

**FEDERAL RESERVE BANK  
OF NEW YORK**

[ Circular No. **10803**  
September 19, 1995 ]

**CAPITAL ADEQUACY GUIDELINES**

- **Amendments Regarding the Treatment of Derivative Contracts**
- **Amendments Regarding the Treatment of Certain Transfers  
of Assets with Recourse**

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

The following statements have been issued by the Board of Governors of the Federal Reserve System announcing (1) amendments to its risk-based capital standards for banks and bank holding companies (Appendix A to Regulations H and Y) concerning the treatment of derivative contracts; and (2) amendments to its risk-based and leverage capital adequacy guidelines for State member banks and bank holding companies (Appendix A and B of Regulation H and Appendix A of Regulation Y) concerning the treatment of certain transfers of assets:

**Derivative Contracts**

The Federal Reserve Board, along with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, is amending the risk-based capital guidelines for banks and bank holding companies (banking organizations) regarding the treatment of derivative contracts.

The final rule is effective October 1, 1995.

The amendments revise the set of conversion factors used to estimate the potential future credit exposure of derivative contracts and permit banking organizations to recognize the effects of bilateral netting arrangements in the calculation of those estimates.

The final rule is based on a revision to the Basle Accord issued by the Basle Supervisors' Committee (BSC) in April 1995.

**Transfers of Assets**

The Federal Reserve Board has issued amendments to 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.

The final rule is effective September 1, 1995.

The amendments implement section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Riegle Act).

The final rule will 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.

Enclosed — for State member banks and bank holding companies, and others who maintain sets of the Board's regulations — is the text of the amendments, which have been reprinted from the *Federal Registers* of September 5 and August 31, respectively; copies will be furnished to others upon request directed to our Circulars Division (Tel. No. 212-720-5215 or 5216). (The related amendments issued by the Office of the Comptroller of the Currency or by the Federal Deposit Insurance Corporation are not included in the enclosures.)

Questions regarding these matters may be directed to Stephanie Martin, Senior Financial Specialist, Bank Analysis Department (Tel. No. 212-720-1418).

WILLIAM J. McDONOUGH,  
*President.*

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**Tuesday  
September 5, 1995**

**CAPITAL ADEQUACY GUIDELINES**

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**Amendments  
Effective October 1, 1995**

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**Part IV  
Federal Reserve System  
12 CFR Parts 208 and 225**

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**Risk-Based Capital Standards; Derivative  
Transactions; Final Rule**

[Enc. Cir. No. 10803]

CAG 104/95



**DEPARTMENT OF THE TREASURY****Office of the Comptroller of the Currency****12 CFR Part 3**

[Docket No. 95-20]

RIN 1557-AB14

**FEDERAL RESERVE SYSTEM****12 CFR Parts 208 and 225**

[Regulations H and Y; Docket No. R-0845]

**FEDERAL DEPOSIT INSURANCE CORPORATION****12 CFR Part 325**

RIN 3064-AB43

**Risk-Based Capital Standards: Derivative Transactions**

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

**ACTION:** Final rule.

**SUMMARY:** The OCC, the Board, and the FDIC (the banking agencies) are amending their respective risk-based capital standards for banks and bank holding companies (banking organizations, institutions). This final rule implements a recent revision to the Basle Accord revising and expanding the set of conversion factors used to calculate the potential future exposure of derivative contracts and recognizing the effects of netting arrangements in the calculation of potential future exposure for derivative contracts subject to qualifying bilateral netting arrangements. The effect of this final rule is threefold. First, long-dated interest rate and exchange rate contracts are subject to higher conversion factors and new conversion factors are set forth that specifically apply to derivative contracts related to equities, precious metals, and other commodities. Second, institutions are permitted to recognize a reduction in potential future credit exposure for transactions subject to qualifying bilateral netting arrangements. Third, derivative contracts related to equities, precious metals and other commodities may be recognized in bilateral netting arrangements for risk-based capital purposes.

**EFFECTIVE DATE:** October 1, 1995.

**FOR FURTHER INFORMATION CONTACT:** OCC: For issues relating to netting and

the calculation of risk-based capital ratios, Roger Tufts, Senior Economic Advisor (202/874-5070), Office of the Chief National Bank Examiner. For legal issues, Eugene H. Cantor, Senior Attorney, Securities and Corporate Practices (202/874-5210), or Ronald Shimabukuro, Senior Attorney, Legislative and Regulatory Activities Division (202/874-5090), Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, D.C. 20219.

**Board:** 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.

**FDIC:** William A. Stark, Assistant Director, (202/898-6972), Curtis Wong, Capital Markets Specialist, (202/898-7327), Division of Supervision, or Jeffrey M. Kopchik, Counsel, (202/898-3872), Legal Division, FDIC, 550 17th St., N.W., Washington, D.C. 20429.

**SUPPLEMENTARY INFORMATION:****I. Background**

The Basle Accord<sup>1</sup> established a risk-based capital framework for assessing capital adequacy that was implemented in the United States by the banking agencies in 1989. Under this framework, off-balance-sheet transactions are incorporated into the risk-based structure by converting each item into a credit equivalent amount that 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 collateral.

The credit equivalent amount of an off-balance-sheet interest rate or exchange rate contract (rate contract) is determined by adding together the current replacement cost (current exposure) of the contract and an estimate of the possible increase in future replacement cost (potential future

exposure, also referred to as the add-on) in view of the volatility of the current exposure of the contract. The maximum risk category for rate contracts is 50 percent.<sup>2</sup>

**Current Exposure**

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 is zero or negative, then the current exposure is zero. The sum of current exposures for a defined set of contracts is sometimes referred to as the gross current exposure for that set of contracts. When they were initially issued, the Basle Accord and the banking agencies' risk-based capital standards provided, generally, that current exposure would be determined individually for each rate contract entered into by a banking organization.

In July 1994 the Basle Accord was revised to permit institutions to net, that is, offset, positive and negative mark-to-market values of rate contracts entered into with a single counterparty subject to a qualifying, legally enforceable, bilateral netting arrangement. Effective at year-end 1994, the banking agencies each amended, in a uniform manner, their risk-based capital standards to implement the revision to the Accord.<sup>3</sup> Accordingly, U.S. banking organizations with qualifying, legally enforceable, bilateral netting arrangements may replace the gross current exposure of a set of contracts included in such an arrangement with a single net current exposure for purposes of determining the credit equivalent amount for the included contracts.

**Potential Future Exposure**

The potential future exposure portion of the credit equivalent amount for rate contracts is an estimate of the additional credit exposure that may arise as a result of fluctuations in prices or rates. The add-on for potential future exposure is estimated by multiplying the notional principal amount<sup>4</sup> of the contract by a credit conversion factor that is determined by the remaining maturity of the contract and the type of

<sup>2</sup> Exchange rate contracts with an original maturity of 14 calendar days or less and instruments traded on exchanges that require daily receipt and payment of cash variation margin are excluded from the risk-based capital ratio calculations.

<sup>3</sup> The Board issued its amendment on December 7, 1994 (59 FR 62987), the OCC and FDIC issued their amendments on December 28, 1994 (59 FR 66645 for the OCC final rule and 59 FR 66656 for the FDIC final rule).

<sup>4</sup> The notional principal amount is a reference amount of money used to calculate payment streams between counterparties.



contract. The original conversion factors in the Basle Accord and the banking agencies' risk-based capital standards are set forth in the following matrix:

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

An individual add-on for potential future exposure is calculated for all rate contracts regardless of whether the market value is zero, positive, or negative, or whether the current exposure is calculated on a gross or net basis. The banking agencies' recent amendments to expand the recognition of bilateral netting arrangements did not revise the calculation of the add-on for potential future exposure. Accordingly, an add-on is calculated separately for each individual contract subject to a qualifying bilateral netting arrangement. These individual potential future exposures are added together to arrive at a gross add-on amount. The gross add-on amount is added to the net current exposure to determine one credit

equivalent amount for the contracts subject to the qualifying bilateral netting arrangement.

Commenters to the Basle proposal to expand the recognition of bilateral netting arrangements urged regulators to also recognize reductions in potential future credit exposure arising from such arrangements. They also commented that commodity and equity derivative transactions should be eligible for netting for risk-based capital purposes. Accordingly, in July 1994 the Basle Supervisors Committee proposed revisions to the Basle Accord regarding the risk-based capital treatment of derivative transactions.<sup>5</sup> Under the proposed revision, the matrix of conversion factors used to calculate potential future exposure would be expanded to take into account innovations in the derivatives markets. Specifically, the Basle Committee proposed that higher conversion factors be added to address long-dated transactions (that is, contracts with remaining maturities over five years) and new conversion factors be added to explicitly cover certain types of derivatives transactions not directly

mentioned by the Accord when it was endorsed in 1988. These include commodity-, precious metal-, and equity-linked derivative transactions.<sup>6</sup> The proposed revision also would have formally extended the recognition of qualifying bilateral netting arrangements to commodity, precious metal, and equity derivative contracts so that these types of transactions could be netted when determining current exposure for the netting contract. In addition, the proposed revision set forth a formula for institutions to employ in recognizing reductions in the potential future exposure of derivatives contracts that can result from entering into qualifying bilateral netting arrangements.

**II. The Agencies' Proposals**

After the Basle Supervisors Committee issued its proposed revisions to the Basle Accord, the banking agencies each issued for public comment proposals to amend their respective risk-based capital standards based on the international proposal.<sup>7</sup> The agencies' proposed conversion factor matrix is set forth below:

CONVERSION FACTOR MATRIX <sup>1</sup>  
[Amounts in percent]

Residual maturity	Interest rate	Foreign exchange and gold	Equity <sup>2</sup>	Precious metals, except gold	Other commodities
Less than one year .....	0.0	1.0	6.0	7.0	12.0
One to five years .....	0.5	5.0	8.0	7.0	12.0
Five years or more .....	1.5	7.5	10.0	8.0	15.0

<sup>1</sup> For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.

<sup>2</sup> For contracts that automatically reset to zero value following a payment, the remaining maturity is set equal to the time remaining until the next payment.

The proposed matrix was designed to accommodate a variety of contracts and was intended to provide a reasonable balance between precision, on the one hand, and complexity and burden, on the other.

The agencies also proposed the same methodology as the Basle Supervisors Committee to calculate a reduction in the add-on amount for contracts subject to qualifying bilateral netting arrangements. Under the agencies' proposals, institutions would apply the

following formula <sup>\*</sup> to adjust the amount of the add-on for potential future exposure:

$$A_{net} = 0.5(A_{gross} + (NGR \times A_{gross}))$$

Where  $A_{net}$  is the adjusted add-on for all contracts subject to the netting arrangement,  $A_{gross}$  is the amount of the add-on as calculated under the current agency standards, and NGR is the ratio of the net current exposure of the set of contracts included in the netting arrangement to the gross current exposure of those contracts. The proposals would have given partial credit to the effect of the NGR by

applying a weighted averaging factor of 0.5.

Under the proposals, institutions would calculate a separate NGR for each counterparty with which it has a qualifying bilateral netting contract. The proposals requested general comments as well as specific comment as to whether the NGR should be calculated on a counterparty-by-counterparty basis or on an aggregate basis for all contracts subject to qualifying bilateral netting arrangements.

<sup>5</sup> The proposed revisions are contained in a document entitled "The capital adequacy treatment of the credit risk associated with certain off-balance-sheet items" that is available upon request from the Board's or OCC's Freedom of Information Offices or the FDIC's Office of the Executive Secretary.

<sup>6</sup> In general terms, these are off-balance-sheet derivative contracts that have a return, or a portion of their return, linked to the price or an index of prices for a particular commodity, precious metal, or equity. These types of transactions were not specifically addressed in the 1988 Accord (or in the banking agencies' original risk-based capital standards) because they were not prevalent in the derivatives markets at that time.

<sup>7</sup> The Board issued its proposal on August 24, 1994 (59 FR 43508), the OCC issued its proposal on September 1, 1994 (59 FR 45243), and the FDIC issued its proposal on October 19, 1994 (59 FR 52714).

<sup>\*</sup> This formula may also be expressed as:  $A_{net} = (1-P)A_{gross} + P(NGR \times A_{gross})$  [P or policy factor = 0.5].



### III. Comments Received

The banking agencies together received nineteen public comments on their proposed amendments. Fifteen of the commenters were banks and bank holding companies and four were industry trade associations and other organizations. Commenters generally supported the proposed amendments, in particular the recognition of the effects of bilateral netting arrangements in the calculation of potential future exposure, and several urged adoption of the amendments as soon as possible. Commenters offered suggestions and opinions on several aspects of the proposals including the conversion factors, the formula for recognizing potential future exposure, ways of calculating the NGR, and recognizing additional risk-reducing techniques.

#### *Expanded Matrix*

Over one half of the commenters addressed the proposed expanded conversion factor matrix. Of these commenters, most indicated the proposed factors were generally reasonable and acceptable. Several commenters discussed the underlying assumptions used in the simulation models for arriving at the proposed factors for commodity transactions and expressed concern that the conversion factors for certain commodity derivative transactions were too high. One commenter suggested the conversion factor for commodity contracts across all time bands should be twelve percent. Another commenter expressed the view that the proposed conversion factor for interest rate contracts with remaining maturities greater than five years (1.5 percent) was an excessive increment over the current 0.5 percent conversion factor for interest rate contracts with remaining maturities greater than one year. This commenter suggested an additional time band for interest rate contracts with five to eight years remaining maturity and a corresponding conversion factor of 1.0 percent. Another commenter suggested there should be no capital charge for potential future exposure for commodity contracts based on two floating indices.

One commenter supported continuing the existing time band of "one year or less" as opposed to the proposed time band of "less than one year." Two commenters expressed the view that the proposed time band for contracts with remaining maturities greater than five years was unnecessary. One commenter suggested adding a time band and appropriate conversion factors for contracts with remaining maturities between one and two years.

Several commenters discussed the matrix footnotes. One suggested extending the footnote applicable to equity contracts with automatic reset features following a payment to any derivative contract with effective early termination or periodic reset features. With regard to the footnote pertaining to contracts with multiple exchanges of principal, one commenter requested further clarification on the types of contracts included, while another expressed the view that multiplying the conversion factor by the number of remaining payments in a contract was too conservative. A few commenters recommended clarification as to the appropriate capital treatment when transactions are leveraged or enhanced by a stated multiple.

#### *Netting and Potential Future Exposure*

A number of commenters discussed the proposed formula for recognizing the effects of bilateral netting arrangements in the calculation of potential future exposure. Most of these commenters supported the use of the NGR as a reasonable proxy to estimate the risk-reducing benefits of netting arrangements. Several commenters supported giving full weight to the NGR or, alternatively, weighting the NGR with a higher averaging factor than the proposed 0.5 factor. Another commenter offered a revised formula that would weight the netting portion of the formula by two and divide the entire formula by three. This commenter stated the revised formula would effectively reduce the credit equivalent amount and place greater emphasis on the portion of the formula affected by a netting arrangement. One commenter suggested that net credit risk should be the basis for the add-on amount.

Several commenters addressed the proposal's specific request for comment on whether the NGR should be calculated on a counterparty-by-counterparty basis or on an aggregate basis across all portfolios eligible for capital netting treatment. A few commenters supported a counterparty-by-counterparty NGR as providing a more accurate indication of credit risks. Other commenters preferred an aggregate NGR, characterizing an aggregate NGR as less burdensome to calculate. Two commenters suggested applying a single NGR to all counterparties within each risk weight classification.

#### *Other Comments*

Several commenters encouraged recognizing other risk reducing techniques such as margin and collateral agreements, frequent

settlement of mark-to-market values, and periodic resetting of terms and early termination agreements. One commenter suggested there should be no capital charge for potential future exposure when current exposure is less than a certain level (e.g., negative \$1 million). One commenter suggested using negative net mark-to-market values to offset potential future exposure. A few commenters supported the use of internal systems to calculate capital requirements and recommended continued monitoring of developments in the banking industry.

### IV. Final Rule

After consideration of the comments received and further deliberation on the issues involved, the banking agencies have determined to adopt a final rule that is substantially the same as proposed. The final rule amends the matrix of conversion factors used to calculate potential future exposure and permits institutions to recognize the effects of qualifying bilateral netting arrangements in the calculation of potential future exposure. The final rule is consistent with a revision to the Basle Accord announced by the Basle Supervisors Committee in April 1995.<sup>9</sup>

#### *Expanded Matrix*

The banking agencies believe that the proposed conversion factors generally provide a reasonable measure of potential future exposure for long-dated interest rate and exchange rate contracts and for other derivative instruments not addressed in the original Accord. In addition, the banking agencies believe that the proposed matrix adequately accommodates a variety of contracts and appropriately provides a reasonable balance between precision, and complexity and burden. The agencies, however, have taken into consideration issues raised by commenters regarding the simulation methods used to arrive at the conversion factors for other commodities. After additional simulation analysis, the agencies have concluded that the conversion factor for other commodity transactions with maturities of one year or less should be lowered from 12 percent to 10 percent. Any off-balance-sheet derivative contract not explicitly covered by the expanded matrix is subject to the add-on conversion factors for other

<sup>9</sup>The revision to the Basle Accord is in an annex with the heading "Forwards, swaps, purchased options and similar derivative contracts" that was issued along with the Basle Supervisors Committee's consultative proposal on Market Risk on April 12, 1995. This document is available upon request from the Board's and OCC's Freedom of Information Offices and the FDIC's Office of the Executive Secretary.



commodities. Furthermore, in response to commenters' concerns, the banking agencies have revised the proposed time band of "less than one year" to "one year or less" to maintain consistency with the existing time bands for remaining maturity.

The proposed matrix included a footnote applicable to equity contracts that automatically reset market value to zero following a payment. Under the proposal, the remaining maturity of such contracts would be the time until the next payment. Several commenters asserted this treatment should extend to a wider range of contracts. The agencies have determined that for contracts structured to settle outstanding exposure to zero following specified payment dates and where the terms of the contract are reset so that the market value of the contract is zero on these dates, the remaining maturity may be set equal to the time until the next reset date. However, the agencies believe that a long-dated interest rate swap, with, for example, a six-month zero reset provision, represents a greater risk than an interest rate swap that terminates after six months. The final rule provides that the minimum add-on conversion factor for interest rate contracts with remaining maturities of greater than one year is 0.5 percent.

Under the final rule, which is identical to the proposal in this regard, gold derivative contracts are accorded the same conversion factors as exchange rate contracts. However, while exchange rate contracts with original maturities of fourteen calendar days or less may be excluded from the risk-based ratio calculation,<sup>10</sup> gold contracts with such original maturities are to be included.

Finally, the agencies note that the conversion factors are to be regarded as provisional and may be subject to amendment as a result of changes in the volatility of rates and prices.

#### Netting and Potential Future Exposure

The final rule adopts, in substantially the same form, the proposed methodology for reducing potential future exposure for contracts subject to qualifying bilateral netting arrangements. The agencies have considered the argument presented by several commenters that the proposed formula did not give sufficient

recognition to reductions in credit risk resulting from participating in qualifying netting arrangements. These commenters suggested giving full weight to the NGR or, alternatively, that it be weighted at 90 percent. The agencies believe that only partial weight should be given to the NGR as it is neither a precise, nor a stable indicator of future changes in net exposure relative to changes in gross exposure. The agencies agree, to a limited extent, with commenters that a 0.5 averaging factor (referred to as the policy or P factor) may not sufficiently recognize reductions in potential future exposure resulting from qualifying bilateral netting arrangements and have determined that the P factor should be raised to 0.6. This weight represents an appropriate compromise between recognizing effects of bilateral netting arrangements in calculating the add-on and providing a cushion against additional exposure that may arise as a result of fluctuations in prices or rates. The formula adopted by the agencies is expressed as:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

The agencies have also considered comments discussing whether the NGR should be calculated on a counterparty-by-counterparty basis (that is, an individual NGR for each bilateral netting contract) or on an aggregate basis for all contracts subject to legally enforceable netting arrangements. The agencies have determined that an institution may elect to calculate separate NGRs for each of its bilateral netting arrangements or an aggregate NGR so long as the method chosen is used consistently and is subject to examiner review.

Regardless of the method employed by an institution to calculate its NGR(s), the NGR should be applied separately and individually to each of the institution's bilateral netting arrangements. If an institution calculates an NGR for each bilateral netting arrangement, then it should use a different NGR when determining the potential future exposure for each bilateral netting arrangement. If an institution aggregates its net and gross replacement costs across all bilateral netting contracts to determine a single NGR, then it should use the same NGR when determining the potential future exposure for each bilateral netting arrangement.

Institutions with equity, precious metal, and other commodity contracts included in bilateral netting contracts should now include those types of transactions when determining the net current exposure for the bilateral netting

contract and when determining potential future exposure in accordance with this final rule.

The final rule permits, subject to certain conditions, institutions to take into account qualifying collateral when assigning the credit equivalent amount of a netting arrangement to the appropriate risk category in accordance with the procedures and requirements currently set forth in each agency's risk-based capital standards.

Finally, the agencies note that the methodology for recognizing the effects of qualifying bilateral netting arrangements is subject to review and revision as determined to be appropriate.

#### V. Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the agencies do not believe that this final rule will have a significant impact on a substantial number of small business entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). In this regard, while some institutions with limited derivative portfolios may experience an increase in capital charges, for most of these institutions the final rule will have no effect. For institutions with more developed derivative portfolios, the overall effect of the rule will likely be to reduce regulatory burden and decrease the capital charge for certain derivative transactions. In addition, because the risk-based capital standards generally do not apply to bank holding companies with consolidated assets of less than \$150 million, this final rule will not affect such companies.

#### VI. Paperwork Reduction Act and Regulatory Burden

The agencies have 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. As noted above, the rule may result in higher capital charges for some institutions and lower charges for others, but any additional paperwork or recordkeeping burden should be minimal. The rule provides a more accurate measure of risks related to derivative contracts and the capital required to cover those risks.

<sup>10</sup> Exchange rate contracts with original maturities of 14 calendar days or less are normally excluded from the risk-based capital ratio. When such contracts are included in a bilateral netting arrangement, however, the institution may elect consistently either to include or exclude all market values of those contracts when determining net current exposure. These contracts should continue to be excluded when determining potential future exposure.



Section 302 also requires such a rule to become effective on the first day of the calendar quarter following publication of the rule, unless the agency, for good cause, determines an earlier effective date is appropriate. Accordingly, the agencies have determined that an effective date of October 1, 1995 is appropriate.

#### VII. OCC Executive Order 12866

It has been determined that this final rule is not a significant regulatory action as defined in Executive Order 12866.

#### VIII. OCC Unfunded Mandates Act of 1995

Section 202 of the Unfunded Mandates Act of 1995 (Unfunded Mandates Act) (signed into law on March 22, 1995) requires that certain agencies prepare a budgetary impact statement before promulgating a rule that includes a federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires the agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC has determined that this joint agency final rule will not result in expenditures by state, local and tribal governments, or by the private sector, of more than \$100 million in any one year. Accordingly, the OCC has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

As discussed in the preamble, this joint agency final rule amends the risk-based capital guidelines to (1) revise and expand the credit conversion factors used to calculate the potential future credit exposure for derivative contracts and long-dated interest rate and foreign exchange rate contracts and (2) permit banks to net multiple derivative contracts subject to a qualifying bilateral netting contract when calculating the potential future credit exposure. While the impact of this final rule on any particular national bank will depend on the composition of its derivatives portfolio, the OCC believes that this final rule generally will have little or no impact on most banks since most banks have limited derivative portfolios. For those banks with more developed derivatives portfolios, the OCC believes that the effect of this final rule will likely be a decrease in the capital requirements for certain derivative contracts.

#### List of Subjects

##### 12 CFR Part 3

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

##### 12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Flood insurance, 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.

##### 12 CFR Part 325

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



**FEDERAL RESERVE SYSTEM**

**12 CFR CHAPTER II**

For the reasons set out in the joint preamble, the Board of Governors of the Federal Reserve System 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; 42 U.S.C. 4012a, 4104a, 4104b.

<sup>22</sup> Derivative contracts are an exception to the general rule of applying collateral and guarantees to the face value of off-balance sheet items. The sufficiency of collateral and guarantees is determined on the basis of the credit equivalent amount of derivative contracts. However, collateral and guarantees held against a qualifying bilateral netting contract is not recognized for capital

2. In part 208, appendix A is amended by revising the last paragraph of section III.C.3. and footnote 40 in the introductory text of section III.D. to read as follows:

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

\* \* \* \* \*

**III. \* \* \***

C. \* \* \*

3. \* \* \*

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

\* \* \* \* \*

D. \* \* \* 40 \* \* \*

\* \* \* \* \*

3. In part 208, appendix A is amended by revising the section III.E. heading and section III.E. to read as follows:

\* \* \* \* \*

purposes unless it is legally available for all contracts included in the qualifying bilateral netting contract.

<sup>23</sup> Notwithstanding section 3(b)(5)(B) of this appendix A, gold contracts do not qualify for this exception.

<sup>40</sup> The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market

**III. \* \* \***

E. Derivative Contracts (Interest Rate, Exchange Rate, Commodity—(including precious metals) and Equity-Linked Contracts)

1. *Scope.* Credit equivalent amounts are computed for each of the following off-balance-sheet derivative contracts:

a. Interest Rate Contracts. These include single currency interest rate swaps, basis swaps, forward rate agreements, interest rate options purchased (including caps, collars, and floors purchased), and any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward deposits accepted).

b. Exchange Rate Contracts. These include cross-currency interest rate swaps, forward foreign exchange contracts, currency options purchased, and any other instrument linked to exchange rates that gives rise to similar credit risks.

c. Equity Derivative Contracts. These include equity-linked swaps, equity-linked options purchased, forward equity-linked contracts, and any other instrument linked to equities that gives rise to similar credit risks.

d. Commodity (including precious metal) Derivative Contracts. These include commodity-linked swaps, commodity-linked options purchased, forward commodity-linked contracts, and any other instrument

value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made 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.



linked to commodities that gives rise to similar credit risks.

e. Exceptions. Exchange rate contracts with an original maturity of fourteen or fewer calendar days and derivative contracts traded on exchanges that require daily receipt and payment of cash variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange rate contracts except that gold contracts with an original maturity of fourteen or fewer calendar days are included in the risk-based ratio calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

2. Calculation of credit equivalent amounts. a. The credit equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with section III.E.3. 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 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 equal to 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 underlying rates, prices, and indices, 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 use, subject to examiner review, the effective rather than the apparent or stated notional amount in this calculation. The credit conversion factors are:

CONVERSION FACTORS  
(In percent)

Remaining maturity	Interest rate	Exchange rate and gold	Equity	Commodity, excluding precious metals	Precious metals, except gold
One year or less .....	0.0	1.0	6.0	10.0	7.0
Over one to five years .....	0.5	5.0	8.0	12.0	7.0
Over five years .....	1.5	7.5	10.0	15.0	8.0

d. For a contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity is equal to the time until the next reset date. For an interest rate contract with a remaining maturity of more than one year that meets these criteria, the minimum conversion factor is 0.5 percent.

e. For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest rate, exchange rate, equity, or commodity contracts as set forth in section III.E.1. of this appendix A, is subject to the same conversion factors as a commodity, excluding precious metals.

f. No potential future exposure is calculated for a single currency interest rate swap in which payments are made based upon two floating rate indices (a so called floating/floating or basis swap); the credit exposure on such a contract is evaluated solely on the basis of the mark-to-market value.

g. The Board notes that the conversion factors set forth above, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

3. Netting. a. For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values when determining 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 derivative 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 the 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 derivative 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.<sup>49</sup>

<sup>49</sup> 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

c. A bank netting individual contracts for the purpose of calculating credit equivalent amounts of derivative contracts, 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 section III.E.3.a.ii. 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 contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract (net current exposure) and (ii) the sum of the estimates of potential future credit exposures on all individual contracts subject to the netting contract (gross potential future exposure) adjusted to reflect the effects of the netting contract.<sup>50</sup>

e. The net current exposure is the sum of 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 net current exposure is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the net current

if the defaulter or the estate of the defaulter is a net creditor under the contract.

<sup>50</sup> 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.



exposure is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts included under the netting contract may not qualify. In such instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

f. Gross potential future exposure, or  $A_{gross}$  is calculated by summing the estimates of potential future exposure (determined in accordance with section III.E.2 of this appendix A) for each individual contract subject to the qualifying bilateral netting contract.

g. The effects of the bilateral netting contract on the gross potential future exposure are recognized through the application of a formula that results in an adjusted add-on amount ( $A_{net}$ ). The formula, which employs the ratio of net current exposure to gross current exposure (NGR) is expressed as:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

h. The NGR may be calculated in accordance with either the counterparty-by-counterparty approach or the aggregate approach.

i. Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure for a netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract calculated in accordance with section III.E.2. of this appendix A. Net negative mark-to-market values for individual netting contracts with the same counterparty may not be used to offset net positive mark-to-market values for other netting contracts with that counterparty.

ii. Under the aggregate approach, the NGR is the ratio of the sum of all of the net current exposures for qualifying bilateral netting contracts to the sum of all of the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in section III.E.3.h.i. of this appendix A). Net negative mark-to-market values for individual counterparties may not be used to offset net positive mark-to-market values for other counterparties.

iii. A bank must consistently use either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR

should be applied individually to each qualifying bilateral netting contract to determine the adjusted add-on for that netting contract.

i. 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 or fewer calendar days or instruments traded on exchanges that require daily payment and receipt of cash variation margin—a bank may elect to either include or exclude all mark-to-market values of such contracts when determining net current exposure, provided the method chosen is applied consistently.

4. *Risk Weights.* Once the credit equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral.<sup>51</sup> However, the maximum risk weight applicable to the credit equivalent amount of such contracts is 50 percent.

5. *Avoidance of double counting.* a. In certain cases, credit exposures arising from the derivative contracts covered by section III.E. of this appendix A may already be reflected, in part, on the balance sheet. To avoid double counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the derivative instruments covered by these guidelines may need to be excluded from balance sheet assets in calculating a bank's risk-based capital ratios.

b. Examples of the calculation of credit equivalent amounts for contracts covered under this section III.E. are contained in Attachment V of this appendix A.

\* \* \* \* \*

4. In appendix A to part 208, Attachments IV and V are revised to read as follows:

\* \* \* \* \*

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

**100 Percent Conversion Factor**

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

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

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

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

5. Securities lent for which the bank is at risk.

**50 Percent Conversion Factor**

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

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

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

**20 Percent Conversion Factor**

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

**Zero Percent Conversion Factor**

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

**Credit Conversion for Derivative Contracts**

1. The credit equivalent amount of a derivative 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 derivative 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:

**CONVERSION FACTORS**

[In percent]

Remaining maturity	Interest rate	Exchange rate and gold	Equity	Commodity, excluding precious metals	Precious metals, except gold
One year or less .....	0.0	1.0	6.0	10.0	7.0
Over one to five years .....	0.5	5.0	8.0	12.0	7.0
Over five years .....	1.5	7.5	10.0	15.0	8.0

<sup>51</sup> For derivative contracts, sufficiency of collateral or guarantees is generally 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.



For contracts subject to a qualifying bilateral netting contract, the potential future exposure is, generally, the sum of the individual potential future exposures for each contract included under the netting contract adjusted by the application of the following formula:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

NGR is the ratio of net current exposure to gross current exposure.

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 fewer are excluded. Instruments traded on exchanges that require daily receipt and payment of cash variation margin are also excluded.

ATTACHMENT V—CALCULATING CREDIT EQUIVALENT AMOUNTS FOR DERIVATIVE CONTRACTS

Type of contract	Notional principal amount	Conversion factor	Potential exposure (dollars)	Mark-to-market	Current exposure (dollars)	Credit equivalent amount
(1) 120-day forward foreign exchange .....	5,000,000	0.01	50,000	100,000	100,000	150,000
(2) 4-year forward foreign exchange .....	6,000,000	0.05	300,000	-120,000	0	300,000
(3) 3-year single-currency fixed & floating interest rate swap .....	10,000,000	0.005	50,000	200,000	200,000	250,000
(4) 6-month oil swap .....	10,000,000	0.10	1,000,000	-250,000	0	1,000,000
(5) 7-year cross-currency floating & floating interest rate swap .....	20,000,000	0.075	1,500,000	-1,500,000	0	1,500,000
Total .....			2,900,000	+	300,000	3,200,000

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

Contract	Potential future exposure	Net current exposure	Credit equivalent amount
(1) .....	50,000	.....	.....
(2) .....	300,000	.....	.....
(3) .....	50,000	.....	.....
(4) .....	1,000,000	.....	.....
(5) .....	1,500,000	.....	.....
Total .....	2,900,000	+0	2,900,000

NOTE: The total of the mark-to-market values from the first table is -\$1,370,000. Since this is a negative amount, the net current exposure is zero.

b. To recognize the effects of bilateral netting on potential future exposure the following formula applies:

$$A_{net} = (.4 \times A_{gross}) + .6(NGR \times A_{gross})$$

c. In the above example where the net current exposure is zero, the credit equivalent amount would be calculated as follows:

$$NGR = 0 = (0 / 300,000)$$

$$A_{net} = (0.4 \times \$2,900,000) + 0.6 (0 \times \$2,900,000)$$

$$A_{net} = \$1,160,000$$

The credit equivalent amount is \$1,160,000 + 0 = \$1,160,000.

d. If the net current exposure was a positive number, for example \$200,000, the credit equivalent amount would be calculated as follows:

$$NGR = .67 = (\$200,000 / \$300,000)$$

$$A_{net} = (0.4 \times \$2,900,000) + 0.6 (.67 \times \$2,900,000)$$

$$A_{net} = \$2,325,800$$

The credit equivalent amount would be \$2,325,800 + \$200,000 = \$2,525,800.

**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, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. In part 225, appendix A is amended by revising the last paragraph of section III.C.3. and footnote 43 in the introductory text of section III.D. to read as follows:

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

III. \* \* \*  
C. \* \* \*  
3. \* \* \*

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

\* \* \* \* \*

D. \* \* \* \* \*

\* \* \* \* \*

3. In part 225, appendix A is amended by revising the section III.E. heading and section III.E. to read as follows:

\* \* \* \* \*

III. \* \* \*

*E. Derivative Contracts (Interest Rate, Exchange Rate, Commodity- (including*

<sup>43</sup> The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made 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.



*precious metals) and Equity-Linked Contracts)*

1. *Scope.* Credit equivalent amounts are computed for each of the following off-balance-sheet derivative contracts:

a. *Interest Rate Contracts.* These include single currency interest rate swaps, basis swaps, forward rate agreements, interest rate options purchased (including caps, collars, and floors purchased), and any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward deposits accepted).

b. *Exchange Rate Contracts.* These include cross-currency interest rate swaps, forward foreign exchange contracts, currency options purchased, and any other instrument linked to exchange rates that gives rise to similar credit risks.

c. *Equity Derivative Contracts.* These include equity-linked swaps, equity-linked options purchased, forward equity-linked contracts, and any other instrument linked to equities that gives rise to similar credit risks.

d. *Commodity (including precious metal) Derivative Contracts.* These include commodity-linked swaps, commodity-linked options purchased, forward commodity-linked contracts, and any other instrument linked to commodities that gives rise to similar credit risks.

e. *Exceptions.* Exchange rate contracts with an original maturity of fourteen or fewer calendar days and derivative contracts traded on exchanges that require daily receipt and payment of cash variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange rate contracts except that gold contracts with an original maturity of fourteen or fewer calendar days are included in the risk-based ratio calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

2. *Calculation of credit equivalent amounts.* a. The credit equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with section III.E.3. 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 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 equal to 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 underlying rates, prices, and indices, 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. Banking organizations should use, subject to examiner review, the effective rather than the apparent or stated notional amount in this calculation. The credit conversion factors are:

**Conversion Factors**  
(In percent)

Remaining maturity	Interest rate	Exchange rate and gold	Equity	Commodity, excluding precious metals	Precious metals, except gold
One year or less .....	0.0	1.0	6.0	10.0	7.0
Over one to five years .....	0.5	5.0	8.0	12.0	7.0
Over five years .....	1.5	7.5	10.0	15.0	8.0

d. For a contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity is equal to the time until the next reset date. For an interest rate contract with a remaining maturity of more than one year that meets these criteria, the minimum conversion factor is 0.5 percent.

e. For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest rate, exchange rate, equity, or commodity contracts as set forth in section III.E.1. of this appendix A is subject to the same conversion factors as a commodity, excluding precious metals.

f. No potential future exposure is calculated for a single currency interest rate swap in which payments are made based upon two floating rate indices (a so called floating/floating or basis swap); the credit exposure on such a contract is evaluated solely on the basis of the mark-to-market value.

g. The Board notes that the conversion factors set forth above, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

3. *Netting.* a. For purposes of this appendix A, netting refers to the offsetting of positive

and negative mark-to-market values when determining 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 derivative 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 banking organization 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 banking organization 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 banking organization's exposure to be the 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 derivative 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.<sup>53</sup>

c. A banking organization netting individual contracts for the purpose of calculating credit equivalent amounts of derivative contracts represents that it has met the requirements of this appendix A and all the appropriate documents are in the banking organization's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a

<sup>53</sup> 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.



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 section III.E.3.a.ii. 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 contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract (net current exposure) and (ii) the sum of the estimates of potential future credit exposures on all individual contracts subject to the netting contract (gross potential future exposure) adjusted to reflect the effects of the netting contract.<sup>54</sup>

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

f. Gross potential future exposure, or  $A_{gross}$  is calculated by summing the estimates of potential future exposure (determined in accordance with section III.E.2 of this appendix A) for each individual contract subject to the qualifying bilateral netting contract.

g. The effects of the bilateral netting contract on the gross potential future exposure are recognized through the application of a formula that results in an adjusted add-on amount ( $A_{net}$ ). The formula, which employs the ratio of net current exposure to gross current exposure (NGR), is expressed as:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

h. The NGR may be calculated in accordance with either the counterparty-by-counterparty approach or the aggregate approach.

i. Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure for a netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract calculated in accordance with section III.E.2. of this appendix A. Net negative mark-to-market values for

individual netting contracts with the same counterparty may not be used to offset net positive mark-to-market values for other netting contracts with the same counterparty.

ii. Under the aggregate approach, the NGR is the ratio of the sum of all of the net current exposures for qualifying bilateral netting contracts to the sum of all of the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in section III.E.3.h.i. of this appendix A). Net negative mark-to-market values for individual counterparties may not be used to offset net positive current exposures for other counterparties.

iii. A banking organization must use consistently either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR should be applied individually to each qualifying bilateral netting contract to determine the adjusted add-on for that netting contract.

i. 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 or fewer calendar days or instruments traded on exchanges that require daily payment and receipt of cash variation margin—an institution may elect to either include or exclude all mark-to-market values of such contracts when determining net current exposure, provided the method chosen is applied consistently.

4. *Risk Weights.* Once the credit equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral.<sup>55</sup> However, the maximum risk weight applicable to the credit equivalent amount of such contracts is 50 percent.

5. *Avoidance of double counting.* a. In certain cases, credit exposures arising from the derivative contracts covered by section III.E. of this appendix A may already be reflected, in part, on the balance sheet. To avoid double counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the derivative instruments covered by these guidelines may need to be excluded from balance sheet assets in calculating a banking organization's risk-based capital ratios.

b. Examples of the calculation of credit equivalent amounts for contracts covered under this section III.E. are contained in Attachment V of this appendix A.

\* \* \* \* \*

4. In appendix A to part 225, Attachments IV and V are revised to read as follows:

\* \* \* \* \*

receipts falling due on each value date in each currency.

<sup>55</sup> For derivative contracts, sufficiency of collateral or guarantees is generally determined by

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

##### 100 Percent Conversion Factor

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

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

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

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

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

##### 50 Percent Conversion Factor

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

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

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

##### 20 Percent Conversion Factor

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

##### Zero Percent Conversion Factor

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

##### Credit Conversion for Derivative Contracts

1. The credit equivalent amount of a derivative 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 derivative 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:

<sup>54</sup> 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

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.



CONVERSION FACTORS  
[In percent]

Remaining maturity	Interest rate	Exchange rate and gold	Equity	Commodity, excluding precious metals	Precious metals, except gold
One year or less .....	0.0	1.0	6.0	10.0	7.0
Over one to five years .....	0.5	5.0	8.0	12.0	7.0
Over five years .....	1.5	7.5	10.0	15.0	8.0

For contracts subject to a qualifying bilateral netting contract, the potential future exposure is, generally, the sum of the individual potential future exposures for each contract included under the netting contract adjusted by the application of the following formula:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

NGR is the ratio of net current exposure to gross current exposure.

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 or fewer days are excluded. Instruments traded on exchanges that require daily receipt and payment of cash variation margin are also excluded.

ATTACHMENT V—CALCULATING CREDIT EQUIVALENT AMOUNTS FOR DERIVATIVE CONTRACTS

Type of Contract	Notional principal amount	Conversion factor	Potential exposure (dollars)	Mark-to-market	Current exposure (dollars)	Credit equivalent amount
(1) 120-day forward foreign exchange .....	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 4-year forward foreign exchange .....	6,000,000	.05	300,000	- 120,000	0	300,000
(3) 3-year single-currency fixed & floating interest rate swap .....	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 6-month oil swap .....	10,000,000	.10	1,000,000	- 250,000	0	1,000,000
(5) 7-year cross-currency floating & floating interest rate swap .....	20,000,000	.075	1,500,000	- 1,500,000	0	1,500,000
Total .....			2,900,000	+	300,000	3,200,000

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

Contract	Potential future exposure	Net current exposure	Credit equivalent amount
(1) .....	50,000	.....	.....
(2) .....	300,000	.....	.....
(3) .....	50,000	.....	.....
(4) .....	1,000,000	.....	.....
(5) .....	1,500,000	.....	.....
Total .....	2,900,000	+0	2,900,000

Note: The total of the mark-to-market values from the first table is -\$1,370,000. Since this is a negative amount the net current exposure is zero.

b. To recognize the effects of bilateral netting on potential future exposure the following formula applies:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

c. In the above example, where the net current exposure is zero, the credit equivalent amount would be calculated as follows:

$$NGR = 0 = (0 / 300,000)$$

$$A_{net} = (0.4 \times \$2,900,000) + 0.6(0 \times \$2,900,000)$$

$$A_{net} = \$1,160,000$$

The credit equivalent amount is \$1,160,000 + 0 = \$1,160,000.

d. If the net current exposure was a positive number, for example \$200,000, the credit equivalent would be calculated as follows:

$$NGR = .67 = (\$200,000 / \$300,000)$$

$$A_{net} = (0.4 \times \$2,900,000) + 0.6(.67 \times \$2,900,000)$$

$$A_{net} = \$2,325,800$$

The credit equivalent amount would be \$2,325,800 + \$200,000 = \$2,525,800.

\* \* \* \* \*

By order of the Board of Governors of the Federal Reserve System, August 25, 1995.

Jennifer J. Johnson,  
Deputy Secretary of the Board.



FRASER  
Federal Reserve Bank of St. Louis

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Thursday  
August 31, 1995

CAPITAL ADEQUACY GUIDELINES

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Amendments  
Effective September 1, 1995

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Part IV  
Federal Reserve System

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12 CFR Parts 208 and 225  
Capital; Capital Adequacy Guidelines;  
Final Rule

[Enc. Cir. No. 10803]

CAG 117/95



**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:** Final rule.

**SUMMARY:** The Board of Governors of the Federal Reserve System (Board) is amending its risk-based and leverage capital adequacy guidelines for state member banks and bank holding companies (collectively, banking organizations) to implement section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Riegle Act). Section 208 states that a qualifying insured depository institution that transfers small business loans and leases on personal property with recourse shall include only the amount of retained recourse in its risk-weighted assets when calculating its capital ratios, provided that certain conditions are met. This rule will have the effect of lowering the capital requirements for small business loans and leases on personal property that have been transferred with recourse by qualifying banking organizations.

**EFFECTIVE DATE:** September 1, 1995.

**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, Senior Financial Analyst (202/452-5218), 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, N.W., Washington, D.C. 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.<sup>1</sup> 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. Specifically, the Riegle Act states that a qualifying insured depository institution that transfers small business loans and leases on personal property (small business obligations) with recourse need include only the amount of retained recourse in its risk-weighted assets when calculating its capital ratios, rather than the full amount of the transferred small business loans with recourse generally required, 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 in an amount 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 of the Federal Deposit Insurance Act).

The Riegle Act 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

<sup>1</sup> 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).

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 that section 208 sets forth for small business obligations. The Riegle Act also defines a small business as one that meets the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act.<sup>2</sup>

To meet the statutory requirements of section 208 of the Riegle Act, the Board issued a proposed rule amending its risk-based and leverage capital guidelines for state member banks (60 FR 6042, February 1, 1995). Although section 208 pertains only to insured depository institutions, the Board also proposed amending its risk-based capital guidelines for bank holding companies in order to maintain consistency among banking organizations in the calculation of regulatory capital ratios.<sup>3</sup>

The proposal noted that in view of the requirement that the preferential capital treatment set forth in section 208 be disregarded for prompt corrective action purposes, the Board expected that it also would disregard the preferential capital treatment for purposes of determining limitations on an institution's ability to borrow from the discount window and that it would consider disregarding this treatment for purposes of determining a correspondent's capital level under the limitations of the Board's Regulation F (limitations on interbank liabilities). The regulations governing these matters are based in part on regulations implementing the prompt corrective action statute. The comment period on the Board's proposal ended on February 27, 1995.

**Comments Received**

In response to its proposal, the Board received letters from four public commenters consisting of three banking organizations and one banking trade association. All four organizations

<sup>2</sup> See 15 U.S.C. 631 et seq. The Small Business Administration has implemented 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.

<sup>3</sup> The Board did not propose amending its 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.



supported the Board's proposal to lower the capital requirements for both state member banks and bank holding companies on recourse transactions associated with transfers of small business loans and leases. Three respondents favored extending the preferential capital treatment to other types of assets. Two commenters argued that not applying the preferential capital treatment for purposes of determining an institution's prompt corrective action category, its ability to borrow from the discount window, or limitations on interbank liabilities would diminish the benefits of the proposed capital treatment.

Three respondents noted that under the proposal, capital would be required to be maintained for the entire amount of recourse retained while further requiring that a liability reserve be established for expected future losses associated with the recourse arrangements. These commenters stated that this requirement would result in a partial duplication of capital charges and, accordingly, argued that the retained recourse liability should be reduced by the amount of the reserve before calculating capital requirements.

#### Final Rule

After consideration of the comments received and further deliberation on the issues involved, the Board is implementing section 208 of the Riegle Act by adopting a final rule amending the risk-based and leverage capital guidelines for state member banks. In general, the final rule reduces the amount of capital that banking organizations are required to hold against small business obligations transferred with recourse. The final rule provides that qualifying institutions that transfer small business obligations with recourse are required, for risk-based capital purposes, to maintain capital only against the amount of recourse retained and, for leverage ratio purposes, are not required to maintain any capital at all against such obligations transferred with recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the transferring institutions must establish, pursuant to GAAP, a non-capital reserve sufficient to meet the reasonably estimated liability under their recourse arrangements.

As proposed, to maintain consistency in regulatory capital calculations among the banking organizations, the Board is also issuing a parallel final amendment to its risk-based capital guidelines for bank holding companies. The Board notes that the final rule, consistent with

section 208 and its proposal, applies only to transfers of obligations of small businesses that meet the criteria for a small business as established by the Small Business Administration. The Board also notes that the capital treatment specified in section 208 and in this final rule for transfers of small business obligations with recourse takes precedence over the capital requirements recently implemented for transactions involving low levels of recourse.

In setting forth this final rule, the Board has considered the arguments made by commenters for reducing the amount of retained recourse against which capital would be assessed by the amount of the recourse liability reserve that is established pursuant to GAAP. Section 208, however, requires qualifying institutions selling small business obligations with recourse to establish and maintain a reserve equal to the amount of its reasonable estimated liability under the recourse arrangement *and* maintain capital against the amount of retained recourse. The Board notes that the reserve required under GAAP for the reasonable estimated liability on assets transferred with recourse is established to cover expected losses while regulatory capital is maintained to absorb unexpected losses beyond those that were estimated and expected. Thus, the Board believes that it is appropriate to assess risk-based capital against the full amount of recourse, as well as require the establishment of a liability reserve pursuant to GAAP.

However, the final rule does not, as proposed, amend the leverage capital guidelines for state member banks to require that the off-balance sheet amount of retained recourse on small business loans sold with recourse be included in the calculation of the leverage ratio. The Board has concluded that the leverage ratio should continue to be based primarily on the amount of average total on-balance-sheet assets as reported in the Call Report.

The Board's final rule extends the preferential capital treatment for transfers of small business obligations with recourse only to qualifying institutions. A state member bank will 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.<sup>4</sup> Although bank

<sup>4</sup>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

holding companies are not subject to the prompt corrective action regulation, they will be considered qualifying under the Board's final rule 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 order to qualify, an institution must be determined to be well capitalized or adequately capitalized without taking into account the preferential capital treatment the rule provides for any previous transfers of small business obligations with recourse.

Under the final rule, the total outstanding amount of recourse retained by a qualifying banking organization on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the institution's total risk-based capital.<sup>5</sup> 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 exceeds the established limit, it will not be able to apply the preferential capital treatment to any transfers of small business obligations with recourse that occur while the institution is not qualified or above the capital limit. However, those transfers of small business obligations with recourse that were completed while the banking organization was qualified and before it exceeded the established limit of 15 percent of total risk-based capital will continue to receive the preferential capital treatment even when the institution is no longer qualified or the amount of retained recourse on such transfers subsequently exceeds the capital limitation.

Section 208(f) provides that the capital of an insured depository institution shall be computed without regard to section 208 when determining

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.

<sup>5</sup>Thus, a transfer of small business obligations with recourse that results in a qualifying banking organization retaining recourse in an amount greater than 15 percent of its total risk-based capital would not be eligible for the preferential capital treatment, even though the organization's amount of retained recourse before the transfer was less than 15 percent of capital.



whether an institution is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized for purposes of prompt corrective action under the Board's prompt corrective action regulation (12 CFR 208.33(b)).

The caption to section 208(f) of the Riegle Act, "Prompt Corrective Action Not Affected," and the legislative history indicate section 208 was not intended to affect the operation of the prompt corrective action system. See S. Rep. No. 103-169, 103d Cong., 1st Sess. 38, 69 (1993). However, the statute does not include "well capitalized" in the list of capital categories not affected. The prompt corrective action system deals primarily with imposing corrective sanctions on institutions that are less than adequately capitalized. Therefore, allowing a bank that is adequately capitalized without regard to section 208 to use the section's capital provisions for purposes of determining whether the bank is well capitalized generally would not affect the application of the prompt corrective action sanctions to the bank.<sup>6</sup> Other statutes and regulations treat a bank more favorably if it is well capitalized as defined under the prompt corrective action statute, but these provisions are not part of the prompt corrective action system of sanctions. Permitting an institution to be treated as well capitalized for purposes of these other provisions also will not affect the imposition of prompt corrective action sanctions.

There is one provision of the prompt corrective action system that could be affected by treating an institution as well capitalized rather than adequately capitalized. In this regard, if the institution's condition is unsafe and unsound or it is engaging in an unsafe or unsound practice, section 208.33(c) of the Board's prompt corrective action regulation (12 CFR 208.33(c)) authorizes the Board to reclassify a well capitalized institution as adequately capitalized and require an adequately capitalized institution to comply with certain prompt corrective action provisions as if

<sup>6</sup> It is very unlikely but theoretically possible for a banking organization that is undercapitalized without using the preferential capital treatment in section 208 to become well capitalized if the provisions of section 208 are applied. Since, in the Board's view, section 208 was not intended to affect prompt corrective action sanctions, allowing an undercapitalized institution (without taking into account section 208) to be treated as well capitalized (taking into consideration section 208) would be an inappropriate application of the preferential capital treatment permitted under section 208. Thus, undercapitalized banking organizations will not be able to use the capital provisions of section 208 for purposes of improving their prompt corrective action capital category.

that institution were undercapitalized. Because the text and legislative history of section 208 of the Riegle Act clearly indicate that Congress did not intend to affect prompt corrective action sanctions, the Board believes that the provisions of section 208 do not affect the capital calculation for purposes of reclassifying a bank from one capital category to a lower capital category, regardless of the bank's capital level.

Thus, an institution may use the capital treatment described in section 208 of the Riegle Act when determining whether it is well capitalized for purposes of prompt corrective action as well as for other regulations that reference the well capitalized capital category.<sup>7</sup> An institution may not use the capital treatment described in section 208 when determining whether it is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized for purposes of prompt corrective action or other regulations that directly or indirectly reference the prompt corrective action capital categories.<sup>8</sup> Furthermore, the capital ratios of an institution are to be determined without regard to the preferential capital treatment described in section 208 of the Riegle Act for purposes of being reclassified from one capital category to a lower category as described in the Board's prompt corrective action regulation (12 CFR 208.33(c)).

Section 208(g) of the Riegle Act required that final regulations implementing the provisions of section 208 be promulgated not later than 180 days after the date of the statute's enactment, i.e., by March 22, 1995. In order to meet the spirit of the statute, the preferential capital treatment may be applied by qualifying banking organizations for those transfers of small business obligations with recourse that occurred on or after March 22, 1995, provided certain conditions are met.

<sup>7</sup> A institution that is subject to a written agreement or capital directive as discussed in the Board's prompt corrective action regulation would not be considered well capitalized. Also, undercapitalized banking organizations will not be able to use the capital provisions of section 208 for purposes of improving their prompt corrective action capital category. (See footnote 6.)

<sup>8</sup> Under the provisions of section 208, the capital calculation used to determine whether an institution is well capitalized differs from the calculation used to determine whether an institution is adequately capitalized. As a result, it is possible that an institution could be well capitalized using one calculation (i.e., one that considers the preferential capital treatment) and adequately capitalized using the other (i.e., one that is calculated without regard to the preferential capital treatment). In this situation, the institution would be considered well capitalized.

The Board also notes that Section 208(a) of the Riegle Act provides that the accounting principles applicable to the transfer of small business obligations with recourse contained in reports or statements required to be filed with the federal banking agencies by a qualified insured depository institution shall be consistent with GAAP.<sup>9</sup> The Board, in consultation with the other agencies and under the auspices of the Federal Financial Institutions Examinations Council, intends to ensure that appropriate revisions are made to the Consolidated Reports of Condition and Income (Call Reports) and the Call Report instructions to implement the accounting provisions of section 208.

#### Regulatory Flexibility Act

This rule reduces the capital requirements 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 will 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 rule will not affect such companies.

#### Paperwork Reduction Act and Regulatory Burden

The Board has determined that this 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) requires that new regulations take effect on the first day of the calendar quarter following publication of the rule, unless the agency determines, for good cause, that the regulation should become effective on a day other than the first day of the next quarter. October 1, 1995 would be

<sup>9</sup> Transfers of small business obligations with recourse that are consummated at a time when the transferring banking organization does not qualify for the preferential capital treatment or that result in the organization exceeding the 15 percent capital limitation will continue to be reported in accordance with the instructions of the Consolidated Reports of Condition and Income (Call Reports) for sales of assets with recourse. The Call Report instructions generally require banks transferring assets with recourse to continue to report the assets on their balance sheets.



the first day of the calendar quarter following publication of the rule that would also satisfy the requirements of the Administrative Procedures Act (5 U.S.C. 553(d)). The Board has decided that the final rule should be effective immediately since the rule relieves a regulatory burden on banking organizations that transfer small business obligations with recourse by significantly reducing the capital requirements on such obligations. This immediate effective date will permit banks to treat transfers of small business obligations as sales and to reduce the capital requirement for any such sales. Also, there is a statutory requirement for the banking agencies to promulgate final regulations implementing the provisions of section 208 by March 22, 1995. For these same reasons, in accordance with 5 U.S.C. 553(d) (1) and (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 final rule effective immediately.

List of Subjects

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Flood insurance, 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-l, 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; 42 U.S.C. 4012a, 4104a, 4104b.

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

\* \* \* \* \*

III. \* \* \*

CAG 121/95

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 (small business obligations) with recourse shall include in weighted-risk assets only the amount of retained recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the bank must establish pursuant to GAAP 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, a bank is qualifying if it meets the criteria set forth in the Board's prompt corrective action regulation (12 CFR 208.30) for well capitalized or, by order of the Board, adequately capitalized. For purposes of determining whether a bank meets the criteria, its capital ratios must be calculated without regard to the preferential 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 a qualifying bank on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the bank's total risk-based capital. By order, the Board may approve a higher limit.

c. If a bank ceases to be qualifying or exceeds the 15 percent capital limitation, the preferential capital treatment will continue to apply to any transfers of small business obligations with recourse that were consummated during the time that the bank was qualifying and did not exceed the capital limit.

d. The risk-based capital ratios of the bank shall be calculated without regard to the preferential capital treatment for transfers of small business obligations with recourse specified in section III.B.5.a. of this appendix A for purposes of:

(i) Determining whether a bank is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under prompt corrective action (12 CFR 208.33(b)); and

(ii) Reclassifying a well capitalized bank to adequately capitalized and requiring an adequately capitalized bank to comply with certain mandatory or discretionary supervisory actions as if the bank were in the next lower prompt corrective action capital category (12 CFR 208.33(c)).

\* / \* \* \* \*

3. In part 208, appendix B, section II. is amended by redesignating paragraph c. as paragraph g. and adding new paragraphs c., d., e., and f to read as follows:

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

\* \* \* \* \*

II. \* \* \*

c. Notwithstanding other provisions of this appendix B, a qualifying bank that has transferred small business loans and leases on personal property (small business obligations) with recourse shall, for purposes of calculating its tier 1 leverage ratio, exclude from its average total consolidated assets the outstanding principal amount of the small business loans and leases transferred with recourse, provided two conditions are met. First, the transaction must be treated as a sale under generally accepted accounting principles (GAAP) and, second, the bank must establish pursuant to GAAP 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, a bank is qualifying if it meets the criteria set forth in the Board's prompt corrective action regulation (12 CFR 208.30) for well capitalized or, by order of the Board, adequately capitalized. For purposes of determining whether a bank meets these criteria, its capital ratios must be calculated without regard to the preferential 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 a qualifying bank on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the bank's total risk-based capital. By order, the Board may approve a higher limit.

e. If a bank ceases to be qualifying or exceeds the 15 percent capital limitation, the preferential capital treatment will continue to apply to any transfers of small business obligations with recourse that were consummated during the time that the bank was qualifying and did not exceed the capital limit.

f. The leverage capital ratio of the bank shall be calculated without regard to the preferential capital treatment for transfers of small business obligations with recourse specified in section II of this appendix B for purposes of:

(i) Determining whether a bank is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under prompt corrective action (12 CFR 208.33(b)); and

(ii) Reclassifying a well capitalized bank to adequately capitalized and requiring an adequately capitalized bank to comply with certain mandatory or discretionary supervisory actions as if the bank were in the next lower prompt corrective action capital category (12 CFR 208.33(c)).

\* \* \* \* \*



**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, 1828o, 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: Risk-Based Measure**

\* \* \* \* \*

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 (small business obligations) with recourse shall include in weighted-risk assets only the amount of retained recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the banking organization must establish pursuant to GAAP 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, a banking organization is qualifying if it meets the criteria for well capitalized or, by order of the Board, adequately capitalized, as those criteria are set forth in the Board's prompt corrective action regulation for state member banks (12 CFR 208.30). For purposes of determining whether an organization meets these criteria, 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 a qualifying banking organization on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the organization's total risk-based capital. By order, the Board may approve a higher limit.

c. If a bank holding company ceases to be qualifying or exceeds the 15 percent capital limitation, the preferential capital treatment will continue to apply to any transfers of small business obligations with recourse that were consummated during the time that the organization was qualifying and did not exceed the capital limit.

\* \* \* \* \*

By order of the Board of Governors of the Federal Reserve System, August 25, 1995.

**Jennifer J. Johnson,**  
*Deputy Secretary of the Board.*

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