

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 10773]
[February 10, 1995]

RISK-BASED CAPITAL GUIDELINES
Proposed Amendments to the Risk-Based Capital Guidelines

Comments Invited by February 27

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

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

The Federal Reserve Board has requested public comment on a proposal to amend its capital adequacy guidelines for state member banks and bank holding companies (banking organizations) with regard to the regulatory capital treatment of certain transfers of assets with recourse.

Comment is requested by February 27, 1995.

This amendment is being proposed to implement section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Riegle Act).

The proposed rule would have the effect of lowering the capital requirement for small business loans and leases on personal property that have been transferred with recourse by qualified banking organizations.

Printed on the following pages is the text of the proposal, as published in the *Federal Register*. Comments on the proposal should be sent to the Board of Governors, as specified in the notice, by February 27.

WILLIAM J. McDONOUGH,
President.

FEDERAL RESERVE SYSTEM
12 CFR Parts 208 and 225
[Regulations H and Y; Docket No. R-0870]
Capital; Capital Adequacy Guidelines
AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is proposing to amend its capital adequacy guidelines for state member banks and bank holding companies (banking organizations) with regard to the regulatory capital treatment of certain transfers of assets with recourse. This amendment is being proposed to implement section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Riegle Act). The proposed rule would have the effect of lowering the capital requirement for small business loans and leases on personal property that have been transferred with recourse by qualifying banking organizations.

DATES: Comments must be received on or before February 27, 1995.

ADDRESSES: Comments, which should refer to Docket No. R-0870, may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551. Comments also may be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room

MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's rules regarding availability of information.

FOR FURTHER INFORMATION CONTACT:

Rhoger H. Pugh, Assistant Director (202/728-5883); Norah Barger, Manager (202/452-2402); Thomas R. Boemio, Supervisory Financial Analyst (202/452-2982); or David A. Elkes, Financial Analyst (202/452-5218), Division of Banking Supervision and Regulation. 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

The Board's current regulatory capital guidelines are intended to ensure that banking organizations that transfer assets and retain the credit risk inherent in those assets maintain adequate capital to support that risk. For banks, this is generally accomplished by requiring that assets transferred with recourse continue to be reported on the balance sheet in their regulatory reports. Thus, these assets are included in the calculation of banks' risk-based and leverage capital ratios. For bank holding companies, transfers of assets with recourse are reported in accordance with generally accepted accounting principles (GAAP). GAAP treats most such transactions as sales, allowing the assets to be removed from the balance sheet.¹ For purposes of calculating bank holding companies' risk-based capital ratios, however, assets sold with recourse that have been removed from the balance sheet in accordance with GAAP are included in risk-weighted assets. Accordingly, banking organizations are generally required to maintain capital against the full amount of assets transferred with recourse.

Section 208 of the Riegle Act, which Congress enacted last year, directs the federal banking agencies to revise the current regulatory capital treatment applied to depository institutions engaging in recourse transactions that involve small business obligations.

¹ The GAAP treatment focuses on the transfer of benefits rather than the retention of risk and, thus, allows a transfer of receivables with recourse to be accounted for as a sale if the transferor (1) surrenders control of the future economic benefits of the assets, (2) is able to reasonably estimate its obligations under the recourse provision, and (3) is not obligated to repurchase the assets except pursuant to the recourse provision. In addition, the transferor must establish a separate liability account equal to the estimated probable losses under the recourse provision (GAAP recourse liability account).

Specifically, the Riegle Act states that a qualifying insured depository institution that sells small business loans and leases on personal property with recourse need include only the amount of retained recourse in its asset base when calculating its capital ratios, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the depository institution must establish a non-capital reserve sufficient to meet the institution's reasonably estimated liability under the recourse arrangement. The aggregate amount of recourse retained in accordance with the provisions of the Act may not exceed 15 percent of an institution's total risk-based capital or a greater amount established by the appropriate federal banking agency. The Act also states that the preferential capital treatment set forth in section 208 is not to be applied for purposes of determining an institution's status under the prompt corrective action statute (section 38(b) of the Federal Deposit Insurance Act).

The Riegle Act defines a small business as a business that meets the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act.² The Riegle Act also defines a qualifying institution as one that is well capitalized or, with the approval of the appropriate federal banking agency, adequately capitalized, as these terms are set forth in the prompt corrective action statute. For purposes of determining whether an institution is qualifying, its capital ratios must be calculated without regard to the preferential capital treatment the Act sets forth for small business obligations.

Proposal

To implement the requirements of section 208 of the Riegle Act, the Board is proposing to amend its risk-based and leverage capital requirements for state member banks. While section 208 of the Act specifically applies only to insured depository institutions, and not to bank holding companies, the Board is also proposing to amend its risk-based capital guidelines for bank holding companies to reflect the requirements

² See 15 U.S.C. 631 et seq. The Small Business Administration has enacted regulations setting forth the criteria for a small business concern at 13 CFR 121.101-121.2106. For most industry categories, the regulation defines a small business concern as one with 500 or fewer employees. For some industry categories, a small business concern is defined in terms of a greater or lesser number of employees or in terms of a specified threshold of annual receipts.

that section sets forth for banks.³ This would maintain consistency between banks and bank holding companies with regard to the risk-based capital treatment of transfers of small business loans and leases of personal property with recourse. In general, the Board's proposal could significantly reduce the amount of capital that some banking organizations are required to hold against recourse transactions involving small business obligations.

Under the Board's proposal, for the general purpose of calculating risk-based and leverage capital ratios, qualifying institutions that transfer small business obligations with recourse would be required to maintain capital only against the amount of recourse retained, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the transferring institutions must establish a non-capital reserve sufficient to meet the reasonably estimated liability under their recourse arrangements.

The Board's proposal would extend the preferential capital treatment for transfers of small business obligations with recourse only to qualifying institutions. A state member bank would be considered qualifying if, pursuant to the Board's prompt corrective action regulation (12 CFR 208.30), it is well capitalized or, by order of the Board, adequately capitalized.⁴ Although bank holding companies are not subject to the prompt corrective action regulation, they would be considered qualifying under the Board's proposal if they meet the criteria for well capitalized or, by order

of the Board, for adequately capitalized as those criteria are set forth for banks in that regulation. A qualifying institution must be determined to be well capitalized or adequately capitalized without taking into consideration the preferential capital treatment the proposal provides for transfers of small business obligations with recourse.

The Board is also proposing that the total outstanding amount of recourse retained by qualifying banking organizations on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the institution's total risk-based capital. By order, the Board may approve a higher limit. If a banking organization is no longer qualifying, *i.e.*, becomes less than well capitalized, or has met the established limit, it could not apply the preferential capital treatment to any new transfers of small business loans and leases of personal property with recourse. Such types of transfers completed while the institution was qualifying or before it met the established limit, however, would continue to receive the preferential capital treatment.

In accordance with section 208 of the Riegle Act, the Board is proposing, that for purposes of determining a state member bank's capital category under the Board's prompt corrective action regulation, its risk-based and leverage capital ratios shall be calculated without taking into consideration the preferential capital treatment the proposal provides for transfers of small business obligations with recourse.

The Board expects that this preferential capital treatment also would not be applied for purposes of determining limitations on an institution's ability to borrow from the discount window, which is tied to its prompt corrective action status. In addition, the Board will consider whether the preferential capital treatment should be disregarded for purposes of determining an institution's ability to accept interbank liabilities. The relevant regulation sets limits on institutions that are not adequately capitalized, a term the regulation states is similar to, but not identical to, the definition of that term under the prompt corrective action regulation. A decision on whether the preferential capital treatment would be taken into account for purposes of determining an institution's ability to accept brokered deposits and the amount of its risk-based insurance premiums is to be made by the FDIC. The regulations governing these matters employ the prompt corrective action categories.

The Board is seeking comments on all aspects of this proposal.

Regulatory Flexibility Act

The purpose of this proposal is to reduce the regulatory capital requirement on transfers with recourse of small business loans and leases of personal property. Therefore, pursuant to section 605(b) of the Regulatory Flexibility Act, the Board hereby certifies that this rule, as proposed, would not have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations). Accordingly, a regulatory flexibility analysis is not required. The risk-based capital guidelines generally do not apply to bank holding companies with consolidated assets of less than \$150 million; thus, the proposed rule would not affect such companies.

Paperwork Reduction Act and Regulatory Burden

The Board has determined that this proposed 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.

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 proposes to amend 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 continues to read as follows:

³ The Board is not proposing to amend the leverage capital guidelines for bank holding companies since all transfers with recourse that are treated as sales under GAAP are already removed from a transferring bank holding company's balance sheet and, thus, are not included in the calculation of its leverage ratio.

⁴ Under 12 CFR 208.30, a state member bank is deemed to be well capitalized if it: (1) Has a total risk-based capital ratio of 10.0 percent or greater; (2) has a Tier 1 risk-based capital ratio of 6.0 percent or greater; (3) has a leverage ratio of 5.0 percent or greater; and (4) is not subject to any written agreement, order, capital directive or prompt corrective action directive issued by the Board pursuant to section 8 of the FDI Act, the International Lending Supervision Act of 1983, or section 38 of the FDI Act or any regulation thereunder, to meet and maintain a specific capital level for any capital measure.

A state member bank is deemed to be adequately capitalized if it: (1) Has a total risk-based capital ratio of 8.0 or greater; (2) has a Tier 1 risk-based capital ratio of 4.0 percent or greater; (3) has a leverage ratio of 4.0 percent or greater or a leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMEL rating system in its most recent examination and is not experiencing or anticipating significant growth; and (4) does not meet the definition of a well capitalized bank.

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. In Part 208, Appendix A, section III.B. is amended by adding a new paragraph 5. to read as follows:

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

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III. * * *
B. * * *

5. *Small Business Loans and Leases on Personal Property Transferred with Recourse.*
a. Notwithstanding other provisions of this Appendix A, a qualifying bank that has transferred small business loans and leases on personal property with recourse need include in weighted-risk assets only the amount of retained recourse in lieu of the outstanding amount of the loans and leases transferred with recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the bank must establish a non-capital reserve sufficient to meet the bank's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act are eligible for this capital treatment.

b. For purposes of this Appendix A, qualifying banks are those that are well capitalized or, by order of the Board, adequately capitalized. The definitions of well capitalized and adequately capitalized are found in the Board's prompt corrective action regulation (12 CFR 208.30). For purposes of determining whether a bank is qualifying, its capital ratios must be calculated *without regard* to the capital treatment for transfers of small business obligations with recourse specified in section III.B.5.a. of this Appendix A. The total outstanding amount of recourse retained by qualifying banking organizations on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the institution's total risk-based capital. By order, the Board may approve a higher limit.

c. For purposes of determining whether a bank is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under prompt corrective action (12 CFR 208.30), the risk-based capital ratio of the bank shall be determined *without regard* to the capital treatment of transfers of small business obligations with recourse specified in section III.B.5.a. of this Appendix A.

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3. In Part 208, Appendix B, section II is amended by revising paragraph c. and adding new paragraphs d., e., and f.

Appendix B to Part 208—Capital Adequacy Guidelines for State Member Banks: Tier 1 Leverage Measure

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II. * * *

c. Notwithstanding other provisions of this Appendix B, a qualifying bank that has transferred small business loans and leases on personal property with recourse may adjust its average total consolidated assets, for purposes of calculating its tier 1 leverage ratio, to include only the amount of retained recourse in lieu of the outstanding amount of the loans and leases transferred with recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the bank must establish a non-capital reserve sufficient to meet the bank's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act are eligible for this capital treatment.

d. For purposes of this Appendix B, qualifying banks are those that are well capitalized or, by order of the Board, adequately capitalized. The definitions of well capitalized and adequately capitalized are found in the Board's prompt corrective action regulation (12 CFR 208.30). For purposes of determining whether a bank is qualifying, its capital ratios must be calculated *without regard* to the capital treatment for transfers of small business obligations with recourse specified in section II.c. of this Appendix B. The total outstanding amount of recourse retained by qualifying banks on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the institution's total risk-based capital. By order, the Board may approve a higher limit.

e. For purposes of determining whether a bank is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under prompt corrective action (12 CFR 208.30), the leverage capital ratio of the bank shall be determined *without regard* to the capital treatment of transfers of small business obligations with recourse specified in section II.c. of this Appendix B.

f. Whenever appropriate, including when a bank is undertaking expansion, seeking to engage in new activities, or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual bank's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and

practice with regard to leverage guidelines. Banks experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

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

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

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

2. In part 225, Appendix A, section III.B. is amended by adding a new paragraph 5. to read as follows:

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

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III. * * *
B. * * *

5. *Small Business Loans and Leases on Personal Property Transferred with Recourse.*

a. Notwithstanding other provisions of this Appendix A, a qualifying banking organization that has transferred small business loans and leases on personal property with recourse need include in weighted-risk assets only the amount of retained recourse in lieu of the outstanding amount of the loans and leases transferred with recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the banking organization must establish a non-capital reserve sufficient to meet the organization's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act are eligible for this capital treatment.

b. For purposes of this Appendix A, qualifying banking organizations are those that meet the criteria for well capitalized or, by order of the Board, adequately capitalized. The criteria for well capitalized and adequately capitalized are found in the Board's prompt corrective action regulation for state member banks (12 CFR 208.30). For purposes of determining whether an organization is qualifying, its capital ratios must be calculated *without regard* to the capital treatment for transfers of small business obligations with recourse specified in section III.B.5.a. of this Appendix A. The total outstanding amount of recourse retained by qualifying banking organizations on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the institution's total risk-based capital. By order, the Board may approve a higher limit.

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By order of the Board of Governors of the Federal Reserve System, January 26, 1995.

William W. Wiles,
Secretary of the Board.