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Office of Thrift Supervision **September 1, 1998**
Department of the Treasury

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Transmittal

TR–205

Federal Register, Vol.63, No.169, pp. 46517- 46524 **Number: TR–205**

The attached rule amends the Federal financial regulatory agencies' regulatory capital treatment of unrealized gains on certain equity securities. Under the rule, institutions would be permitted to include in supplementary (Tier 2) capital up to 45 percent of the pretax net unrealized gains on certain available-for-sale securities.

The rule was published in the September 1, 1998, edition of the Federal Register, Vol. 63, No. 169, pp. 46517-46524.

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— Ellen Seidman
Director
Office of Thrift Supervision

Attachment

federal register

Tuesday
September 1, 1998

Part III

Department of the Treasury

Office of the Comptroller of the Currency

12 CFR Part 3

Federal Reserve System

12 CFR Parts 208 and 225

Federal Deposit Insurance Corporation

12 CFR Part 325

Department of the Treasury

Office of Thrift Supervision

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12 CFR Part 567

Risk-Based Capital Standards: Unrealized Holding Gains on Certain Equity Securities; Final Rule

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 98–12]

RIN 1557–AB14

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–0982]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AC11

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[Docket No. 98–75]

RIN 1550–AB11

Risk-Based Capital Standards: Unrealized Holding Gains on Certain Equity Securities

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

ACTION: Final rule.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the Agencies) are amending their respective risk-based capital standards for banks, bank holding companies, and thrifts (institutions) with regard to the regulatory capital treatment of unrealized holding gains on certain equity securities. These gains are reported as a component of equity capital under U.S. generally accepted accounting principles (GAAP), but have not been included in regulatory capital under the Agencies' capital standards. This final rule permits institutions to include in supplementary (Tier 2) capital up to 45 percent of the pretax net unrealized holding gains on certain available-for-sale (AFS) equity securities. The final rule is intended to make the regulatory capital treatment of these unrealized gains consistent with the international standards of the Basle Accord.

DATES: This final rule is effective October 1, 1998. The Agencies will not object if an institution wishes to apply the provisions of this final rule beginning on September 1, 1998.

FOR FURTHER INFORMATION CONTACT: *OCC:* Roger Tufts, Senior Economic Advisor (202/874–5070), Amrit Sekhon, Examiner (202/874–5070), Capital Policy Division; or Ronald Shimabukuro, Senior Attorney (202/874–5090), Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

Board: Norah Barger, Assistant Director (202/452–2402), Barbara Bouchard, Manager (202/452–3072), John F. Connolly, Supervisory Financial Analyst (202/452–3621), Division of Banking Supervision and Regulation; or Mark E. Van Der Weide, Staff Attorney (202/452–2263), Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452–3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551.

FDIC: For supervisory issues, Stephen G. Pfeifer, Examination Specialist (202/898–8904) or Carol L. Liquori, Examination Specialist (202/898–7289), Accounting Section, Division of Supervision; for legal issues, Jamey Basham, Counsel, Legal Division (202/898–7265), Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.

OTS: Michael D. Solomon, Senior Program Manager for Capital Policy (202/906–5654), Supervision Policy; or Vern McKinley, Senior Attorney (202/906–6241), Regulations and Legislation Division, Office of the Chief Counsel, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

Background

The Agencies' risk-based capital standards implementing the International Convergence of Capital Measurement and Capital Standards (the Basle Accord) [1] include definitions for core (Tier 1) capital and supplementary (Tier 2) capital.[2] Under the Agencies' capital standards, Tier 1 capital generally includes common stockholders' equity, noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.[3] The common stockholders' equity component is defined to include common stock; related surplus; and retained earnings (including capital reserves and adjustments for the cumulative effect of foreign currency translation); less net unrealized holding losses on AFS equity securities with readily determinable fair values. Net unrealized holding gains on such equity securities and net unrealized holding gains and losses on AFS debt securities are not included in the Agencies' regulatory capital definition of common stockholders' equity.[4] Tier 2 capital includes, subject to certain limitations and conditions, the allowance for loan and lease losses; cumulative perpetual preferred stock and related surplus; and certain other maturing or redeemable capital instruments.

The Basle Accord also permits institutions to include up to 45 percent of the pretax net unrealized gains on equity securities in supplementary capital. As explained in the Basle Accord, the 55 percent discount is applied to the unrealized gains to reflect the potential volatility of this form of unrealized capital, as well as the tax liability charges that generally would be incurred if the unrealized gain were realized or otherwise taxed currently. When the Agencies implemented the Basle Accord by issuing their respective risk-based capital standards in 1989, they decided not to include unrealized gains on AFS equity securities in Tier 2 capital.

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

[2] Each Agency's risk-based capital standards contain more detailed descriptions of core and supplementary capital. *See* 12 CFR Part 3, Appendix A, for national banks; 12 CFR Part 208, Appendix A, for state member banks; 12 CFR Part 225, Appendix A, for bank holding

[3] Bank holding companies may also include limited amounts of cumulative perpetual preferred stock in Tier 1 capital.

[4] For regulatory reporting purposes, institutions record net unrealized gains and losses on AFS securities (debt and equity) in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, ''Accounting for Certain Investments in Debt and Equity Securities.'' AFS securities are all debt securities not held for trading that an institution does not have the positive intent and ability to hold to maturity and equity securities with readily determinable fair values not held for trading. AFS securities must be reported at fair value with unrealized holding gains or losses (i.e., the amount by which fair value exceeds or falls below cost) reported, net of tax, directly in a separate component of common stockholders' equity.

Proposed Rule

The Agencies believe that it is appropriate to continue the existing regulatory capital treatment of net unrealized holding gains and losses on AFS debt securities and net unrealized holding losses on AFS equity securities. However, for institutions that have net unrealized holding gains on AFS equity securities, the Agencies decided to consider whether to include at least a portion of the unrealized gains on such securities in regulatory capital. Accordingly, on October 27, 1997, the Agencies published a joint proposal to amend their respective risk-based capital standards for institutions (62 FR 55682).

Specifically, the Agencies proposed, consistent with the Basle Accord, to permit institutions that legally hold equity securities to include up to 45 percent of the pretax net unrealized holding gains (that is, the excess amount, if any, of fair value over historical cost) on AFS equity securities in Tier 2 capital. The proposed rule required that equity securities be valued in accordance with GAAP and have readily determinable fair values,[5] and institutions should be able to substantiate those values. In the event that an Agency determines that an institution's AFS equity securities are not prudently valued in accordance with GAAP, the institution may be precluded from including all or a portion of the 45 percent of pretax net unrealized holding gains on those securities in Tier 2 capital.

Comments Received

The Agencies received eleven comments on the proposal, six from financial institutions and five from banking trade associations. Seven commenters expressed support for the proposal; the remaining four respondents were opposed.

Respondents supporting the proposal included three institutions and four trade associations. These commenters generally believe that convergence with the Basle Accord will result in greater uniformity with foreign capital standards, and will mitigate a source of competitive inequality arising from continuing differences in supervisory capital requirements across countries. Three commenters representing trade associations further emphasized that the proposed rule would treat net unrealized holding gains on AFS equity securities more consistently with the current treatment of net unrealized holding losses since the latter are already deducted from Tier 1 capital. Another commenter observed that including net unrealized holding gains in Tier 2 capital is more comparable to the GAAP treatment of such gains as a component of equity capital.

Opponents of the proposal, three financial institutions and one banking trade association, expressed varying concerns. The financial institution representatives generally stated that the proposed rule would place an additional burden on small community banks. The remaining opponent of the proposed rule expressed opposition to the fair value treatment of debt and equity securities for regulatory capital calculations (an opinion expressed by two other trade associations, despite their support for the proposal). This commenter noted that market fluctuations could have a significant impact on capital levels if the unrealized equity gains are included and the proposed discount may be insufficient to absorb the potential volatility in the value of these assets. This commenter also disagreed with the timing of the proposal, indicating that the currently strong market could create equity holding gains that may not be sustained if the economy weakens. In such an event, the commenter was concerned that institutions unduly relying on unrealized holding gains in their portfolios may find their capital levels falling below regulatory minimums due to an adverse change in market conditions.

Several commenters made suggestions for improvements or requests for clarification. Two supporters of the proposal recommended that the Agencies further amend the risk-based capital guidelines to eliminate the Tier 1 capital deduction for net unrealized losses on AFS equity securities in favor of a deduction from Tier 2 capital, thereby providing parallel treatment of both unrealized gains and losses on AFS equity securities. Others, claiming that AFS debt securities are as liquid and marketable as AFS equity holdings, recommended that the Agencies work with the Basle Committee to allow unrealized holding gains on debt securities to be treated as supplementary capital.

Two commenters, each with a different overall opinion of the proposed rule, questioned the proposed 55 percent discount applied to the amount permitted to be recognized for regulatory capital purposes. One stated that the discount was excessive and suggested the Agencies consider eliminating or reducing the discount. While generally in favor of the proposal, this commenter noted that a comparable discount was not required by GAAP and pointed out that unrealized losses were not similarly discounted. The other commenter believed unrealized equity gains should either be fully recognized in capital or be entirely disallowed. Since the commenter expected a discount to be included in the final rule, the commenter voiced overall opposition to the proposal.

The Agencies were also asked to clarify that the proposal applies to equity securities held in subsidiaries of financial institutions. Finally, two commenters supported a reexamination of the whole risk-based capital framework, contending that the framework is too complex for small, traditional institutions and the current risk weight categories are too broad.

Response to Comments

After carefully considering the comments received, the Agencies are adopting the final rule substantially as proposed. The Agencies agree that adopting this rule will result in more consistency with the capital standards applied to financial institutions in other countries that have adopted the treatment permitted in the Basle Accord. Although limited to a supplementary capital item, recognizing unrealized gains on AFS equity securities in Tier 2 capital is more consistent with the treatment of unrealized losses on such equity securities and is also more comparable to the GAAP treatment of such gains as a component of equity capital.

Under the final rule an institution is permitted, but not required, to recognize up to 45 percent of pretax net unrealized holding gains on AFS equity securities in Tier 2 capital. The information the institution must assemble in support of such treatment is the same as that already used by the institution when it prepares its

[5] The Agencies intend to rely on the guidance set forth in SFAS 115 for purposes of determining whether equity securities have fair values that are "readily determinable." Under SFAS 115, the fair value of an equity security is readily determinable if sales prices or bid-and-ask quotations are currently available on a securities exchange registered with the Securities and Exchange Commission or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations System or by the National Quotations Bureau. Restricted stock does not meet this definition. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously. The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

regulatory reports[6] in accordance with GAAP and there are no new capital restrictions or limitations imposed. Consequently, the Agencies find no reason to believe that this final rule places an additional burden on institutions of any size, including small community banks.

Unrealized gains and losses on many financial assets, including AFS debt securities and most loans, are ignored for purposes of calculating capital under the Agencies' leverage and risk-based capital standards. However, the Agencies do not agree with the argument raised in some of the comment letters that, for regulatory capital purposes, historical cost (rather than fair value) should be used for equity securities. To the contrary, the Agencies believe that the fair value of equity securities is relevant when evaluating regulatory capital.

At the time the risk-based capital guidelines were promulgated in 1989, GAAP and the regulatory reporting rules generally required equity investments to be valued at the lower of cost or market (LOCOM) with any net unrealized losses on these investments deducted from equity capital.[7] Consistent with this LOCOM accounting approach, the Agencies did not include net unrealized gains on equity securities in Tier 2 capital. However, in 1993, SFAS 115 was adopted. This accounting standard, which applies fair value accounting to many equity securities and requires institutions to reflect changes in the fair value of their AFS equity securities as a component of equity capital, was also adopted by the Agencies for regulatory reporting purposes. Although SFAS 115 further requires AFS debt securities to be carried at fair value, the unrealized holding gains and losses on these securities generally are more temporary in nature because the fair values of these debt instruments, over time, tend to approach their respective face values. Thus, any unrealized gains and losses on these debt instruments generally diminish as the instruments draw closer to their maturity dates. As a result, the Agencies continue to believe that unrealized gains and losses on AFS debt instruments are appropriately excluded from regulatory capital. However, the Agencies now believe it is appropriate, subject to prudential supervisory limitations, to include in Tier 2 capital at least a portion of an institution's net unrealized holding gains on AFS equity securities. Consistent with current supervisory policy, to the extent that unrealized gains and losses on AFS debt securities and other assets are not formally recognized for regulatory capital purposes, the Agencies will continue to consider the impact of any appreciation or depreciation on these assets when evaluating an institution's capital adequacy.

This final rule does not revise the treatment of net unrealized losses on AFS equity securities. The Agencies believe any measure of potential loss must be reflected in Tier 1 capital so as to provide an adequate cushion against risk. Therefore, in accordance with the Agencies' existing capital standards, these net unrealized losses will continue to be deducted in determining Tier 1 capital.

The Agencies agree with the concerns of the commenter that market fluctuations could have a significant impact on capital levels if net unrealized holding gains on equity securities are included in Tier 2 capital. Thus, as a prudent supervisory constraint, and consistent with the Basle Accord, it appears appropriate to limit the amount of net appreciation on AFS equity securities that may be included in Tier 2 capital to no more than 45 percent of the pretax net unrealized holding gains on these securities. Although not required by GAAP, this discount will help minimize supervisory concerns about market volatility, forced sale risk, and possible tax charges.

Furthermore, to prevent undue reliance on such gains to meet minimum capital requirements, unrealized gains on AFS equity securities are not included in the calculation of Tier 1 capital under the Agencies' leverage and risk-based capital ratios. Although up to 45 percent of these net unrealized holding gains may be included in calculating total risk-based capital, the allowable portion of these gains is only included in Tier 2 capital, which, in turn, is limited under the Agencies' risk-based capital standards to no more than 100 percent of Tier 1 capital.

The proposed rulemaking did not address how unrealized gains on equity securities that are held by an institution's subsidiaries should be treated in those cases where the institution's investment in the subsidiary itself is required to be deducted from regulatory capital. If an institution's investment in a subsidiary is deducted for regulatory capital purposes, any unrealized gains on equity securities held by the subsidiary will not be included in the institution's Tier 2 capital. On September 12, 1997, the FDIC published a request for comments regarding proposed changes to the rules regarding the activities of insured state banks and insured state savings associations (62 FR 47969). If this rule is adopted as proposed by the FDIC, a state institution's investment in a subsidiary which, in turn, invests in listed equity securities or shares of investment companies of a type not permitted for a national bank or federal savings association, as authorized by the proposed rule in the case of well-capitalized institutions, would be deducted from Tier 1 capital for regulatory capital purposes.

Finally, the Agencies have considered the commenters' concern that the current risk-based capital rules are too complex for small traditional institutions and that the current risk weight categories are too broad. Although the Agencies are sympathetic to this concern and will continue to seek ways to reduce burden on banks wherever appropriate, a broad-based reexamination of the risk-based capital framework is outside the scope of this rulemaking.

Final Rule

After careful consideration of all the comments received, the Agencies have decided to adopt the final rule with only minor technical modifications. Under the final rule, institutions that legally hold equity securities are permitted to include up to 45 percent of the pretax net unrealized holding gains on AFS equity securities in Tier 2 capital. Revisions from the original proposal have been limited to minor changes in the regulatory text to ensure consistency among the rules issued by each Agency.

Institutions need to be aware that, although including a portion of unrealized gains on AFS equity securities in Tier 2 capital may increase their total risk-based capital ratio, it may reduce their Tier 1 risk-based capital ratio.[8] Such decreases could occur because an institution's total risk-weighted assets (the denominator for both the Tier 1 and total risk-based capital ratios) would increase by the amount of pretax net unrealized holding gains on AFS equity securities included in Tier 2 capital. However, none of these gains would be included in Tier 1

[6] These reports are the Consolidated Reports of Condition and Income for banks supervised by the OCC, the Board, or the FDIC; the Thrift Financial Report for thrift institutions supervised by the OTS; and the FR Y–9C Report for bank holding companies supervised by the Board.

[7] This LOCOM accounting approach for equity securities was required by SFAS No. 12, ''Accounting for Certain Marketable Securities.''

[8] The leverage ratio will not be affected because the unrealized gains on AFS equity securities are not included in the numerator (Tier 1 capital) nor the denominator (total assets as defined in the agencies' capital standards) when computing the leverage ratio.

capital, thereby potentially decreasing an institution's Tier 1 risk-based capital ratio. For this reason, institutions should weigh the effects on both their total risk-based capital ratio and Tier 1 risk-based capital ratio when determining the amount of unrealized gains on AFS equity securities, if any, to include in Tier 2 capital.

Early Compliance

Subject to certain exceptions, 12 U.S.C. 4802(b) provides that new regulations and amendments to regulations prescribed by a Federal banking agency which impose additional reporting, disclosures, or other new requirements on an insured depository institution shall take effect on the first day of a calendar quarter which begins on or after the date on which the regulations are published in final form. However, section 4802(b) also permits persons who are subject to such regulations to comply with the regulation before its effective date. Accordingly, the Agencies will not object if an institution wishes to apply the provisions of this final rule beginning with the date it is published in the **Federal Register**.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Agencies have determined that this final rule will not have a significant economic impact on a substantial number of small entities in accordance with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). The final rule will permit, but not obligate, institutions to include up to 45 percent of the pretax net unrealized holding gains on AFS equity securities in Tier 2 capital. The information which an institution must assemble in support of such treatment is the same as that already created when it prepares its regulatory reports in accordance with GAAP. For those institutions choosing to utilize the final rule, the effect would be to increase immediately the amount of Tier 2 capital held by institutions, including small institutions, by the amount of their qualifying pretax net unrealized holding gains on such securities subject to the existing limit on Tier 2 capital. Thereafter, the amount of Tier 2 capital will increase or decrease as the fair value of the institution's holdings of AFS equity securities changes. The Agencies have concluded that the increase and changes in Tier 2 capital will not have a significant impact on the amount of total capital held by institutions, regardless of size.

Paperwork Reduction Act

The Agencies have determined that the final rule does not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA) (Title II, Pub. L. 1004–121) provides generally for agencies to report rules to Congress for review. The reporting requirement is triggered when a federal agency issues a final rule. Accordingly, the Agencies will file the appropriate reports with Congress as required by SBREFA.

The Office of Management and Budget has determined that this final rule does not constitute a "major rule" as defined by SBREFA.

OCC and OTS Executive Order 12866 Determination

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

OCC and OTS Unfunded Mandates Reform Act of 1995 Determinations

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104–4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in 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 an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, this rule will permit institutions to include up to 45 percent of pretax net unrealized holding gains on AFS equity securities in Tier 2 capital under the Agencies' risk-based capital rules. The final rule will reduce regulatory burden by increasing the amount of supplementary capital held by certain institutions. The OCC and the OTS have therefore determined that the overall effect of the rule on national banks and thrifts will not result in aggregate expenditures by State, local, or tribal governments or by the private sector of $100 million or more. Accordingly, the OCC and the OTS have not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

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, 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

Administrative practice and procedure, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

Authority and Issuance

Office of the Comptroller of the Currency

12 CFR Chapter I

For the reasons set out in the joint preamble, part 3 of chapter I of title 12 of the Code of Federal Regulations is amended as follows:

PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

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

Authority: 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907, and 3909.

2. In appendix A to part 3, section 2. is amended by adding a new paragraph (b)(5) including footnote 5 to read as follows:

Appendix A to Part 3—Risk-Based Capital Guidelines

* * * * *

Section 2. *Components of Capital.*

* * * * *

(b) * * *

(5) Up to 45 percent of the pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities with

readily determinable fair values.[5] Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in Tier 2 capital, but the OCC may take these unrealized gains (losses) into account as additional factors when assessing a bank's overall capital adequacy.

* * * * *

Dated: August 12, 1998.

Julie L. Williams,

Acting Comptroller of the Currency.

Federal Reserve System

12 CFR Chapter II

For the reasons set forth in the joint preamble, parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations are amended as follows:

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

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

Authority: 12 U.S.C. 24, 36, 92(a), 93(a), 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831, 1831o, 1831p–1, 1831r–1, 1835a, 1882, 2901–2907, 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, 4106, and 4128.

2. In appendix A to part 208, the introductory paragraphs in section *II.*A.2. are revised and footnote 8 is removed and reserved to read as follows:

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

* * * * *

II. * * *

A. * * *

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

(i) Allowance for loan and lease losses (subject to limitations discussed below);

(ii) Perpetual preferred stock and related surplus (subject to conditions discussed below);

(iii) Hybrid capital instruments (as defined below) and mandatory convertible debt securities;

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

(v) Unrealized holding gains on equity securities (subject to limitations discussed in section *II.*A.2.e. of this appendix).

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

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

* * * * *

3. In appendix A to part 208, section *II.*A.2., paragraphs d. and e. are revised to read as follows:

* * * * *

II. * * *

A. * * *

2. * * *

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

(ii) Subordinated debt and intermediate-term preferred stock must have an original weighted average maturity of at least five years to qualify as supplementary capital. (If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing bank.)[12] In the case of subordinated debt, the instrument must be unsecured and must clearly state on its face that it is not a deposit and is not insured by a Federal agency. To qualify as capital in banks, debt must be subordinated to general creditors and claims of depositors. Consistent with current regulatory requirements, if a state member bank wishes to redeem subordinated debt before the stated maturity, it must receive prior approval of the Federal Reserve.

e. *Unrealized gains on equity securities and unrealized gains (losses) on other assets.* Up to 45 percent of pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities with readily determinable fair values may be included in supplementary capital. However, the Federal Reserve may exclude all or a portion of these unrealized gains from Tier 2 capital if the Federal Reserve determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but the Federal Reserve may take these unrealized gains (losses) into account as additional factors when assessing a bank's overall capital adequacy.

* * * * *

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

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

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. In appendix A to part 225, the introductory paragraphs of section II.*A*.2. are revised and footnote 8 is removed and reserved to read as follows:

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

* * * * *

II. * * *

A. * * *

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

(i) Allowance for loan and lease losses (subject to limitations discussed below);

(ii) Perpetual preferred stock and related surplus (subject to conditions discussed below);

(iii) Hybrid capital instruments (as defined below), perpetual debt and mandatory convertible debt securities;

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

(v) Unrealized holding gains on equity securities (subject to limitations discussed in section II.A.2.e. of this appendix).

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

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

* * * * *

3. In appendix A to part 225, section II.*A*.2., paragraphs d and e are revised to read as follows:

* * * * *

II. * * *

A. * * *

2. * * *

d. *Subordinated debt and intermediate-term preferred stock.* (i) The aggregate

[5] The OCC reserves the authority to exclude all or a portion of unrealized gains from Tier 2 capital if the OCC determines that the equity securities are not prudently valued.

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

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

(ii) Subordinated debt and intermediate-term preferred stock must have an original weighted average maturity of at least five years to qualify as supplementary capital.[12] (If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument prior to the stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing banking organization.)[13] In the case of subordinated debt, the instrument must be unsecured and must clearly state on its face that it is not a deposit and is not insured by a Federal agency. Bank holding company debt must be subordinated in the right of payment to all senior indebtedness of the company.

e. *Unrealized gains on equity securities and unrealized gains (losses) on other assets.* Up to 45 percent of pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities with readily determinable fair values may be included in supplementary capital. However, the Federal Reserve may exclude all or a portion of these unrealized gains from Tier 2 capital if the Federal Reserve determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but the Federal Reserve may take these unrealized gains (losses) into account as additional factors when assessing an institution's overall capital adequacy.

* * * * *

By order of the Board of Governors of the Federal Reserve System, August 25, 1998.

Jennifer J. Johnson,

Secretary of the Board.

Federal Deposit Insurance Corporation

12 CFR Chapter III

For the reasons set forth in the joint preamble, part 325 of chapter III of title 12 of the Code of Federal Regulations is amended as follows:

PART 325—CAPITAL MAINTENANCE

1. The authority citation for part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 1835, 3907, 3909, 4808; Pub. L. 102–233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102–242, 105 Stat. 2236, 2355, as amended by Pub. L. 103–325, 108 Stat. 2160, 2233 (12 U.S.C. 1828 note); Pub. L. 102–242, 105 Stat. 2236, 2386, as amended by Pub. L. 102–550, 106 Stat. 3672, 4089 (12 U.S.C. 1828 note).

2. In appendix A to part 325, the introductory paragraphs of section I.*A*.2. are revised to read as follows:

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

* * * * *

I. * * *

A. * * *

2. *Supplementary capital elements (Tier 2)* consist of:

i. Allowance for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets;

ii. Cumulative perpetual preferred stock, long-term preferred stock (original maturity of at least 20 years), and any related surplus;

iii. Perpetual preferred stock (and any related surplus) where the dividend is reset periodically based, in whole or part, on the bank's current credit standing, regardless of whether the dividends are cumulative or noncumulative;

iv. Hybrid capital instruments, including mandatory convertible debt securities;

v. Term subordinated debt and intermediate-term preferred stock (original average maturity of five years or more) and any related surplus; and

vi. Net unrealized holding gains on equity securities (subject to the limitations discussed in paragraph I.*A*.2.(f) of this section).

The maximum amount of Tier 2 capital that may be recognized for risk-based capital purposes is limited to 100 percent of Tier 1 capital (after any deductions for disallowed intangibles and disallowed deferred tax assets). In addition, the combined amount of term subordinated debt and intermediate-term preferred stock that may be treated as part of Tier 2 capital for risk-based capital purposes is limited to 50 percent of Tier 1 capital. Amounts in excess of these limits may be issued but are not included in the calculation of the risk-based capital ratio.

* * * * *

3. In appendix A to part 325, the last undesignated paragraph of section I.*A*.2., entitled ''Discount of limited-life supplementary capital instruments,'' is designated as paragraph (e) and a new paragraph (f) is added to section I.*A*.2. to read as follows:

* * * * *

I. * * *

A. * * *

2. * * *

(f) *Unrealized gains on equity securities and unrealized gains (losses) on other assets.* Up to 45 percent of pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities with readily determinable fair values may be included in supplementary capital. However, the FDIC may exclude all or a portion of these unrealized gains from Tier 2 capital if the FDIC determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but the FDIC may take these unrealized gains (losses) into account as additional factors when assessing a bank's overall capital adequacy.

* * * * *

4. In appendix A to part 325, Table I is revised to read as follows:

TABLE I.— DEFINITION OF QUALIFYING CAPITAL

Components	Minimum requirements and limitations
(1) Core Capital (Tier 1)	Must equal or exceed 4% of risk-weighted assets.
(2) Common stockholders' equity capital	No limit.[1]
(3) Noncumulative perpetual preferred stock and any related surplus	No limit.[1]
(4) Minority interests in equity capital accounts of consolidated subsidiaries.	No limit.[1]
(5) Less: All intangible assets other than mortgage servicing rights and purchased credit card relationships.	([2])
(6) Less: Certain deferred tax assets	([3])

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

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

TABLE I.— DEFINITION OF QUALIFYING CAPITAL—Continued

Components	Minimum requirements and limitations
(7) Supplementary Capital (Tier 2)	Total of Tier 2 is limited to 100% of Tier 1.[4]
(8) Allowance for loan and lease losses	Limited to 1.25% of risk-weighted assets.[4]
(9) Unrealized gains on certain equity securities[5]	Limited to 45% of pretax net unrealized gains.[5]
(10) Cumulative perpetual and long-term preferred stock (original maturity of 20 years or more) and any related surplus.	No limit within Tier 2; long-term preferred is amortized for capital purposes as it approaches maturity.
(11) Auction rate and similar preferred stock (both cumulative and noncumulative).	No limit within Tier 2.
(12) Hybrid capital instruments (including mandatory convertible debt securities).	No limit within Tier 2.
(13) Term subordinated debt and intermediate-term preferred stock (original weighted average maturity of five years or more).	Term subordinated debt and intermediate term preferred stock are limited to 50% of Tier 1[4] and amortized for capital purposes as they approach maturity.
(14) Deductions (from the sum of Tier 1 plus Tier 2).	
(15) Investments in banking and finance subsidiaries that are not consolidated for regulatory capital purposes.	
(16) Intentional, reciprocal cross-holdings of capital securities issued by banks.	
(17) Other deductions (such as investments in other subsidiaries or in joint ventures) as determined by supervisory authority.	On a case-by-case basis or as a matter of policy after formal consideration of relevant issues.
(18) Total Capital (Tier 1 + Tier 2—Deductions)	Must equal or exceed 8% of risk-weighted assets.

[1] No express limits are placed on the amounts of nonvoting common, noncumulative perpetual preferred stock, and minority interests that may be recognized as part of Tier 1 capital. However, voting common stockholders' equity capital generally will be expected to be the dominant form of Tier 1 capital and banks should avoid undue reliance on other Tier 1 capital elements.

[2] The amounts of mortgage servicing rights and purchased credit card relationships that can be recognized for purposes of calculating Tier 1 capital are subject to the limitations set forth in § 325.5(f). All deductions are for capital purposes only; deductions would not affect accounting treatment.

[3] Deferred tax assets are subject to the capital limitations set forth in § 325.5(g).

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

[5] Unrealized gains on equity securities are subject to the capital limitations set forth in paragraph I.*A*.2.(f) of Appendix A to part 325.

By order of the Board of Directors.

Dated at Washington, DC, this 25th day of August, 1998.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Office of Thrift Supervision

12 CFR Chapter V

For the reasons set forth in the joint preamble, part 567 of chapter V of title 12 of the Code of Federal Regulations is amended as set forth below:

PART 567—CAPITAL

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

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

2. Section 567.5 is amended by adding a new paragraph (b)(5) to read as follows:

§ 567.5 Components of capital.

* * * * *

(b) * * *

(5) *Unrealized gains on equity securities.* Up to 45 percent of unrealized gains on available-for-sale equity securities with readily determinable fair values may be included in supplementary capital. Unrealized gains are unrealized holding gains, net of unrealized holding losses, before income taxes, calculated as the amount, if any, by which fair value exceeds historical cost. The OTS may disallow such inclusion in the calculation of supplementary capital if the Office determines that the equity securities are not prudently valued.

* * * * *

Dated: August 6, 1998.

By the Office of Thrift Supervision.

Ellen Seidman,

Director.

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