FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10774**
February 28, 1995]

CAPITAL ADEQUACY GUIDELINES
Limitation on the Capital Requirement for Assets Sold with Low Levels of Recourse

Effective March 22, 1995

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 issued a final rule amending its risk-based capital guidelines for state member banks and bank holding companies (banking organizations) to implement section 350 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Riegle Act).
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> The final rule is effective March 22, 1995.
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> This rule will limit the amount of capital required to be held against assets sold with low levels of recourse to the maximum amount of loss possible under the contractual terms of the recourse obligation.
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> By limiting the amount of capital required for such transactions, the rule corrects the anomaly that currently exists in the risk-based capital treatment for recourse arrangements under which a banking organization could be required to hold capital in excess of its possible loss.

Enclosed — for state member banks, bank holding companies, and others who maintain sets of the Board's regulations — is the text of the amendments, effective March 22, 1995, as published in the *Federal Register.* Questions regarding this matter may be directed to Stephanie Martin, Senior Financial Specialist, Bank Analysis Department (Tel. No. 212-720-1418).

William J. McDonough
President.

CAPITAL ADEQUACY GUIDELINES

Amendments
Effective March 22, 1995

Enc. Cir. No. 10774]

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–0835]

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 for state member banks and bank holding companies (banking organizations) to implement section 350 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Riegle Act). Section 350 states that the amount of risk-based capital required to be maintained by any insured depository institution, with respect to assets transferred with recourse, may not exceed the maximum amount of recourse for which the institution is contractually liable under the recourse agreement. This rule will have the effect of correcting the anomaly that currently exists in the risk-based capital treatment of recourse transactions under which an institution could be required to hold capital in excess of the maximum amount of loss possible under the contractual terms of the recourse obligation.

EFFECTIVE DATE: March 22, 1995.

FOR FURTHER INFORMATION CONTACT: Rhoger H Pugh, Assistant Director (202/728–5883), Thomas R. Boemio, Supervisory Financial Analyst (202/452–2982), or David Elkes (202/452–5218), Senior Financial Analyst, Policy Development, Division of Banking Supervision and Regulation. 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

The Board's current regulatory capital guidelines are intended to ensure that banking organizations that transfer assets and retain the credit risk inherent in the 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 regulatory reports. These amounts are thus 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), which treats most such transactions as sales, allowing the assets to be removed from the balance sheet.[1] For purposes of calculating bank

[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

Continued

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. Consequently, both banks and bank holding companies generally are required to maintain capital against the full risk-weighted amount of assets transferred with recourse.

In cases where an institution retains a low level of recourse, the amount of capital required under the Board's risk-based capital guidelines could exceed the institution's maximum contractual liability under the recourse agreement. This can occur in transactions in which a banking organization contractually limits its recourse exposure to less than the full effective risk-based capital requirement for the assets transferred—generally, 4 percent for mortgage assets and 8 percent for most other assets.

The Federal Reserve and the other federal banking agencies have long recognized this anomaly in the risk-based capital guidelines. On May 25, 1994, the banking agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), issued a Notice of Proposed Rulemaking (NPR) (59 FR 27116) that was aimed principally at amending the risk-based capital guidelines to limit the capital charge in low level recourse transactions to an institution's maximum contractual recourse liability. The proposal for these types of transactions would effectively result in a dollar capital charge for each dollar of low level recourse exposure, up to the full effective risk-based capital requirement on the underlying assets.

The proposal requested specific comment on whether an institution should be able to use the balance of the GAAP recourse liability account to reduce the dollar-for-dollar capital charge for the recourse exposure on assets transferred with low level recourse in a transaction recognized as a sale both under GAAP and for regulatory reporting purposes. In addition, the proposal indicated that the capital requirement for an exposure to low level recourse retained in a transaction associated with a swap of mortgage loans for mortgage-related securities would be the lower of the capital charge for the swapped mortgages or the combined capital charge for the low level recourse exposure and the mortgage-related securities, adjusted for any double counting.

The NPR also addressed other issues related to recourse transactions, including equivalent capital treatment of recourse arrangements and direct credit substitutes that provide first dollar loss protection and definitions for "recourse" and associated terms such as "standard representations and warranties." The NPR was issued in conjunction with an Advance Notice of Proposed Rulemaking (ANPR) that outlined a possible alternative approach to deal comprehensively with the capital treatment of recourse transactions and securitizations. The comment period for the NPR and ANPR ended on July 25, 1994.

During the agencies' review of the comments received, the Riegle Act was signed into law on September 23, 1994. Section 350 of the Act requires the federal banking agencies to issue regulations limiting, as of March 22, 1995, the amount of risk-based capital an insured depository institution is required to hold for assets transferred with recourse to the maximum amount of recourse for which the institution is contractually liable. In order to meet the statutory requirements of section 350, the Federal Reserve is now issuing a rule that puts into final form only those portions of the NPR dealing with low level recourse transactions.

Comments Received

In response to the NPR and ANPR, the Federal Reserve Board received letters from 36 public commenters. Of these respondents, 27 addressed issues related to the NPR's proposed low level recourse capital treatment. These commenters included 13 banking organizations, including 11 multinational and regional banking organizations, one community banking organization, and one foreign banking organization; eight trade associations; two law firms; one government-sponsored agency; and three other commenters. Of these 27 respondents, 23 specifically provided a favorable overall assessment of the low level recourse proposal. In general, these respondents viewed the low level proposal as a way of rationally correcting an anomaly in the existing risk-based capital rules so that institutions would not be required to hold capital in excess of their contractual liability.

Ten of the commenters stated that, while the proposed low level recourse capital treatment was a positive step, it still would result in too high of a capital requirement for assets sold with limited recourse. These respondents, which included eight of the thirteen banking organizations and two of the eight trade associations, expressed the view that the banking agencies should adopt the GAAP treatment of assets sold with recourse for purposes of calculating the regulatory capital ratios. These commenters maintained that the GAAP recourse liability account provides adequate protection against the risk of loss on assets sold with recourse, obviating the need for additional capital.

The NPR specifically sought comment on five issues related to the proposed capital treatment of low level recourse transactions. Thirteen of the 27 respondents commented on the first issue, which concerned the treatment of the GAAP recourse liability account established for assets sold with recourse reported as sales for regulatory reporting purposes. These 13 commenters favored reducing the capital requirement for low level recourse transactions by the balance of its GAAP recourse liability account—which would continue to be excluded from an institution's regulatory capital. In their view, not taking this account into consideration would result in double coverage of the portion of the risk provided for in that account.

Fourteen commenters, including five banking organizations and five trade associations, responded to the second issue, which sought comment on whether a dollar-for-dollar capital requirement would be too high for low level recourse transactions. Eleven commenters indicated that such a capital charge would be too high since it was unlikely that an institution would incur losses up to its maximum contractual liability. Two others responded that whether the capital treatment was too high depended upon the credit quality of the underlying asset pool and the structure of the securitization. One commenter stated that the dollar-for-dollar capital charge would not be too onerous.

The third issue dealt with ways of demonstrating that the dollar-for-dollar capital requirement might be too high and possible methods for reducing this requirement without jeopardizing safety and soundness. The eight commenters on this issue indicated that historical analysis, examiner review, and "depression scenario" stress testing would show whether the capital requirement would be too high relative to historical losses.

The fourth issue concerned ways the banking agencies could handle the increased probability of loss to the insurance fund if less than dollar-for-dollar capital is maintained against low

transferor must establish a separate liability account equal to the estimated probable losses under the recourse provision (GAAP recourse liability account).

level recourse transactions. The eight commenters on this issue stated that as long as the amount of required capital held against the low level recourse transactions was prudently assessed based upon expected losses, actual losses would seldom, if ever, exceed the capital requirement. Thus, the insurance funds would not likely experience losses.

The fifth issue sought comment on whether the proposed low level recourse capital treatment would reduce transaction costs or otherwise help to facilitate the sale or securitization of banking organizations' assets. The eight commenters that responded to this issue were all of the opinion that the low level capital treatment generally would help lower transaction costs and help facilitate securitization.

Final Rule

After consideration of the comments received and further deliberation on the issues involved, particularly the requirements of section 350 of the Riegle Act, the Board is adopting a final rule amending the risk-based capital guidelines with respect to the treatment of low level recourse transactions. Specifically, the final amendments implement section 350 by reducing the capital requirements for all recourse transactions in which a state member bank contractually limits its recourse exposure to less than the full, effective risk-based capital requirement for the assets transferred. Although section 350 explicitly extends only to depository institutions, the Board, consistent with its proposal, is also issuing a parallel final amendment to its risk-based capital guidelines for bank holding companies.[2]

The final rule applies to low level recourse transactions involving all types of assets, including small business loans, commercial loans, and residential mortgages. In this regard, the Board notes that previously under the risk-based capital guidelines residential mortgage loans transferred with recourse were excluded from risk-weighted assets if the institution did not retain significant risk of loss. As proposed, this treatment would no longer apply and the low level recourse capital treatment the Board is now issuing would extend to these types of mortgage loan transfers.

Under the low level recourse rule, a banking organization that contractually limits its maximum recourse obligation to less than the full effective risk-based capital requirement for the transferred assets would be required to hold risk-based capital equal to the contractual maximum amount of its recourse obligation. This requirement limits to one dollar the capital charge for each dollar of low-level recourse exposure. Under this dollar-for-dollar capital requirement, the capital charge for a 100 percent risk-weighted asset transferred with 3 percent recourse would be 3 percent of the value of the transferred assets, rather than the 8 percent previously required. Thus, a banking organization's capital requirement on a low level recourse transaction would not exceed the contractual maximum amount it could lose under the recourse obligation.

Under the final rule, an institution may reduce the dollar-for-dollar capital charge held against the recourse exposure on assets transferred with low level recourse for a transaction recognized as a sale under GAAP and for regulatory reporting purposes by the balance of any associated non-capital GAAP recourse liability account. In adopting this aspect of the final rule, the Board concurs with commenters that indicated that nonrecognition of the liability account would result in double coverage of the portion of the credit risk provided for in that account.

In applying the final rule, the Board will, as proposed, limit the capital requirement for an exposure to low level recourse retained in a transaction associated with a swap of mortgage loans for mortgage-related securities to the lower of the capital charge for the swapped mortgages or the combined capital charge for the low level recourse exposure and the mortgage-related securities, adjusted for any double counting.

In setting forth this final rule, the Board has considered the arguments that several commenters made for adopting for regulatory capital purposes the GAAP treatment for all assets sold with recourse, including those sold with low levels of recourse. Under such a treatment, assets sold with recourse in accordance with GAAP would have no capital requirement, but the GAAP recourse liability account would provide some level of protection against losses.

The Board continues to believe it would not be appropriate to adopt for regulatory capital purposes the GAAP treatment of recourse transactions, even if the transferring bank retains only a low level of recourse. In the Board's view, the GAAP recourse liability account would be an inadequate substitute for maintaining capital at a level commensurate with the risks. One of the principal purposes of regulatory capital is to provide a cushion against unexpected losses. In contrast, the GAAP recourse liability account is, in effect, a specific reserve that is intended to cover only an institution's probable expected losses under the recourse provision. In this regard, the Board notes that the capital guidelines explicitly state that specific reserves may not be included in regulatory capital.

In addition, the amount of credit risk that is typically retained in a recourse transaction greatly exceeds the normal expected losses associated with the transferred assets. Thus, even though a transferring institution may reduce its exposure to potential catastrophic losses by limiting the amount of recourse it provides, it may still retain, in many cases, the bulk of the risk inherent in the assets. For example, an institution transferring high quality assets with a reasonably estimated expected loss rate of one percent that retains ten percent recourse in the normal course of business will sustain the same amount of losses it would have had the assets not been transferred. This occurs because the amount of exposure under the recourse provision is very high relative to the amount of expected losses. The Board believes that in such transactions the transferor has not significantly reduced its risk for purposes of assessing regulatory capital and should continue to be assessed regulatory capital as though the assets had not been transferred.

The GAAP reliance on reasonable estimates of all probable credit losses over the life of the receivables transferred poses additional concerns to the Board. While it may be possible to make such estimates for pools of consumer loans or residential mortgages, the Board is of the view that it is currently difficult to do so for other types of loans. Even if it is possible to make a reasonable estimate of probable credit losses at the time an asset or asset pool is transferred, the ability of an institution to make a reasonable estimate may change over the life of the transferred assets.

Finally, the Board is concerned that an institution transferring assets with recourse might estimate that it would not have *any* losses under the recourse provision, in which case it would not establish any GAAP recourse liability account for the exposure. If the transferor recorded either no liability or only a nominal liability in the GAAP

[2] In addition to amending the risk-based capital guidelines to reduce the capital requirement for low level recourse transactions (see paragraph g of section III.D.1. of the guidelines), the Board is also making some technical, nonsubstantive changes to that section of the guidelines by identifying each paragraph in the section with a letter designation.

obligation to make a payment to the customer or to a third party in the event the customer *fails to repay* an outstanding debt obligation or *fails to perform* a contractual obligation is treated, for risk-based capital purposes, as respectively, a financial guarantee standby letter of credit or a performance standby.

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

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

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

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

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By order of the Board of Governors of the Federal By Reserve System, February 7, 1995.

William W. Wiles,

Secretary of the Board.

[FR Doc. 95–3469 Filed 2–10–95; 8:45 am]

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[48] In regulatory reports and under GAAP, bank holding companies are permitted to treat some asset sales with recourse as "true" sales. For risk-based capital purposes, however, such assets sold with recourse and reported as "true" sales by bank holding companies are converted at 100 percent and assigned to the risk category appropriate to the underlying obligor or, if relevant, the guarantor or nature of the collateral, provided that the transactions meet the definition of assets sold with recourse (including assets sold subject to pro rata and other loss sharing arrangements), that is contained in the instructions to the commercial bank Consolidated Reports of Condition and Income (Call Report). This treatment applies to any assets, including the sale of 1- to 4-family and multifamily residential mortgages, sold with recourse. Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of 1- to 4-family residential mortgages, are to be converted at 100 percent and assigned to the risk category appropriate to the obligor, or if relevant, the nature of any collateral or guarantees. The terms of a transfer of assets with recourse may contractually limit the amount of the institution's liability to an amount less than the effective risk-based capital requirement for the assets being transferred with recourse. If such a transaction is recognized as a sale under GAAP, the amount of total capital required is equal to the maximum amount of loss possible under the recourse provision, less any amount held in an associated non-capital liability account established pursuant to GAAP to cover estimated probable losses under the recourse provision.

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

recourse liability account for a succession of asset transfers, it could accumulate large amounts of credit risk that would not be reflected, or would be only partially reflected, on the balance sheet.

The Board is issuing this final rule now in order to implement section 350 of the Riegle Act in accordance with the statutory deadline. Consequently, the rule deals with only those portions of the NPR concerned with low level recourse transactions. The Board will continue to consider, on an interagency basis, the other aspects of the NPR, as well as all aspects of the ANPR that was issued in conjunction with the NPR.

Regulatory Flexibility Act

The purpose of this final rule is to reduce the risk-based capital requirement on transfers of assets with low levels of recourse. Therefore, pursuant to section 605(b) of the Regulatory Flexibility Act, the Board hereby certifies that this rule will have a beneficial economic impact on small business entities (in this case, small banking organizations) that sell assets with low levels of recourse. The risk-based capital guidelines generally do not apply to bank holding companies with consolidated assets of less than $150 million; thus, this 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 requires that new regulations take effect on the first day of the calendar quarter following publication of the rule, unless, *inter alia*, the regulation, pursuant to any other Act of Congress, is required to take effect on a date other than the date determined under section 302. Section 350 of the Riegle Act requires that before the end of the 180-day period beginning on the date of enactment of the Act, or in this case no later than March 22, 1995, the amount of risk-based capital required to be maintained, under regulations prescribed by the appropriate Federal banking agency, by any insured depository institution transferring assets with recourse be limited to the maximum amount of recourse for which such institution is contractually liable under the recourse agreement. Accordingly, the Board has determined that an effective date of March 22, 1995 is appropriate.

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 amends 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:

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.D.1. is revised to read as follows:

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

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III. * * *

D. * * *

1. *Items with a 100 percent conversion factor.*

a. A 100 percent conversion factor applies to direct credit substitutes, which include guarantees, or equivalent instruments, backing financial claims, such as outstanding securities, loans, and other financial liabilities, or that back off-balance sheet items that require capital under the risk-based capital framework. Direct credit substitutes include, for example, financial standby letters of credit, or other equivalent irrevocable undertakings or surety arrangements, that guarantee repayment of financial obligations such as: commercial paper, tax-exempt securities, commercial or individual loans or debt obligations, or standby or commercial letters of credit. Direct credit substitutes also include the acquisition of risk participations in bankers acceptances and standby letters of credit, since both of these transactions, in effect, constitute a guarantee by the acquiring bank that the underlying account party (obligor) will repay its obligation to the originating, or issuing, institution.[41] (Standby letters of credit that are performance-related are discussed below and have a credit conversion factor of 50 percent.)

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

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

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

e. The distinguishing characteristic of a standby letter of credit for risk-based capital purposes is the combination of irrevocability with the fact that funding is triggered by some failure to repay or perform an obligation. Thus, any commitment (by

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

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

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

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

whatever name) that involves an *irrevocable* obligation to make a payment to the customer or to a third party in the event the customer fails to repay an outstanding debt obligation or fails to perform a contractual obligation is treated, for risk-based capital purposes, as respectively, a financial guarantee standby letter of credit or a performance standby.

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

g. Sale and repurchase agreements and asset sales with recourse (to the extent not included on the balance sheet) and forward agreements also are converted at 100 percent. The risk-based capital definition of the sale of assets with recourse, including the sale of 1- to 4-family residential mortgages, is the same as the definition contained in the instructions to the commercial bank Call Report. Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of 1- to 4-family residential mortgages, are to be converted at 100 percent and assigned to the risk weight appropriate to the obligor, or if relevant, the nature of any collateral or guarantees. The terms of a transfer of assets with recourse may contractually limit the amount of the institution's liability to an amount less than the effective risk-based capital requirement for the assets being transferred with recourse. If such a transaction (including one that is reported as a financing, i.e., the assets are not removed from the balance sheet) meets the criteria for sales treatment under GAAP, the amount of total capital required is equal to the maximum amount of loss possible under the recourse provision. If the transaction is also treated as a sale for regulatory reporting purposes, then the required amount of capital may be reduced by the balance of any associated non-capital liability account established pursuant to GAAP to cover estimated probable losses under the recourse provision. So-called "loan strips" (that is, short-term advances sold under long-term commitments without direct recourse) are defined in the instructions to the commercial bank Call Report and for risk-based capital purposes as assets sold with recourse.

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

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

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

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.D.1. is revised to read as follows:

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

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III. * * *

D. * * *

1. *Items with a 100 percent conversion factor.*

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

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

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

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

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

e. The distinguishing characteristic of a standby letter of credit for risk-based capital purposes is the combination of irrevocability with the fact that funding is triggered by some failure to repay or perform an obligation. Thus, any commitment (by whatever name) that involves an *irrevocable*

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

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

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