciated to avoid reductions in Tier 1 capital. Six commenters offered views on this issue. Most of these commenters felt that including unrealized gains and losses in regulatory capital would provide some disincentive for banks not to pursue such a strategy. Another commenter stated that while the exclusion of the net unrealized gains and losses could lead a company to selectively sell only securities in which it had a gain, the Securities and Exchange Commission (SEC) would question such a practice.

In setting forth the fifth issue, the Board asked commenters to suggest the appropriate manner for maintaining an Allocated Transfer Risk Reserve (ATRR) for certain foreign debt securities (e.g., "Brady Bonds") held as securities available for sale. Three multinational banking institutions responded to this issue. All three organizations stated that the ATRR should not be applied to such foreign securities since such securities are reflected on banks' financial statements at market value.

The last issue concerned the importance of maintaining consistent application of the Basle capital standards. Fourteen banking organizations and associations commented on this issue. Seven commenters, all of which were foreign banks, stated that the proposal to include the new common equity component in Tier 1 was inconsistent with the provisions of the Basle Accord. They stated that Tier 1 treatment could create competitive inequality with international banks. Moreover, they stated that Tier 1 treatment could cause inconsistency between the Tier 1 measure applied to U.S. banks and the Tier 1 measure applied by other banks regulated by different accounting rules, reducing the meaningfulness of the capital adequacy comparisons. However, three banking organizations, all of which supported the Tier 1 proposal, stated that the proposal was consistent with the Basle Accord and, therefore, would not reduce the meaningfulness of comparisons.

Final Rule

After consideration of the public comments and further deliberation on the issues involved, the Board is adopting a final rule that amends the risk-based capital guidelines to explicitly state that net unrealized gains and losses on available-for-sale securities generally are not be included in capital. Under the final rule, however, unrealized losses on marketable equity securities would continue to be deducted from Tier 1 capital. This final rule was developed in close coordination with the other federal banking agencies and results in a capital treatment for net unrealized gains and losses on securities available for sale that is the same as the interim capital treatment agreed to by the agencies in December 1993.

The Board is adopting one of the alternative capital treatments suggested in December 1993 as a final rule rather than the Tier 1 treatment proposed for a number of reasons. First, most commenters opposed the Board's proposal to include the FAS 115 net unrealized gains and losses in risk-based capital calculations because of concerns about the potential volatility in regulatory capital. As discussed under the section entitled "Comments Received," commenters noted that the inclusion of the net unrealized gains and losses on available-for-sale securities would result in fluctuations in regulatory capital due to temporary changes in interest rates. Thus, an institution's capital as calculated for prompt corrective action, risk-based insurance deposit premiums, lending limits, and other limits based on capital would be affected by unrealized changes in the value of securities that it may not intend or need to sell.

Some commenters also expressed concerns about having to reflect in regulatory capital changes in the market value of selected items on one side of the balance sheet but not the other side. In this regard, the Board notes that it and the other banking agencies opposed FAS 115 as representing piecemeal adoption of mark-to-market accounting when it was issued for public comment. By not adopting FAS 115 for regulatory capital purposes, the Board is taking an action that is consistent with the position, which was taken by the agencies at the time FAS 115 was proposed, that the standard could produce distorted financial statements because it marked some balance sheet items to market but ignored changes in the market value of other items, including liabilities, that could have offsetting price changes. In addition, the Board has long opposed proposals to adopt mark-to-market accounting because of the difficulty in determining the market values of various assets and liabilities and the inappropriateness of using this accounting method for institutions that do not actively trade in marketable financial assets.

The Board believes that not including the FAS 115 net unrealized gains and losses in capital is consistent with the Basle Accord, which (except for trading account assets) generally does not permit Tier 1 capital to be increased by unrealized gains on securities. In addition, the Board finds that FDICIA 121's requirement that the accounting principles used in regulatory reports be no less stringent than GAAP does not apply to the Board's definition of regulatory capital. This finding suggests that excluding net gains and losses from regulatory capital is consistent with FDICIA 121. Moreover, consistent with past opinions expressed by the Board, the Board is not convinced that marking to market available-for-sale securities as FAS 115 requires is necessarily a more stringent reporting treatment than valuing such securities at amortized cost. While mark-to-market treatment results in the recognition of unrealized losses in GAAP equity capital, it also permits the unlimited recognition of unrealized gains in such capital

Furthermore, the Board believes that concerns about not deducting net unrealized losses on available-for-sale securities are overstated since the regulatory reports filed by banking organizations that are available to the public have long collected information on the amortized cost and market value of all securities held in their portfolios (including those held as long-term investments). Thus, examiners and analysts can readily take any depreciation, as well as any appreciation, in a banking organization's securities portfolio into consideration in the determination of the institution's overall capital adequacy.

Finally, the Board has decided to continue to deduct net unrealized losses on marketable equity securities since, unlike debt securities, equities have no maturity date and an uncertain final value. This decision is consistent with longstanding supervisory practice.

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Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board hereby certifies that this final rule will not have a significant impact on a substantial number of small business entities (in this case, small banking organizations). The risk-based capital guidelines generally do not apply to bank holding companies with consolidated assets of less than $150 million; thus, the final rule will not affect such companies.

Paperwork Reduction Act and Regulatory Burden

The Board has determined that this final rule will not increase the regulatory paperwork burden of banking organizations pursuant to the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*).

Section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Pub. L. 103-325, 108 Stat. 2160) provides that the federal banking agencies must consider the administrative burdens and benefits of any new regulations that impose additional requirements on insured depository institutions. Section 302 also requires such a rule to take effect on the first day of the calendar quarter following final publication of the rule, unless the agency, for good cause, determines an earlier effective date is appropriate.

The new capital rule does not impose any new requirements on depository institutions of bank holding companies for purposes of calculating their risk-based and leverage capital ratios. The amended rule clarifies the capital treatment of a common stockholders' equity component, "net unrealized holding gains (losses) on securities available for sale," created by FAS 115, but does not change current treatment. For these reasons, the Board has determined that an effective date of December 31, 1994, is appropriate. For these same reasons, in accordance with 5 U.S.C. 553(d)(3), the Board finds there is good cause not to follow the 30-day notice requirements of 5 U.S.C. 553(d) and to make the rule effective on December 31, 1994.

List of Subjects

12 CFR Part 208

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

12 CFR Part 225

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

For the reasons set forth in the preamble, the Board is amending 12 CFR parts 208 and 225 as set forth below:

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

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

Authority: 12 U.S.C. 36, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1823(j), 1828(o), 1831o, 1831p–1, 3105, 3310, 3331–3351 and 3906–3909; 15 U.S.C 78b, 78l(b), 78l(g), 78l(i), 78o–4(c)(5), 78q, 78q–1 and 78w; 31 U.S.C. 5318.

2. Appendix A to part 208 is amended by revising sections II.A.1.a. and II.A.2.f to read as follows:

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

* * * * *

II. * * *

A. * * *

1. * * *

a. *Common stockholders' equity* For purposes of calculating the risk-based capital ratio, common stockholders' equity is limited to 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; less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized holding gains (losses) on available-for-sale debt securities are not included in common stockholders' equity

* * * * *

2 * * *

f. *Revaluation reserves* i Such reserves reflect the formal balance sheet restatement or revaluation for capital purposes of asset carrying values to reflect current market values. The federal banking agencies generally have not included unrealized asset appreciation 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.

ii. 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 security revaluation reserves. The Federal Reserve will consider any appreciation, as well as any depreciation, in specific asset values as additional considerations in assessing overall capital strength and financial condition.

* * * * *

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

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

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

2. Appendix A to part 225 is amended by revising sections II.A.1.a. and II.A.2.f to read as follows:

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

* * * * *

II. * * *

A. * * *

1 * * *

a. *Common stockholders' equity* For purposes of calculating the risk-based capital ratio, common stockholders' equity is limited to 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, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized holding gains (losses) on available-for-sale debt securities are not included in common stockholders' equity

* * * * *

2 * * *

f. *Revaluation reserves* i. Such reserves reflect the formal balance sheet restatement or revaluation for capital purposes of asset carrying values to reflect current market values. The Federal Reserve generally has not included unrealized asset appreciation in capital ratio calculations, although it has long taken such values into account as a separate factor in assessing the overall financial strength of a banking organization

ii 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 bank holding companies are encouraged to disclose their equivalent of premises (building) and security revaluation reserves. The Federal Reserve will consider any appreciation, as well as any depreciation, in specific asset values as additional considerations in assessing overall capital strength and financial condition.

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Board of Governors of the Federal Reserve System, December 2, 1994.

Barbara R. Lowrey,

Associate Secretary of the Board.

[FR Doc. 94-30156; Filed 12-7-94; 8:45 am]

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DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 94–22]

RIN 1557–AB14

FEDERAL RESERVE SYSTEM

12 CFR Part 208

[Regulation H; Docket No. R–0764]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AB15

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[No. 94–152]

RIN 1550–AA59

Risk-Based Capital Standards; Concentration of Credit Risk and Risks of Nontraditional Activities

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

ACTION: Final rule.

SUMMARY: The OCC, the Board, the FDIC and the OTS (collectively "the agencies") are issuing this final rule to implement the portions of section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) that require the agencies to revise their risk-based capital standards for insured depository institutions to ensure that those standards take adequate account of concentration of credit risk and the risks of nontraditional activities. The final rule amends the risk-based capital standards by explicitly identifying concentration of credit risk and certain risks arising from nontraditional activities, as well as an institution's ability to manage these risks, as important factors in assessing an institution's overall capital adequacy.

EFFECTIVE DATE: January 17, 1995.

FOR FURTHER INFORMATION CONTACT: OCC: For issues relating to concentration of credit risk and the risks of nontraditional activities, Roger Tufts, Senior Economic Advisor (202/874–5070), Office of the Chief National Bank Examiner. For legal issues, Ronald Shimabukuro, Senior Attorney, Bank Operations and Assets Division (202/874–4460), Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, DC 20219.

Board: For issues related to concentration of credit risk, David Wright, Supervisory Financial Analyst, (202/728–5854) and for issues related to the risks of nontraditional activities, William Treacy, Supervisory Financial Analyst, (202/452–3859), Division of Banking Supervision and Regulation; Scott G. Alvarez, Associate General Counsel (202/452–3583), Gregory A. Baer, Managing Senior Counsel (202/452–3236), Legal Division, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452–3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

FDIC: Daniel M. Gautsch, Examination Specialist (202/898–6912), Stephen G. Pfeifer, Examination Specialist (202/898–8904), Division of Supervision, or Fred S. Carns, Chief, Financial Markets Section, Division of Research and Statistics (202/898–3930). For legal issues, Pamela E. F LeCren, Senior Counsel (202/898–3730) or Claude A. Rollin, Senior Counsel (202/898–3985), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

OTS: John Connolly, Senior Program Manager, Capital Policy (202) 906–6465; Dorene Rosenthal, Senior Attorney, Regulations, Legislation and Opinions Division (202) 906–7268, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

The risk-based capital standards adopted by the agencies tailor an institution's minimum capital requirement to broad categories of credit risk embodied in its assets and off-balance-sheet instruments. These standards require institutions to have total capital equal to at least 8 percent of their risk-weighted assets.[1] Institutions with high or inordinate levels of risk are expected to operate above minimum capital standards. Currently, each agency addresses capital adequacy through a variety of supervisory actions and considers the risks of credit concentrations and nontraditional activities in taking those varied supervisory actions.

Section 305(b) of FDICIA, Pub. L. 102–242 (12 U.S.C. 1828 note), requires the agencies to revise their risk-based capital standards for insured depository institutions to ensure that those standards take adequate account of interest rate risk, concentration of credit risk and the risks of nontraditional activities. This final rule addresses concentration of credit risk and the risks of nontraditional activities. The agencies are addressing interest rate risk through separate rulemakings. *See* OCC, Board and FDIC joint notice of proposed rulemaking, 58 FR 48206 (September 14, 1993) and OTS final rulemaking, 58 FR 45799 (August 31, 1993). In addition, the agencies issued separate final rules to implement the section 305 requirement that risk-based capital standards reflect the actual performance and expected risk of loss of multifamily mortgages.

For the risks related to concentration of credit and nontraditional activities, the agencies published a joint notice of proposed rulemaking on February 22, 1994. *See* 59 FR 8420. The agencies received 54 comments, including duplicate comments among the agencies. A description of the joint proposed rule along with a discussion of the comments follows.

II. Concentration of Credit Risk

A. Proposed Approach

In the joint proposed rule, the agencies stated that it was not currently feasible to quantify the risk related to concentrations of credit for use in a formula-based capital calculation. Although most institutions can identify and track large concentrations of credit risk by individual or related groups of borrowers, and some can identify concentrations by industry, geographic area, country, loan type or other relevant factors, there is no generally accepted approach to identifying and quantifying the magnitude of risk associated with concentrations of credit. In particular, definitions and analyses of concentrations are not uniform within the industry and are based in part on the subjective judgments of each institution using its experience and knowledge of its specific borrowers, market areas and products.

Nonetheless, techniques do exist to identify broad classes of concentrations

[1] As defined, risk-weighted assets include credit exposures contained in off-balance-sheet instruments.

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and to recognize significant exposures. The effective tracking and management of such risk is important to ensuring the safety and soundness of financial institutions. Institutions with significant concentrations of credit risk require capital above the regulatory minimums. As new developments in identifying and measuring concentration of credit risk emerge, the agencies will consider potential refinements to the risk-based capital standards.

Accordingly, the agencies proposed to take account of concentration of credit risk in their risk-based capital guidelines or regulations by amending the standards to explicitly cite concentrations of credit risk and an institution's ability to monitor and control them as important factors in assessing an institution's overall capital adequacy. The joint proposed rule contemplated that in addition to reviewing concentrations of credit risk pursuant to section 305, the agencies also may review an institution's management of concentrations of credit risk for adequacy and consistency with safety and soundness standards regarding internal controls, credit underwriting or other relevant operational and managerial areas to be promulgated pursuant to section 132 of FDICIA.

B. Comments

The vast majority of commenters supported the agencies' decision not to propose any quantitative formula or standard. Many commenters, however, expressed a general concern as to how the agencies would implement and interpret the joint proposed rule. Commenters noted with approval the agencies' observation that rulemaking in this area could inadvertently create false incentives or unintended consequences that might decrease the safety and soundness of the banking and thrift industries or unnecessarily reduce the availability of credit to potential borrowers. Several commenters, particularly smaller banks, agreed with the agencies that, while portfolio diversification is a desirable goal, it may also increase an institution's overall risk if accomplished by lending in unfamiliar market areas to out-of-territory borrowers or by rapid expansion of new loan products for which the institution does not have adequate expertise.

A significant number of commenters went further, however, suggesting that any requirement for institutions to hold additional capital for significant concentrations of credit risk, including the case-by-case approach proposed by the agencies, would hurt small banks with limited portfolios and would encourage unhealthy diversification. Under the "Qualified Thrift Lender" test, for example, thrifts must hold 65 percent of their assets in qualifying categories. This requirement necessarily "concentrates" a thrift's portfolio in certain types of assets. Agricultural banks described their position as similar, and therefore opposed any requirement of additional capital in order to compensate for exposures to concentrations of credit.

One commenter felt that the potential risk of loss from concentrations of credit should be reflected in the allowance for loan and lease losses (ALLL). As described in the December 21, 1993 Interagency Policy Statement regarding the ALLL, the current amount of the loan and lease portfolio that is not likely to be collected should be reflected in the ALLL. In making a determination as to the appropriate level for the ALLL, the policy statement identifies concentrations of credit risk as one of several factors to be taken into account by an institution. While both the ALLL and capital serve as a cushion against losses, the difference between the ALLL and capital is that the ALLL should be maintained at a level that is adequate to absorb estimated losses, while capital is meant to provide an additional cushion for unexpected future losses. Because the magnitude and timing of losses from concentrations are hard to predict and therefore come unexpectedly, institutions with significant levels of concentrations of credit risk should hold capital above the regulatory minimums. At the same time, institutions with concentrations of credit that are experiencing a deterioration in credit quality and collectability should reflect the increased risk in those concentrations in the ALLL. Any identifiable loan and lease losses should be recognized immediately by reducing the asset's value and the ALLL.

C. Final Rules

After careful consideration of all the comments, the agencies have decided to adopt the proposed rules on concentration of credit risk without modification. The agencies believe that there is not currently an acceptable method to add a quantitative formula to the risk-based capital standards in order to measure concentration of credit risk. However, the agencies also believe that institutions identified through the examination process as having significant exposure to concentration of credit risk or as not adequately managing concentration risk, should hold capital in excess of the regulatory minimums.

The agencies have reached this conclusion for two reasons. First, although the agencies recognize that in some cases concentrations of credit are inevitable, they nonetheless can pose important risks. Other things being equal, an institution that is not diversified faces risks that a diversified institution does not, and accordingly presents risks to the deposit insurance fund that a diversified institution does not. Second, Congress in section 305 of FDICIA clearly mandated that these risks be taken into account in determining an institution's capital adequacy. OTS, however, does not believe it is appropriate to, and will not, implement section 305 in a way that penalizes thrift institutions for complying with the statutory Qualified Thrift Lender test. In addition, the agencies are not encouraging out-of-territory lending as a response to diversification concerns.

III. Risks of Nontraditional Activities

A. Proposed Approach

The agencies proposed to take account of the risks posed by nontraditional activities by ensuring that, as members of the industry began to engage in, or significantly expand their participation in, a nontraditional activity, the risks of that activity would be promptly analyzed and the activity given appropriate capital treatment. The agencies also proposed to amend their risk-based capital standards to explicitly cite the risks arising from nontraditional activities, and management's ability to monitor and control these risks, as important factors to consider in assessing an institution's overall capital adequacy.

New developments in technology and financial markets have introduced significant changes to the banking industry, and in some cases have led institutions to engage in activities not traditionally considered part of their business. Both in the risk-based capital regulations and guidelines adopted by the agencies in 1989 and in subsequent revisions and interpretations, the agencies have adopted measures to take adequate account of the risks of nontraditional activities under the risk-based capital standards. For example, the FRB, FDIC and the OCC have recently published for comment a proposal to change the way that the counterparty credit risks are measured and incorporated into a risk-based capital ratio for equity index, commodity, and precious metals off-balance sheet instruments. These

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proposed changes were unique for each of the distinct products. The OTS intends to issue a parallel proposal in the near future. As nontraditional activities develop in the future, the agencies will address each activity on a case-by-case basis. Thus, to the extent that section 305 constitutes a mandate to the agencies to make certain that risk-based capital standards are kept current with industry practices, the agencies have been acting consistently with the intent of section 305.

B. Comments and Final Rules

While most comments focused on concentration of credit risk rather than nontraditional activities, some commenters noted their approval of the agencies' approach with regard to both parts of the rulemaking. Only a few commenters criticized the agencies' proposal on nontraditional activities, expressing concern that the agencies' proposals were too vague for examiners to apply or that the proposals were too inflexible.

After careful consideration of all the comments, the agencies are adopting the joint proposed rule on nontraditional activities without modification. The agencies believe that this final rule appropriately recognizes that the effect of a nontraditional activity on an institution's capital adequacy depends on the activity, the profile of the institution, and the institution's ability to monitor and control the risks arising from that activity. The agencies will continue their efforts to incorporate nontraditional activities into risk-based capital. In addition, to the extent appropriate, the agencies will issue examination guidelines on new developments in nontraditional activities or concentrations of credit to ensure that adequate account is taken of the risks of these activities.

IV. Paperwork Reduction Act

No collections of information pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*) are contained in this final rule. Consequently, no information has been submitted to the Office of Management and Budget for review.

V. Regulatory Flexibility Act Statement

Each agency hereby certifies pursuant to section 605b of the Regulatory Flexibility Act (5 U.S.C. 605(b)) that the final rule will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). This final rule does not necessitate the development of sophisticated recordkeeping or reporting systems by small institutions; nor will small institutions need to seek out the expertise of specialized accountants, lawyers, or managers in order to comply with the regulation.

VI. Executive Order 12866

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

List of Subjects

12 CFR Part 3

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

12 CFR Part 208

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

12 CFR Part 325

Bank deposit insurance, Banks, Banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.

12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

Authority and Issuance

OFFICE OF THE COMPTROLLER OF THE CURRENCY

12 CFR Chapter I

For the reasons set out in the joint preamble, 12 CFR part 3 is amended as set forth below:

PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

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

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

2. Section 3.1 is revised to read as follows:

This part is issued under the authority of 12 U.S.C. 1 *et seq.*, 93a, 161, 1818, 3907 and 3909.

3. Section 3.10 is revised to read as follows:

§ 3.10 Applicability.

The OCC may require higher minimum capital ratios for an individual bank in view of its circumstances. For example, higher capital ratios may be appropriate for:

(a) A newly chartered bank;

(b) A bank receiving special supervisory attention;

(c) A bank that has, or is expected to have, losses resulting in capital inadequacy;

(d) A bank with significant exposure due to interest rate risk, the risks from concentrations of credit, certain risks arising from nontraditional activities, or management's overall inability to monitor and control financial and operating risks presented by concentrations of credit and nontraditional activities;

(e) A bank with significant exposure due to fiduciary or operational risk;

(f) A bank exposed to a high degree of asset depreciation, or a low level of liquid assets in relation to short-term liabilities;

(g) A bank exposed to a high volume of, or particularly severe, problem loans;

(h) A bank that is growing rapidly, either internally or through acquisitions; or

(i) A bank that may be adversely affected by the activities or condition of its holding company, affiliate(s), or other persons or institutions including chain banking organizations, with which it has significant business relationships.

Dated: November 18, 1994.

Eugene A. Ludwig,

Comptroller of the Currency.

FEDERAL RESERVE SYSTEM

12 CFR Chapter II

For the reasons set forth in the joint preamble, 12 CFR Part 208 is amended as set forth below:

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

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

Authority: 12 U.S.C. 36, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1823(j), 1828(o), 1831o, 1831p–1, 3105, 3310, 3331–3351, and 3906–3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o–4(c)(5), 78q, 78q–1, and 78w; 31 U.S.C. 5318.

2. Appendix A to Part 208 is amended by revising the fifth and sixth paragraphs under *"I. Overview"* to read as follows:

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

I. Overview

* * * * *

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

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does incorporate elements of transfer risk as well as limited instances of interest rate and market risk The framework incorporates risks arising from traditional banking activities as well as risks arising from nontraditional activities The risk-based ratio does not however incorporate other factors that can affect an institution's financial condition These factors include overall interest rate exposure, liquidity, funding and market risks, the quality and level of earnings, investment, loan portfolio, and other concentrations of credit risk, certain risks arising from nontraditional activities, the quality of loans and investments, the effectiveness of loan and investment policies, and management s overall ability to monitor and control financial and operating risks, including the risks presented by concentrations of credit and nontraditional activities

In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of those factors, including, in particular the level and severity of problem and classified assets For this reason, the final supervisory judgement 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.

* * * * *

By order of the Board of Governors of the Federal Reserve System, December 9, 1994

Barbara R. Lowrey,

Associate Secretary of the Board

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

For the reasons set forth in the joint preamble, 12 CFR Part 325 is amended as follows.

PART 325—CAPITAL MAINTENANCE

1 The authority citation for part 325 is revised to read as follows·

Authority: 12 U S C 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1828 note, 1831n note, 1831o, 3907, 3909

§ 325.3 [Amended]

2 Section 325 3(a) is amended in the fourth sentence by adding "significant risks from concentrations of credit or nontraditional activities," immediately after "funding risks," and by adding "will take these other factors into account in analyzing the bank's capital adequacy and" immediately after 'FDIC" and before "may"

3 The fifth paragraph of the introductory text of Appendix A to Part 325 is revised to read as follows

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

* * * * *

The risk-based capital ratio focuses principally on broad categories of credit risk, however, the ratio does not take account of many other factors that can affect a bank's financial condition These factors include overall interest rate risk exposure, liquidity funding and market risks, the quality and level of earnings, investment loan portfolio, and other concentrations of credit risk, certain risks arising from nontraditional activities, the quality of loans and investments, the effectiveness of loan and investment policies, and management's overall ability to monitor and control financial and operating risks, including the risk presented by concentrations of credit and nontraditional activities. In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of each of these other factors, including, in particular, the level and severity of problem and adversely classified assets For this reason, the final supervisory judgment on a bank's capital adequacy may differ significantly from the conclusions that might be drawn solely from the absolute level of the bank's risk-based capital ratio.

* * * * *

By order of the Board of Directors.

Dated at Washington, DC, this 9th day of August 1994

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Acting Executive Secretary

OFFICE OF THRIFT SUPERVISION

12 CFR Chapter V

For the reasons set forth in the joint preamble, 12 CFR Part 567 is amended as follows:

SUBCHAPTER D—REGULATIONS APPLICABLE TO ALL SAVINGS ASSOCIATIONS

PART 567—CAPITAL

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

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

2. Section 567.3 is amended by revising paragraphs (b)(3) and (b)(9) to read as follows:

§ 567.3 Individual minimum capital requirements.

* * * * *

(b) * * *

(3) A savings association that has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration of credit risk, certain risks arising from nontraditional activities, or similar risks; or a high proportion of off-balance sheet risk, especially standby letters of credit;

* * * * *

(9) A savings association that has a record of operational losses that exceeds the average of other, similarly situated savings associations; has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly the risks presented by concentrations of credit and nontraditional activities, or has a poor record of supervisory compliance

* * * * *

Dated August 12, 1994

By the Office of Thrift Supervision

Jonathan L. Fiechter,

Acting Director

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