

# Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## DEPARTMENT OF THE TREASURY

### Office of the Comptroller of the Currency

#### 12 CFR Part 3

[Docket No. 00-17]

RIN 1557-AB14

## FEDERAL RESERVE SYSTEM

#### 12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R-1080]

## FEDERAL DEPOSIT INSURANCE CORPORATION

#### 12 CFR Part 325

RIN 3064-AC34

## DEPARTMENT OF THE TREASURY

### Office of Thrift Supervision

#### 12 CFR Part 565 and 567

[Docket No. 2000-70]

RIN 1550-AB11

### Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Residual Interests in Asset Securitizations or Other Transfers of Financial Assets

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

**ACTION:** Notice of proposed rulemaking.

**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) propose to amend their capital adequacy standards

for banks, bank holding companies and thrifts (collectively, banking organizations) concerning the treatment of certain residual interests in asset securitizations or other transfers of financial assets. Residual interests are defined as those on-balance sheet assets that represent interests (including beneficial interests) in the transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets; and are structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit enhancement techniques (credit enhancement). Examples of residual interests include, but are not limited to, interest only strips receivable (I/O strips), spread accounts, cash collateral accounts, retained subordinated interests, and other similar forms of on-balance sheet assets that function as a credit enhancement. Residual interests as defined in the proposed rule do not include interests purchased from a third party.

Generally, these residual interests are non-investment grade or unrated assets retained by the issuing institution in order to provide "first-loss" credit support for the senior positions in a securitization or other financial asset transfer. They generally lack an active market through which a readily available market price can be obtained. In addition, many of these residual interests are exposed, on a leveraged basis, to a significant level of credit and interest rate risk that make their valuation extremely sensitive to changes in the underlying credit and prepayment assumptions. As a result, such residual interests present valuation and liquidity concerns. High concentrations of such illiquid and volatile assets in relation to capital can threaten the safety and soundness of banking organizations.

This proposed rule is intended to better align regulatory capital requirements with the risk exposure of these types of residual interests, encourage conservative valuation methods, and restrict excessive concentrations in these assets. The proposed rule would require that risk-based capital be held in an amount equal to the amount of the residual interest that is retained on the balance sheet by a banking organization in a

securitization or other transfer of financial assets, even if the capital charge exceeds the full risk-based capital charge typically held against the transferred assets. The proposed rule also would restrict excessive concentrations in residual interests by limiting the amount that may be included in Tier 1 capital for both leverage and risk-based capital purposes. When aggregated with nonmortgage servicing assets and purchased credit card relationships (PCCRs), the balance sheet amount of residual interests would be limited to 25 percent of Tier 1 capital, with any amount in excess of this limitation deducted in determining the amount of a banking organization's Tier 1 capital.

**DATES:** Comments must be received by December 26, 2000.

**ADDRESSES:** Comments should be directed to:

*OCC:* Comments may be submitted to Docket No. 00-17, Communications Division, Third Floor, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219. Comments will be available for inspection and photocopying at that address. In addition, comments may be sent by facsimile transmission to FAX number (202/874-5274), or by electronic mail to [regs.comment@occ.treas.gov](mailto:regs.comment@occ.treas.gov).

*Board:* Comments directed to the Board should refer to Docket No. R-1080 and may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington DC 20551 or mailed electronically to [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Comments addressed to the attention of Ms. Johnson may also be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or the security control room in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room MP-500 of the Martin Building between 9 a.m. and 5 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's Rules Regarding Availability of Information.

*FDIC:* Send written comments to Robert E. Feldman, Executive Secretary, Attention: Comments/OES, Federal Deposit Insurance Corporation, 550 17th

Street, NW., Washington, DC 20429. Comments may be hand-delivered to the guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m. Send facsimile transmissions to FAX number (202/898-3838); Internet address: [comments@fdic.gov](mailto:comments@fdic.gov). Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, NW., Washington, DC 20429, between 9 a.m. and 4:30 p.m. on business days.

*OTS:* Send comments to Manager, Dissemination Branch, Information Management and Services Division, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552, Attention Docket No. 2000-70. Hand deliver comments to the Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days. Send facsimile transmissions to FAX Number (202) 906-7755; or (202) 906-6956 (if comments are over 25 pages). Send e-mails to [public.info@ots.treas.gov](mailto:public.info@ots.treas.gov), and include your name and telephone number. Interested persons may inspect comments at the Public Reference Room, 1700 G Street, NW., from 10 a.m. until 4 p.m. on Tuesdays and Thursdays.

**FOR FURTHER INFORMATION CONTACT:**

*OCC:* Amrit Sekhon, Risk Specialist (202/874-5211), Capital Policy; Ron Shimabukuro, Senior Attorney, or Laura Goldman, Senior Attorney, Legislative and Regulatory Activities Division (202/874-5090).

*Board:* Thomas R. Boemio, Senior Supervisory Financial Analyst (202/452-2982); Arleen Lustig, Supervisory Financial Analyst (202/452-2987), Division of Banking Supervision and Regulation; and Mark E. Van Der Weide, Counsel, (202/452-2263), Legal Division. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Janice Simms (202/872-4984), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

*FDIC:* William A. Stark, Assistant Director, Division of Supervision (202/898-6972); Stephen G. Pfeifer, Senior Examination Specialist, Division of Supervision (202/898-8904); Keith A. Ligon, Chief, Policy Unit, Division of Supervision (202/898-3618); and Marc J. Goldstrom, Counsel, Legal Division (202/898-8807).

*OTS:* Michael D. Solomon, Senior Program Manager for Capital Policy (202/906-5654), and Teresa A. Scott, Counsel, Banking and Finance (202/906-6478), Regulation and Legislation

Division, Office of the Chief Counsel, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

**SUPPLEMENTARY INFORMATION:** This preamble consists of the following sections:

- I. Introduction
- II. Nature of Supervisory Concerns
- III. Current Capital Treatment for Residual Interests
- IV. Residual Interests Subject to the Proposal
- V. Proposed Amendments to the Capital Standards
- VI. Request for Public Comment
- VII. Plain Language
- VIII. Regulatory Analysis

**I. Introduction**

The proposed rule addresses the supervisory concerns arising from the illiquid and volatile nature of residual interests that are retained by the securitizer or other seller of financial assets, when those residual interests are used as a credit enhancement to support the financial assets transferred. The proposal also reduces the risk from excessive concentrations in these residual interests, including those situations where large residual interests are retained in connection with the sale or securitization of low quality, higher risk loans. As discussed in more detail in section V, the proposed rule would (1) require capital to be maintained in an amount equal to the amount of the residual interest that is retained on the balance sheet for risk-based capital purposes, and (2) require the amount of any such residual interests to be included in the 25 percent of Tier 1 capital sublimit that currently applies to nonmortgage servicing assets and purchased credit card relationships (PCCRs), with any amounts in excess of this limit deducted from Tier 1 capital for both leverage and risk-based capital purposes.

**II. Nature of Supervisory Concerns**

Securitizations and other financial asset transfers provide an efficient mechanism for banking organizations to sell loan assets or credit exposures. The benefits of these transactions must be balanced against the significant risks that such activities can pose to banking organizations and to the deposit insurance funds. Recent examinations have disclosed significant weaknesses in the risk management processes related to securitization activities at certain institutions. The most frequently encountered problems stem from: (1) The failure to recognize recourse obligations that frequently accompany securitizations and to hold sufficient capital against such obligations; (2) the excessive or inadequately supported

valuation of residual interests; (3) the liquidity risk associated with over reliance on asset securitization as a funding source; and (4) the absence of adequate independent risk management and audit functions.

The Agencies addressed these concerns in the Interagency Guidance on Asset Securitization (Securitization Guidance) issued in December 1999.<sup>1</sup> The Securitization Guidance highlighted some of the risks associated with asset securitization and emphasized the Agencies' concerns with certain residual interests generated from the securitization and sale of assets.

The Securitization Guidance addressed the fundamental risk management practices that should be in place at institutions that engage in securitization activities and stressed the need for bank management to implement policies and procedures that include limits on the amount of residual interests that may be carried as a percentage of capital. In particular, the Securitization Guidance set forth the supervisory expectation that the value of a residual interest in a securitization must be supported by objectively verifiable documentation of the asset's fair market value utilizing reasonable, conservative valuation assumptions. Under this guidance, residual interests that do not meet this expectation, or that fail to meet the supervisory standards set forth in the Securitization Guidance, should be classified as "loss" and disallowed as assets of the banking organization for regulatory capital purposes.

Moreover, the Agencies indicated in this guidance that institutions found lacking effective risk management programs or engaging in practices that present safety and soundness concerns would be subject to more frequent supervisory review, limitations on residual interest holdings, more stringent capital requirements, or other supervisory response. The Securitization Guidance further advised the industry that given the risks presented by securitization activities, and the illiquidity and potential volatility of residual interests, the Agencies were actively considering the establishment of regulatory restrictions that would limit or eliminate the amount of certain residual interests that

<sup>1</sup> See OCC Bulletin 99-46 (December 14, 1999) (OCC); FDIC FIL 109-99 (December 13, 1999) (FCIC); SR 99-37(SUP) (December 13, 1999) (FRB); and CEO LTR 99-119 (December 14, 1999) (OTS). See this guidance for a more detailed discussion of the risk management processes applicable to securitization activities.

may be recognized in determining the adequacy of regulatory capital.

The Agencies have identified three areas of continuing supervisory concern:

- (1) Inappropriate or aggressive valuations of residual interests;
- (2) Inadequate capital in relation to the risk exposure of the organization retaining residual interests; and
- (3) Excessive concentrations of residual interests in relation to capital.

The Statement of Financial Accounting Standards No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities" (FAS 125)<sup>2</sup> governs the recognition of a residual interest in a securitization as an asset of the sponsoring institution. Under these generally accepted accounting principles (GAAP), when a transfer of assets is treated as a sale, the securitizing or selling institution carries any residual interests as an asset on its books at an estimate of fair value.<sup>3</sup> Retaining this residual interest on the balance sheet in connection with a sale generally has the effect of increasing the amount of current earnings generated by the gains from the sale.

The Agencies have become increasingly concerned with fair value estimates that are based on unwarranted assumptions of expected cash flows. No active market exists for many residual interests. As a result, there is no marketplace from which an arm's length market price can readily be obtained to support the residual interest valuation. Recent examinations have highlighted the inherent uncertainty and volatility regarding the initial and ongoing valuation of residual interests. A banking organization that securitizes assets may overvalue its residual interests and thereby inappropriately generate "paper profits" (or mask actual losses) through incorrect cash flow modeling, flawed loss assumptions, inaccurate prepayment estimates, and inappropriate discount rates. Residual interests are exposed to a significant level of credit and interest rate risk that make their valuation extremely sensitive to changes in the underlying

assumptions. Market events can affect the discount rate or performance of assets supporting residual interests and can swiftly and dramatically alter their value. Should the institution hold an excessive concentration of such assets in relation to capital, the safety and soundness of the institution may be threatened.

The Agencies believe that the current regulatory capital requirements do not adequately reflect the risk of unexpected losses associated with these transactions. The booking of a residual interest using gain-on-sale accounting can increase the selling institution's capital and thereby allow the bank to leverage the capital created from the securitization. This increased leverage resulting from the current recognition of uncertain future cash flows is a supervisory concern. Accordingly, the proposed rule focuses on those transfers of financial assets treated as sales under GAAP.<sup>4</sup>

A related concern is the adequacy of capital held by institutions that securitize or sell assets and retain residual interests. First, the lack of liquidity of residual interests and the potential volatility of residual interests arising from their leveraged credit and interest rate risk limits their ability to support the institution, especially in times of stress. Second, any weaknesses in the valuation of the residual interest can translate into weaknesses in the quality of capital available to support the institution. Liberal or unsubstantiated assumptions can result in material inaccuracies in financial statements. Even when such residual interests have been appropriately valued, relatively small changes in the underlying assumptions can lead to material changes in the residual interest's fair value. Inaccuracies in the initial valuation of residual interests, as well as changes in the underlying assumptions over time, can result in substantial write-downs of residual interests. If these generally illiquid and volatile residual interests represent an excessive concentration of the

sponsoring institution's capital, they can contribute to the ultimate failure of the institution.

The concerns regarding excessive concentration and adequacy of capital are heightened where the residual interests are generated from the securitization of certain assets, such as low-quality or high loan-to-value loans. Recent examinations have shown that in order to provide adequate credit enhancement to the senior positions in securitizations involving low quality assets, institutions generally must retain relatively greater credit risk exposure. In such transactions, the sponsoring institutions may retain residual interests in amounts that exceed the risk-based capital that would have been associated with the loans had they not been transferred.

Because of these continuing supervisory concerns, the Agencies believe it is appropriate to propose these revisions to their respective capital adequacy rules in order to limit the amount of residual interests that are retained by banking organizations and require adequate capital for the risk exposure created.

### III. Current Capital Treatment for Residual Interests

#### *Assets Sold "With Recourse"*<sup>5</sup>

Under current risk-based capital guidelines, banking organizations that retain "recourse" on assets sold generally are required to hold capital as though the loans remained on the institution's books,<sup>6</sup> up to the "full capital charge".<sup>7</sup> For regulatory capital

<sup>5</sup> Consolidated Reports of Condition and Income (Call Report) instructions issued by the Federal Financial Institutions Examination Council provide examples of transfers of assets that involve recourse arrangements. See the Call Report Glossary entry for "Sales of Assets for Risk-Based Capital Purposes." These examples address the risk of loss retained in connection with transfers of assets. OTS currently defines the term "recourse" more broadly in its capital rules at 12 CFR 567.1 to include the "acceptance, assumption or retention" of the risk of loss. The Agencies have issued a separate proposal that, among other things, would provide a uniform definition of "recourse." See 65 FR 12319 (March 8, 2000).

<sup>6</sup> Under the Agencies' current capital rules, assets transferred with recourse in a transaction that is reported as a sale under generally accepted accounting principles (GAAP) are removed from the balance sheet and are treated as off-balance sheet exposures for risk-based capital purposes. For transactions reported as a sale, the entire amount of the assets sold (not just the contractual amount of the recourse obligation) is normally converted into an on-balance sheet credit equivalent amount using a 100 percent conversion factor. This credit equivalent amount is then risk weighted for risk-based capital calculation purposes.

<sup>7</sup> For assets that are assigned to the 100 percent risk-weight category, the full capital charge is 8 percent of the amount of assets transferred, and

<sup>2</sup> FAS 125 establishes certain transfer of control, accounting, and valuation criteria surrounding the transfer of financial assets as a benchmark for determining whether a transfer is recorded as a "sale" and, if so, at what value it is recorded. Under FAS 125, the transferring financial institution generally will immediately recognize gains from the sale of the transferred assets and record retained interests in a manner that captures all of the financial components of, including the residual interests that arise in connection with, the securitization or other asset transfer.

<sup>3</sup> The fair value reflects the expected future cash flows discounted in an appropriate market interest rate, and is calculated using assumptions regarding estimated credit loss rates and prepayment speeds.

<sup>4</sup> When the securitization or other transfer of financial assets is treated as a financing, under GAAP and for regulatory capital purposes, rather than a sale, the assets continue to be reflected on the balance sheet of the transferring institution. In these circumstances, the assets continue to be subject to the minimum capital requirement (generally 8 percent). The level of supervisory concern is diminished in these circumstances because there is no residual interest created to pose valuation or liquidity concerns. Importantly, a financing transaction does not generate earnings leading to the creation of capital. For this reason, the proposal only changes the regulatory capital requirements for banking organizations when they securitize or otherwise transfer financial assets and treat the transactions as sales under GAAP.

purposes, recourse is generally defined as an arrangement in which a banking organization retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of the institution's claim on the assets.<sup>8</sup>

As required by statute,<sup>9</sup> the Agencies have adopted rules that provide "low-level recourse" treatment for those institutions that securitize or sell assets and retain recourse in dollar amounts less than the full capital charge.<sup>10</sup> Before the issuance of the low-level recourse rules, these institutions could have been required to hold a greater level of capital than their maximum contractual exposure to loss on the transferred assets. The low-level recourse treatment applies to transactions accounted for as sales under FAS 125 in which a banking organization contractually limits its recourse exposure to less than the full capital charge for the assets transferred.

Under the low-level recourse rule, a banking organization generally holds capital on a dollar-for-dollar basis up to the amount of the maximum contractual exposure. In the absence of any other recourse provisions, the on-balance sheet amount of the residual interests represents the maximum contractual exposure. For example, assume that a banking organization securitizes \$100 million of credit card loans and records a residual interest on the balance sheet of \$5 million that serves as a credit enhancement for the assets transferred. Before the low-level recourse rule was issued, the institution would be required to hold \$8 million of risk-based capital against the \$100 million in loans

sold, as though the loans had not been sold. Under the low-level recourse rule, the institution would be required to hold \$5 million in capital, that is, "dollar-for-dollar" capital up to the institution's maximum contractual exposure.

Existing regulatory capital rules, however, do not require institutions to hold "dollar-for-dollar" capital against residual interests that exceed the full capital charge (\$8 million in the above example). Typically, institutions that securitize and sell higher risk assets are required to retain a large residual interest (often greater than the full capital charge of 8 percent on 100 percent risk-weighted assets) in order to ensure that the more senior positions in the securitization or other asset sale can receive the desired investment ratings. Write-downs of the recorded value of the residual interest, due to unrealistic (or changing) loss or prepayment assumptions, can result in residual losses that exceed the amount of capital held against these assets, thereby impairing the safety and soundness of the institution.

For example, assume that a banking organization securitizes \$100 million of subprime credit card loans and records a residual interest on the balance sheet of \$15 million that serves as a credit enhancement for the securitization. Under the current risk-based capital rules, the transferred loans would be treated as sold with recourse, and an 8 percent risk-based capital charge for these 100 percent risk-weighted loans would be required; that is, \$8 million in risk-based capital would be required to be held against the \$100 million of transferred loans. In this hypothetical example, however, the amount of residual interests retained on the balance sheet (\$15 million) exceeds the full equivalent risk-based capital charge held against the assets transferred (\$8 million). Accordingly, the amount of the residual interest is not fully covered by dollar-for-dollar risk-based capital; only \$8 million in capital is required to be held by the institution against the \$15 million residual interest exposure.

This example demonstrates that, for residual interests that exceed the dollar amount of the full capital charge on the assets transferred, current capital standards do not require dollar-for-dollar capital protection for the full contractual exposure to loss retained by the selling institution. Any losses in excess of the full capital charge (8 percent in the example above) could negatively affect the capital adequacy of the institution. Should the asset be written down from \$15 million to \$5 million, the \$8 million of required

capital would be insufficient to absorb the full loss of \$10 million.

#### *B. Prior Consideration of Concentration Limits on Residual Interests*

In 1998, the Agencies amended their capital rules to change the regulatory capital treatment of servicing assets.<sup>11</sup> This rulemaking increased from 50 percent to 100 percent the amount of mortgage servicing assets that could be included in Tier 1 capital. The Agencies imposed more restrictive limits on the amount of nonmortgage servicing assets and PCCRs that could be included in Tier 1 capital. These stricter limitations were imposed due to the lack of depth and maturity of the marketplace for such assets, and related concerns about their valuation, liquidity, and volatility.

At the time the Agencies issued the final rule on servicing assets, the Agencies declined to adopt similar capital limits for I/O strips, a form of residual interest, notwithstanding that certain I/O strips possessed cash flow characteristics similar to servicing assets and presented similar valuation, liquidity, and volatility concerns. At that time, the Agencies chose not to impose such limitations in recognition of the "prudential effects of banking organizations relying on their own risk assessment and valuation tools, particularly their interest rate risk, market risk, and other analytical models."<sup>12</sup> The Agencies expressly indicated that they would continue to review banking organizations' valuation of I/O strips and the concentrations of these assets relative to capital. Moreover, the Agencies noted that they "may, on a case-by-case basis, require banking organizations that the Agencies determine have high concentrations of these assets relative to their capital, or are otherwise at risk from these assets, to hold additional capital commensurate with their risk exposures."<sup>13</sup> In addition, most of the residual interests at that time that were used as credit enhancements did not exceed the full capital charge on the transferred assets and thus were subject to "dollar-for-dollar" capital requirements under the Agencies' existing low-level recourse rules. However, a trend toward the securitization of higher risk loans has now resulted in residual interests that exceed the full capital charge and for which "dollar-for-dollar" capital is not required under the current risk-based capital rules. This trend has also resulted in certain banking organizations engaged in such

institutions are required to hold 8 cents of capital for every dollar of assets transferred with recourse. For assets that are assigned to the 50 percent risk-weight category, the full capital charge is 4 cents of capital for every dollar of assets transferred with recourse.

<sup>8</sup> The risk-based capital treatment for sales with recourse can be found at 12 CFR 3, appendix A, section (3)(b)(1)(iii) (OCC); 12 CFR 208, appendix A, section III.D.1 and 12 CFR 225, appendix A, section III.D.1 (FRB); 12 CFR 325, appendix A, section II.D.1 (FDIC); and 12 CFR 567.6(a)(2)(i)(C) (OTS).

<sup>9</sup> Low-level recourse treatment is mandated by section 350 of the Riegle Community Development and Regulatory Improvement Act, 12 U.S.C. 4808, which generally provides that: "the amount of risk-based capital required to be maintained \* \* \* by any insured depository institution with respect to assets transferred with recourse by such institution may not exceed the maximum amount of recourse for which such institution is contractually liable under the recourse agreement."

<sup>10</sup> The Agencies' low-level recourse rules appear at: 12 CFR 3, appendix A, section 3(d) (OCC); 12 CFR 208, appendix A, section III.D.1.g and 225, appendix A, section III.D.1.g (FRB); 12 CFR 325, appendix A, section II.D.1 (FDIC); and 12 CFR 567.6(a)(2)(i)(C) (OTS). A brief explanation is also contained in the instructions for regulatory reporting in section RC-R for the Call Report or schedule CCR for the Thrift Financial Report.

<sup>11</sup> See 63 FR 42668 (August 10, 1998).

<sup>12</sup> *Id.* at 42672.

<sup>13</sup> *Id.*

securitization transactions having large concentrations in residual interests as a percentage of capital.

#### IV. Residual Interests Subject to the Proposal

Included in this proposal are residual interests that are structured to absorb more than a pro rata share of credit loss related to the securitized or sold assets through subordination provisions or other credit enhancement techniques. Such residual interests can take many forms. Generally, these residual interests are non-investment grade or unrated "first-loss" positions that provide credit support for the senior positions of the securitization or other asset sale. A key aspect of such residual interests is that they reflect an arrangement in which the institution retains risk of credit loss in connection with an asset transfer. In addition to recourse provisions that may require the selling institution to support a securitization, residual interests can take the form of spread accounts, over-collateralization, subordinated securities, cash collateral accounts, or other similar forms of on-balance sheet assets that function as a credit enhancement. Servicing assets that function as credit enhancements would be subject to the proposed rule.

The definition of residual interests excludes those interests that do not serve as credit enhancements. In this regard, highly rated, liquid, marketable residual interests where the institution assumes only the interest rate risk associated with the assets transferred in the securitization (e.g., Fannie Mae or Freddie Mac I/O strips) do not serve as a credit enhancement for the transferred assets and thus do not expose the institution to a concentrated level of credit risk. Further, such instruments are traded in a currently active marketplace and thus do not present the same degree of liquidity and valuation concerns.

The residual interests covered by the proposed rule are generally retained by the securitizing institution rather than sold because they are generally illiquid and volatile in nature and thus present liquidity and valuation concerns. The proposed rule extends only to residual interests that have been retained by a banking organization as a result of a securitization or other sale transaction and does not cover residual interests that a banking organization has purchased from another party.<sup>14</sup>

<sup>14</sup> The proposed rule would extend to all residual interests as defined, whether included in the banking book or included in the trading book and subject to the market risk rules.

Purchased residual interests can present the same degree of concentrated credit risk associated with retained residual interests. The exclusion of purchased residual interests from the proposed rule could establish a different capital treatment for the same asset, depending on whether the interest is purchased from a third party or retained in connection with the transfer of financial assets to a third party. The Agencies are particularly concerned about the possible "swapping" of residual interests, where there is otherwise limited breadth and depth of the market for these residual interests, and both parties stand to gain from accommodation valuations of each asset.

However, residual interests purchased in an arm's length transaction may not pose the same degree of liquidity risk as interests that are retained. In addition, purchased interests do not present the same opportunity to create capital as do interests that are originated and retained by a securitizing institution. Further, unlike retained residual interests where an overvaluation of the residual interest can lead to a higher gain on sale and the creation of additional capital, there is a marketplace discipline on the initial amount at which a purchased residual interest is recorded (that is, it is limited to the purchase price), and there is no incentive on the part of the purchaser to pay a price above market because such a purchase does not create any capital for the purchaser.

The Agencies are considering including such purchased interests within the scope of the rule and are requesting comment on this issue.

#### V. Proposed Amendments to the Capital Standards

##### A. Proposed Treatment of Residual Interests

The Agencies propose to amend the regulatory risk-based capital standards by eliminating the distinction between the treatment of low-level recourse obligations and the treatment of assets securitized or sold with recourse in those cases where the amount of the residual interest retained on balance sheet exceeds the full capital charge for the assets transferred. The current rules essentially place a ceiling on the "dollar-for-dollar" capital requirement for recourse obligations. Removal of this "cap" will ensure that all residual interests are subject to the same "dollar-for-dollar" capital standard that is applied to residual interests in low-level recourse transactions and that capital is held for the organization's total contractual exposure to loss.

In addition to modifying the risk-based capital treatment for residual interests, the Agencies propose limiting the amount of residual interests that can be recognized in determining Tier 1 capital under the Agencies' leverage and risk-based capital standards. The purpose of the limit is to prevent excessive concentrations in holdings of residual interests. The Agencies propose including residual interests within the 25 percent of Tier 1 capital sublimit already placed upon nonmortgage servicing assets and PCCRs. Under this restriction, any amounts of residual interests, when aggregated with nonmortgage servicing assets and PCCRs, that exceed of 25 percent of Tier 1 capital, would be deducted from Tier 1 capital for purposes of calculating both the risk-based and leverage capital ratios.<sup>15</sup>

In addition to including residual interests in the sublimit currently applied to PCCRs and nonmortgage servicing assets, residual interests would also be included in the calculation of the overall 100 percent limit on servicing assets. Under this proposal, the maximum allowable amount of mortgage servicing assets, PCCRs, nonmortgage servicing assets, and residual interests, in the aggregate, would be limited to 100 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed PCCRs, any disallowed nonmortgage servicing assets, any disallowed residual interests, and any disallowed deferred tax assets. The residual interests, however, would not be subject to the 90 percent of fair value limitation that applies to servicing assets and PCCRs. Under the proposed rule, residual interests would already be subject to a "dollar-for-dollar" capital requirement. Any residual interests deducted in determining the Tier 1 capital numerator for the leverage and risk-based capital ratios also would be excluded from the denominators of these ratios.

In summary, under the proposed rule, institutions generally would be required to hold "dollar-for-dollar" capital for residual interests and additionally would be required to deduct from Tier 1 capital the amount of any residual interests (when aggregated with nonmortgage servicing assets and PCCRs) that exceed the established 25 percent sublimit. In combination, the proposal is intended to ensure that all

<sup>15</sup> The unrealized gains that may be recorded by an institution with respect to residual interests that are accounted for as available-for-sale securities are presently not included in Tier 1 capital and would not be subject to further deduction under this rule.

residual interests are supported by “dollar-for-dollar” capital and that excessive concentrations (over 25 percent) in residual interests relative to capital are avoided.<sup>16</sup>

#### B. Net-of-Tax Treatment

The Agencies propose to extend the current net-of-tax treatment permitted in their existing capital standards to residual interests.<sup>17</sup> Thus, the proposed rule would permit: (1) Disallowed amounts of residual interests (that is, those amounts in excess of the 25 percent of Tier 1 capital sublimit) to be determined on a basis that is net of any associated deferred tax liability, and (2) any amounts of residual interests that are subject to the “dollar-for-dollar” capital requirement (that is, those amounts included in the 25 percent of Tier 1 capital sublimit) to be determined on a basis that is net of any associated deferred tax liability. In instances where there is no difference between the book basis and the tax basis of the residual interest, no deferred tax liability would be created. Any deferred tax liability used to reduce the capital requirement for a residual interest would not be available for the organization to use in determining the amount of net deferred tax assets that may be included in the calculation of Tier 1 capital.<sup>18</sup>

The following example helps illustrate the proposed tax treatment. Assume residual interests of \$100 with an associated deferred tax liability of \$35 and Tier 1 capital (before the deduction of any disallowed residual interests) of \$200. In this example, the 25 percent concentration limit on residual interests (when combined with nonmortgage servicing assets and

PCCRs) would be \$50 (*i.e.*, 25 percent times \$200). The amount of disallowed residual interests (before considering the associated deferred tax liability) would have been \$50. The deferred tax liability associated with the otherwise disallowed residual interests of \$50 would be \$17.50 (a \$35 associated deferred tax liability against \$100 in residual interests drives a 35 percent tax effect against the \$50 disallowed residual interest). Thus, the amount of disallowed residual interests to be deducted in determining Tier 1 capital under the leverage and risk-based capital standards net of the associated deferred tax liability would be \$32.50 (*i.e.*, the \$50 in disallowed residual interests minus the \$17.50 tax effect associated with the disallowed residual interests).

In determining risk-weighted assets, the remaining \$50 amount of residual interests allowable in Tier 1 would be subject to a “dollar-for-dollar” capital on a basis that is also net of the deferred tax liability associated with the \$50 residual interest. The deferred tax liability associated with the \$50 not deducted from Tier 1 capital would be \$17.50 (*i.e.*, the 35 percent tax effect as calculated above times \$50). Thus, the amount of residual interests that would be subjected to “dollar-for-dollar” treatment would be \$32.50 (\$50 less the \$17.50 in deferred tax liabilities). Calculation of this “dollar-for-dollar” capital charge is consistent with the “dollar-for-dollar” capital requirements that are currently required for low-level recourse transactions.

Other alternative calculations are possible and will be considered by the Agencies.<sup>19</sup> The Agencies seek comment on whether the complexity of a “net-of-tax” approach is necessary and justified,

and if so, what, if any, alternative calculations should be allowed.

#### C. Reservation of Authority

While this proposal should help remedy some of the major concerns associated with the generally illiquid and volatile nature of residual interests, the Agencies are also proposing to add language to the risk-based capital standards that will provide greater flexibility in administering the standards. Institutions are developing novel transactions that do not fit well into the risk-weight categories set forth in the standards. Institutions are also devising novel instruments that nominally fit into a particular risk-weight category, but that impose risks on the banking organization at levels that are not commensurate with the nominal risk-weight for the asset, exposure, or instrument. Accordingly, the Agencies are proposing to add language to the standards to clarify the Agencies’ authority, on a case-by-case basis, to determine the appropriate risk-weight asset amount in these circumstances. Exercise of this authority by the Agencies may result in a higher or lower risk weight for an asset. This reservation of authority explicitly recognizes the Agencies’ retention of sufficient discretion to ensure that institutions, as they develop novel financial assets, will be treated appropriately under the risk-based capital standards.

#### D. Relationship of This Residual Interest Proposal to the March 2000 Securitization Proposal

This proposed rule regarding residual interests (residual interest proposal) and the March 2000 notice of proposed rulemaking on the risk-based capital treatment of recourse arrangements, direct credit substitutes, and asset securitizations (the securitization proposal) are interrelated in that both proposals would address the regulatory capital treatment for residual interests that are retained in connection with securitizations and other transfers of financial assets.<sup>20</sup> The capital treatment of residual interests under the securitization proposal differs in certain respects from the treatment proposed in this residual interest proposal. In any final rule that addresses the regulatory capital treatment of residual interests, the Agencies will ensure that any regulatory capital treatment of residual

<sup>16</sup> The Agencies are also proposing minor technical changes. For example, this proposal does not effect the calculation of tangible equity the under prompt corrective action regulations. However, because the Agencies define tangible equity using different core capital concepts (*i.e.*, “core capital” vs. “core capital elements”), the OTS is proposing a technical revision to its definition of tangible equity (12 CFR 565.2(f)) to ensure that this calculation is not effected by the proposal.

In addition, the FDIC is also amending its regulations to remove an obsolete provision concerning the transitional 7.25 percent risk-based capital standard that was only effective until December 31, 1992. This provision currently appears in section III.B of appendix A to part 325. Similarly, OTS is making technical revisions to related regulatory provisions at 12 CFR 565.2(f).

<sup>17</sup> The proposed treatment is consistent with that permitted for low-level recourse exposures, disallowed servicing assets, and disallowed intangible assets in non-taxable business combinations.

<sup>18</sup> For example, see § 325.5(g) of the FDIC’s capital regulations (12 CFR 325.5(g)), which sets forth the limitations on the amount of deferred tax assets that state nonmember banks can recognize for purposes of calculating Tier 1 capital under the leverage and risk-based capital rules.

<sup>19</sup> Two additional treatments are possible. Under the first approach, the amount of residual interests subject to a “dollar-for-dollar” deduction for risk-based capital purposes, and a concentration limit for leverage capital purposes, would be the “at-risk” amount; that is, the residual interests reduced by any associated deferred tax liability. For example, assume residual interests of \$100 with an associated deferred tax liability of \$35. Under this approach, the amount of residual interests subject to a “dollar-for-dollar” capital charge and a concentration limit is \$65 (\$100 – \$35). In a worst-case scenario, if the value of the residual interests drops to zero, then the corresponding deferred tax liability would also drop to zero, and therefore capital would decline by \$65—the net-of-tax amount. If the 25% of Tier 1 concentration limitation is \$50, then the deduction would be \$15 (\$65 – \$50). Under the second approach, the amount of residual interests subject to the “dollar-for-dollar” capital requirement and 25% of Tier 1 capital concentration limit would be determined on a gross basis, that is, without netting the associated deferred tax liability.

<sup>20</sup> See 65 FR 12320 (March 8, 2000) for the text of the proposed revisions to the risk-based capital treatment of recourse arrangements, direct credit substitutes, and asset securitizations.

interests resulting from these two proposals will be consistent.

In the securitization proposal, the Agencies propose using external credit ratings to match the risk-based capital requirement more closely to the relative risk of loss in asset securitizations. Highly rated investment-grade positions in securitizations would receive a favorable (less than 100 percent) risk-weight. Below-investment grade or unrated positions in securitizations would receive a less favorable risk-weight (greater than 100 percent risk-weight or gross-up treatment). A residual interest retained by an institution in an asset securitization (as well as residual interests that are purchased) would be subject to this capital framework under the securitization proposal.

The residual interest proposal differs from the securitization proposal in several respects. For example, under the residual interest proposal, all residual interests that are retained by the institution and that fall within the 25 percent of Tier 1 capital limit would be subject to "dollar-for-dollar" capital treatment regardless of rating (and comment is sought on whether purchased interests should be treated similarly). To date, the Agencies believe that residual interests in asset securitizations generally are unrated and illiquid interests; however, as the market evolves, residual interests may in the future take the form of rated, liquid, certificated securities. If the rating provided to such a residual interest were investment grade (or no more than one category below investment grade) the securitization proposal would afford that residual interest more favorable capital treatment than the dollar-for-dollar capital requirement set forth in this residual interest proposal. In addition, the risk-based capital requirement for unrated residual interests that are subject to gross-up treatment under the securitization proposal would not exceed the full risk-based capital charge for the underlying assets that are being supported by the residual interest. Under this residual interest proposal, however, "dollar-for-dollar" capital would be required for the amount of the residual interest that is retained and falls within the 25 percent of Tier 1 capital limit, even if this amount exceeds the full capital charge typically held against the underlying assets that have been transferred with recourse. Also, unlike the residual interest proposal, the securitization proposal does not establish any concentration limit for residual interests as a percentage of capital.

These differences between the residual interest proposal and the securitization proposal will be taken into account in any final rule published under either proposal. In developing a final rule on residual interests, the Agencies specifically invite comment on how the capital treatment for residual interests under this residual interest proposal should be reconciled with the capital treatment set forth in the securitization proposal.

#### *E. Effective Date*

The Agencies intend to apply this proposal to existing as well as future transactions. Because banking organizations may need additional time to adapt to any new capital treatment, the Agencies may delay the effective date for a specific period of time (transition period). The Agencies view this transition period as an opportunity for institutions to consider the proposal's impact on their balance sheet structure and capital position. The Agencies invite comment on the need for and duration of a transition period.

#### **VI. Request for Public Comment**

The Agencies invite public comment on all aspects of the proposed rule. In particular, the Agencies request comment on the definition of residual interest, the treatment of residual interests in determining compliance with minimum capital requirements, the conditions established in the proposal, and the implementation of the proposal. The Agencies also specifically request comment on the "dollar-for-dollar" risk-based capital charge for residual interests, the 25 percent of Tier 1 capital concentration limit on the amount of residual interests that can be recognized for leverage and risk-based capital purposes, and the issue of whether a "net-of-associated deferred tax liability" approach is appropriate in determining the capital requirements for residual interests.

#### **VII. Plain Language**

Section 722 of the Gramm-Leach-Bliley (GLB) Act (12 U.S.C. 4809) requires federal banking agencies to use "plain language" in all proposed and final rules published after January 1, 2000. We invite your comments on how to make this proposed rule easier to understand. For example:

- (1) Have we organized the material to suit your needs?
- (2) Are the requirements in the rule clearly stated?
- (3) Does the rule contain technical language or jargon that isn't clear?
- (4) Would a different format (grouping and order of sections, use of headings,

paragraphing) make the rule easier to understand?

(5) Would more (but shorter) sections be better?

(6) What else could we do to make the rule easier to understand?

#### **VIII. Regulatory Analysis**

##### *A. Regulatory Flexibility Act Analysis*

*Board:* Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board has determined that this proposal will not have a significant impact on a substantial number of small business entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). The Board's comparison of the applicability section of this proposal with Call Report data on all existing banks shows that application of the proposal to small entities will be rare. Accordingly, a regulatory flexibility analysis is not required. 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 proposal will not affect such companies".

*FDIC:* Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) the FDIC hereby certifies that the final rule will not have a significant economic impact on a substantial number of small entities. Comparison of Call Report data on FDIC-supervised banks to the items covered by the proposal that result in increased capital requirements shows that application of the proposal to small entities will be the infrequent exception.

*OTS:* Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) the OTS certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Comparison of TFR data on OTS supervised savings associations regarding the items that would result in increased capital requirements indicate that the application of the proposal to small entities will be the infrequent exception.

*OCC:* Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) the OCC certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Call Report data indicate that generally small banks do not have large residual interests that exceed the full risk-based capital charge required for transferred assets, and typically do not hold residual interests in amounts that would exceed the 25 percent of Tier 1 capital limitation. For these reasons, the OCC believes that application of the proposed rule to small entities will be rare.



Consequently, a regulatory flexibility analysis is not required.

#### B. Paperwork Reduction Act

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

#### C. OCC and OTS Executive Order 12866 Statement

The Comptroller of the Currency and the Director of the OTS have determined that the proposal described in this notice is not a significant regulatory action under Executive Order 12866. Accordingly, a regulatory impact analysis is not required. Nonetheless the OCC specifically invites comment on the dollar impact of the proposed rule.

#### D. OCC and OTS Unfunded Mandates Act Statement

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 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 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 an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC and OTS have determined that this proposed rule will not result in expenditures by state, local, and tribal government, or by the private sector, of more than \$100 million or more in any one year. Based on the Call Report, TFR and other data, OTS and OCC estimate that those banks and savings associations that would be required to increase capital under the proposed rule will not incur additional expenses in this amount in any one year. Therefore, the OCC and OTS have not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered. Nonetheless the OCC specifically invites comment on the dollar impact of the proposed rule.

#### E. The Treasury and General Government Appropriations Act, 1999—Assessment of Federal Regulations and Policies on Families

The Agencies have determined that this proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

### 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 565

Administrative practice and procedures, Capital, Savings associations.

#### 12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

### Department of the Treasury

#### Office of the Comptroller of the Currency

#### 12 CFR Chapter I

#### Authority and Issuance

For the reasons set out in the joint preamble, the Office of the Comptroller of the Currency proposes to amend part 3 of chapter I of title 12 of the Code of Federal Regulations 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.

#### § 3.4 [Amended]

2. In § 3.4:

A. The existing text is designated as paragraph (a);

B. The second sentence in the newly designated paragraph (a) is revised; and

C. New paragraph (b) is added to read as follows:

#### § 3.4 Reservation of authority.

(a) \* \* \* Similarly, the OCC may find that a particular intangible asset need not be deducted from Tier 1 or Tier 2 capital. \* \* \*

(b) Notwithstanding the risk categories in section 3 of appendix A to this part, the OCC may find that the assigned risk weight for any asset does not appropriately reflect the risks imposed on a bank and may require another risk weight that the OCC deems appropriate. Similarly, if no risk weight is specifically assigned, the OCC may assign any risk weight that the OCC deems appropriate. In making its determination, the OCC considers risks associated with the asset as well as other relevant factors.

3. In appendix A to part 3:

A. In section 1:

i. Redesignate paragraphs (c)(25) through (c)(31) as paragraphs (c)(28) through (c)(34), paragraph (c)(24) as paragraph (c)(26), and paragraphs (c)(13) through (c)(23) as paragraphs (c)(14) through (c)(24);

ii. Add new paragraphs (c)(13), (c)(25), and (c)(27);

B. In section 2, revise paragraphs (c)(1)(ii), (c)(2) introductory text, (c)(2)(i), (c)(2)(ii) introductory text, (c)(2)(iii), and (c)(2)(iv);

C. In section 3, add new paragraph (e) to read as follows:

### Appendix A To Part 3—Risk-Based Capital Guidelines

#### Section 1. Purpose, Applicability of Guidelines, and Definitions

\* \* \* \* \*

(c) \* \* \*

(13) *Financial asset* means cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from a first entity or to exchange other financial instruments on potentially favorable terms with the first entity.

\* \* \* \* \*

(25) *Residual interest* means any on-balance sheet asset that represents an interest (including a beneficial interest) created by the transfer of financial assets, whether through a securitization or otherwise, and structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit enhancement techniques. Residual interests generally include interest only strips receivable, spread accounts, cash collateral accounts, retained subordinated interests and other similar forms of on-balance sheet assets that function as a credit enhancement. Residual interests do not include residual interests purchased from a third party.

\* \* \* \* \*

(27) *Securitization*. Securitization means the pooling and repackaging of loans or other



credit exposures into securities that can be sold to investors.

\* \* \* \* \*

*Section 2. Components of Capital*

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

\* \* \* \* \*

(ii) Other intangible assets and residual interests, except as provided in section 2(c)(2) of this appendix A; and \* \* \*

(2) *Qualifying intangible assets and residual interests.* Subject to the following conditions, mortgage servicing assets, nonmortgage servicing assets,<sup>6</sup> purchased credit card relationships and residual interests need not be deducted from Tier 1 capital:

(i) The total of all intangible assets and residual interests that are included in Tier 1 capital is limited to 100 percent of Tier 1 capital, of which no more than 25 percent of Tier 1 capital can consist of purchased credit card relationships, nonmortgage servicing assets and residual interests in the aggregate. Calculation of these limitations must be based on Tier 1 capital net of goodwill, and all identifiable intangible assets, other than mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships and residual interests.

(ii) Banks must value each intangible asset and residual interest included in Tier 1 capital at least quarterly. In addition, intangible assets included in Tier 1 capital must also be valued at the lesser of:

\* \* \* \* \*

(iii) The quarterly determination of the current fair value of the intangible asset or residual interest must include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates.

(iv) Banks may elect to deduct disallowed servicing assets and residual interests on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income.

\* \* \* \* \*

*Section 3. Risk Categories/Weights for On-Balance Sheet Assets and Off-Balance Sheet Items*

\* \* \* \* \*

(e) *Residual interests.* (1) General capital requirement. All residual interests are subject to both a capital concentration limit and a residual interest capital requirement in accordance with sections 3(e)(2) and 3(e)(3) of this appendix A. In determining the general capital requirement for a residual interest, the amount of all residual interests

in excess of the capital concentration limit must be deducted from Tier 1 capital, in accordance with section 3(e)(2) of this appendix A, before the residual interest capital requirement in section 3(e)(3) of this appendix A is applied.

(2) *Capital concentration limit.* In addition to the residual interest capital requirement provided by section 3(e)(3) of this appendix A, a bank must deduct from Tier 1 capital all residual interest in excess of the 25 percent sublimit on qualifying intangible assets and residual interests in accordance with section 2(c)(2)(i) of this appendix A.

(3) *Residual interests capital requirement.* A bank must maintain risk-based capital for a residual interest equal to the amount of the residual interest that is retained on the balance sheet (less any amount disallowed in accordance with section 3(e)(2) of this appendix A and net of any associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred.

(4) *Residual interests and other recourse obligations.* Where a bank holds a residual interest and another recourse obligation (such as a standby letter of credit) in connection with the same asset transfer, the bank must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under section 3(e)(3) of this appendix A or the full risk-based capital requirement for the assets transferred, subject to the low-level recourse rules under section 3(d) of this appendix A.

\* \* \* \* \*

Dated: August 16, 2000.

**John D. Hawke, Jr.,**  
*Comptroller of the Currency.*

**Federal Reserve System**

*12 CFR Chapter II*

**Authority and Issuance**

For the reasons set forth in the joint preamble, the Board of Governors of the Federal Reserve System proposes to amend parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations as follows:

**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. 24, 36, 92a, 93a, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831o, 1831p–1, 1831r–1, 1835a, 1882, 2901–2907, 3105, 3310, 3331–3351 and 3906–3909; 15 U.S.C. 78b, 781(b), 781(g), 781(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:

A. Section II.A.1. and the first seven paragraphs of section II.A.2. are revised, and footnote 5 is removed and reserved;

B. In sections II, III and IV, footnotes 13 through 52 are redesignated as footnotes 14 through 53.

C. In section II.B., a new paragraph (i)(c) and new footnote 14 are added, section II.B.1.b. and newly designated footnote 15 are revised, new sections II.B.1.c. through II.B.1.g. are added, and section II.B.4. is revised;

D. In section III.A., the four undesignated paragraphs are designated as sections III.A.1. through III.A.4., and a new section III.A.5. is added.

E. Section III.B.6. is added.

F. Attachment II is revised.

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

\* \* \* \* \*

II. \* \* \*

A. \* \* \*

1. *Core capital elements (tier 1 capital).*

The tier 1 component of a bank's qualifying capital must represent at least 50 percent of qualifying total capital and may consist of the following items that are defined as core capital elements:

- (i) Common stockholders' equity;
- (ii) Qualifying noncumulative perpetual preferred stock (including related surplus);
- (iii) Minority interest in the equity accounts of consolidated subsidiaries.

Tier 1 capital is generally defined as the sum of core capital elements<sup>5</sup> less goodwill, other intangible assets, and residual interests required to be deducted in accordance with section II.B.1. of this appendix A.

\* \* \* \* \*

2. *Supplementary capital elements (tier 2 capital).* The tier 2 component of a bank's qualifying 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 A).

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, other intangible assets, and residual interests required to be deducted in accordance with section II.B.1. of this appendix A).

\* \* \* \* \*

B. \* \* \*

<sup>5</sup> [Reserved]

<sup>6</sup> Intangible assets are defined to exclude any IO strips receivable related to these mortgage and non-mortgage servicing assets. See section 1(c)(14) of this appendix A. Consequently, IO strips receivable related to mortgage and non-mortgage servicing assets are not required to be deducted under section 2(2)(2) of this appendix A. However, these IO strips receivable are subject to a 100 percent risk weight under section 3(a)(4) of this appendix A.

(i) \* \* \*

(c) Certain on-balance sheet residual interests—deducted from the sum of core capital elements in accordance with sections II.B.1.c. through e. of this appendix A.<sup>14</sup>

\* \* \* \* \*

1. *Goodwill, other intangible assets, and residual interests.* \* \* \*

b. *Other intangible assets.* i. All servicing assets, including servicing assets on assets other than mortgages (*i.e.*, nonmortgage servicing assets), are included in this appendix as identifiable intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, a bank's capital are readily marketable mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships. The total amount of these assets that may be included in capital is subject to the limitations described below in sections II.B.1.d. and e. of this appendix A.

ii. The treatment of identifiable intangible assets set forth in this section generally will be used in the calculation of a bank's capital ratios for supervisory and applications purposes. However, in making an overall assessment of a bank's capital adequacy for applications purposes, the Board may, if it deems appropriate, take into account the quality and composition of a bank's capital, together with the quality and value of its tangible and intangible assets.

c. *Residual interests.* Residual interests may be included in, that is, not deducted from, a bank's capital subject to the limitations described below in sections II.B.1.d. and e. of this appendix A.

d. *Fair value limitation.* The amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that a bank may include in capital shall be the lesser of 90 percent of their fair value, as determined in accordance with section II.B.1.f. of this appendix A, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions in the commercial bank Consolidated Reports of Condition and Income (Call Reports). The amount of residual interests a bank may include in capital shall be 100 percent of its book value. If both the application of the limits on mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and residual interests and the adjustment of the balance sheet amount for these assets would result in an amount being deducted from capital, the bank would deduct only the greater of the two amounts

<sup>14</sup> Residual interests consist of balance sheet assets that: (a) Represent interests (including beneficial interests) in transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets; and (b) are structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit enhancement techniques. Residual interests do not include interests purchased from a third party. Residual interests generally include interest-only strips receivable, spread accounts, cash collateral accounts, retained subordinated interests, and other similar forms of on-balance sheet assets that function as a credit enhancement.

from its core capital elements in determining tier 1 capital.

e. *Tier 1 capital limitation.* i. The total amount of mortgage and nonmortgage servicing assets, purchased credit card relationships, and residual interests that may be included in capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. Nonmortgage servicing assets, purchased credit card relationships, and residual interests, in the aggregate, are subject to a separate sublimit of 25 percent of tier 1 capital.<sup>15</sup>

ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and residual interests, tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed residual interests, and any disallowed deferred-tax assets, regardless of the date acquired.

iii. Banks may elect to deduct disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, and disallowed residual interests on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred-tax assets when determining the amount of deferred-tax assets that are dependent upon future taxable income.

f. *Valuation.* Banks must review the book value of all intangible assets and residual interests at least quarterly and make adjustments to these values as necessary. The fair value of mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and residual interests also must be determined at least quarterly. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates. Examiners will review both the book value and the fair value assigned to these assets, together with supporting documentation, during the examination process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of a bank's intangible assets or residual interests.

g. *Growing organizations.* Consistent with long-standing Board policy, banks experiencing substantial growth, whether internally or by acquisition, are expected to

<sup>15</sup> Amounts of servicing assets, purchased credit card relationships, and residual interests in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a bank's core capital elements in determining tier 1 capital. However, identifiable intangible assets (other than mortgage servicing assets and purchased credit card relationships) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets or residual interests.

\* \* \* \* \*

4. *Deferred-tax assets.* The amount of deferred-tax assets that is dependent upon future taxable income, net of the valuation allowance for deferred-tax assets, that may be included in, that is, not deducted from, a bank's capital may not exceed the lesser of:

(i) The amount of these deferred-tax assets that the bank is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year,<sup>21</sup> or

(ii) 10 percent of tier 1 capital. The reported amount of deferred-tax assets, net of any valuation allowance for deferred-tax assets, in excess of the lesser of these two amounts is to be deducted from a bank's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than mortgage and nonmortgage servicing assets, purchased credit card relationships, prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed residual interests, and any disallowed deferred-tax assets. There generally is no limit in tier 1 capital on the amount of deferred-tax assets that can be realized from taxes paid in prior carry-back years or from future reversals of existing taxable temporary differences, but, for banks that have a parent, this may not exceed the amount the bank could reasonably expect its parent to refund.

III. \* \* \*

A. \* \* \*

5. The Federal Reserve will, on a case-by-case basis, determine the appropriate risk-weight for any asset that does not fit wholly within one of the risk categories set forth below or that imposes risks on a bank that are not commensurate with the risk weight otherwise specified below for the asset.

B. \* \* \*

6. *Residual interests—*a. *General capital requirement.* All residual interests are subject to both a residual interest capital requirement and a capital concentration limitation in accordance with sections II.B.1.e. and III.B.6.b. of this appendix A. In determining

<sup>21</sup> To determine the amount of expected deferred-tax assets realizable in the next 12 months, an institution should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating loss carry-forwards to be used during that year or the amount of existing temporary differences a bank expects to reverse within the year. Such projections should include the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating losses or tax-credit carry-forwards that would otherwise expire during the year. Institutions do not have to prepare a new 12-month projection each quarter. Rather, on interim report dates, institutions may use the future-taxable income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

the capital requirement for a residual interest, the amount of all residual interests in excess of the capital concentration limit must be deducted from tier 1 capital, in accordance with section II.B.1.e. of this appendix A, before the residual interest capital requirement in this section is applied.

b. *Residual interest capital requirement.* Notwithstanding section III.D.1.g. of this appendix A, a bank must maintain capital for a residual interest equal to the amount of the residual interest that is retained on the

balance sheet (less any amount disallowed in accordance with section II.B.1.e. of this appendix A and net of any associated deferred tax liability), even if the amount of capital required to be maintained exceeds the standard capital charge that would be required under section IV.A. of this appendix A for assets transferred.

c. *Multiple recourse obligations.* Where a bank holds a residual interest and another recourse obligation (such as a standby letter of credit) in connection with the same asset

transfer, the bank must maintain risk-based capital equal to the greater of:

- (i) The risk-based capital requirement for the residual interest as calculated under section III.B.6.b. of this appendix A; or
- (ii) The full risk-based capital requirement for the assets transferred, subject to the low-level recourse rules (section III.D.1.g. of this appendix A).

\* \* \* \* \*

**ATTACHMENT II.—SUMMARY OF DEFINITION OF QUALIFYING CAPITAL FOR STATE MEMBER BANKS\***  
[Using the Year-End 1992 Standards]

Components	Minimum requirements after transition period
Core Capital (tier 1) .....	Must equal or exceed 4% of weighted-risk assets.
Common stockholders' equity .....	No limit.
Qualifying noncumulative perpetual preferred stock .....	No limit; banks should avoid undue reliance on preferred stock in tier 1.
Minority interest in equity accounts of consolidated Subsidiaries ....	Banks should avoid using minority interests to introduce elements not otherwise qualifying for tier 1 capital.
Less: Goodwill, other intangible assets, and residual interests required to be deducted from capital <sup>1</sup>	
Supplementary Capital (tier 2) .....	Total of tier 2 is limited to 100% of tier 1. <sup>2</sup>
Allowance for loan and lease losses .....	Limited to 1.25% of weighted-risk assets. <sup>2</sup>
Perpetual preferred stock .....	No limit within tier 2.
Hybrid capital instruments and equity contract notes .....	No limit within tier 2.
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more).	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1, <sup>2</sup> amortized for capital purposes as they approach maturity.
Revaluation reserves (equity and building) .....	Not included; banks encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making and overall assessment of capital.
Deductions (from sum of tier 1 and tier 2):	
Investments in unconsolidated subsidiaries .....	As a general rule, one-half of the aggregate investments will be deducted from tier 1 capital and one-half from tier 2 capital. <sup>3</sup>
Reciprocal holdings of banking organizations' capital securities.	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority.	On a case-by-case basis or as a matter of policy after formal rule-making.
Total Capital (tier 1+tier 2 – deductions) .....	Must equal or exceed 8% of weighted-risk assets.

<sup>1</sup> Requirements for the deduction of other intangible assets and residual interests are set forth in section II.B.1. of this appendix.

<sup>2</sup> Amounts in excess of limitations are permitted but do not qualify as capital.

<sup>3</sup> A proportionately greater amount may be deducted from tier 1 capital, if the risks associated with the subsidiary so warrant.

\* See discussion in section II of the guidelines for a complete description of the requirements for, and the limitations on, the components of qualifying capital.

3. In appendix B to part 208, section II. b. is revised to read as follows:

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

\* \* \* \* \*

II. b. A bank's Tier 1 leverage ratio is calculated by dividing its Tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of Tier 1 capital as set forth in the risk-based capital guidelines contained in appendix A of this part will be used.<sup>2</sup> As a general matter,

<sup>2</sup> Tier 1 capital for state member banks includes common equity, minority interest in the equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, as a general matter, Tier 1 capital excludes goodwill; amounts of mortgage servicing

average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income (Call Reports), less goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and residual interests that, in the aggregate, are in excess of 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets, purchased credit card relationships, and residual interests that, in the aggregate, are in excess of 25 percent of Tier 1 capital; all other

assets, nonmortgage servicing assets, purchased credit card relationships, and residual interests that, in the aggregate, exceed 100 percent of Tier 1 capital; nonmortgage servicing assets, purchased credit card relationships, and residual interests that, in the aggregate, exceed 25 percent of Tier 1 capital; other identifiable intangible assets; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of appendix A of this part.<sup>3</sup>

\* \* \* \* \*

**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(l), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

<sup>3</sup> Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A of this part.

2. In appendix A to part 225:

A. Section II.A.1. and the first seven paragraphs of section II.A.2. are revised, and footnote 6 is removed and reserved;

B. In sections II, III and IV, footnotes 13 through 57 are redesignated as footnotes 14 through 58.

C. In section II.B., a new paragraph (i)(c) and new footnote 15 are added, section II.B.1.b and newly designated footnote 16 are revised, new sections II.B.1.c. through II.B.1.g. are added, and section II.B.4. is revised.

D. In section III.A, the four undesignated paragraphs are designated as sections III.A.1. through III.A.4. and a new section III.A.5, is added.

E. Section III.B.6. is added.

F. Attachment II is revised.

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

\* \* \* \* \*

II. \* \* \*

A. \* \* \*

#### 1. Core capital elements (tier 1 capital).

The tier 1 component of an institution's qualifying capital must represent at least 50 percent of qualifying total capital and may consist of the following items that are defined as core capital elements:

- (i) Common stockholders' equity;
- (ii) Qualifying noncumulative perpetual preferred stock (including related surplus);
- (iii) Qualifying cumulative perpetual preferred stock (including related surplus); subject to certain limitations described below;
- (iv) Minority interest in the equity accounts of consolidated subsidiaries. Tier 1 capital is generally defined as the sum of core capital elements<sup>6</sup> less goodwill, other intangible assets, and residual interests required to be deducted in accordance with section II.B.1. of this appendix A.

\* \* \* \* \*

2. *Supplementary capital elements (tier 2 capital).* The tier 2 component of an institution's qualifying 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 A).

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,

other intangible assets, and residual interests required to be deducted in accordance with section II.B.1. of this appendix A).

\* \* \* \* \*

B. \* \* \*

(i) \* \* \*

(c) Certain on-balance sheet residual interests deducted from the sum of core capital elements in accordance with sections II.B.1.c. through e. of this appendix A.<sup>15</sup>

\* \* \* \* \*

#### 1. *Goodwill, other intangible assets, and residual interests.* \* \* \*

b. *Other intangible assets.* i. All servicing assets, including servicing assets on assets other than mortgages (*i.e.*, nonmortgage servicing assets), are included in this appendix as identifiable intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, an organization's capital are readily marketable mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships. The total amount of these assets that may be included in capital is subject to the limitations described below in sections II.B.1.d. and e. of this appendix A.

ii. The treatment of identifiable intangible assets set forth in this section generally will be used in the calculation of a bank holding company's capital ratios for supervisory and applications purposes. However, in making an overall assessment of an organization's capital adequacy for applications purposes, the Board may, if it deems appropriate, take into account the quality and composition of an organization's capital, together with the quality and value of its tangible and intangible assets.

c. *Residual interests.* Residual interests may be included in, that is, not deducted from, an organization's capital subject to the limitations described below in sections II.B.1.d. and e. of this appendix A.

d. *Fair value limitation.* The amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that a bank holding company may include in capital shall be the lesser of 90 percent of their fair value, as determined in accordance with section II.B.1.f. of this appendix A, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C Report). The amount of residual interests a bank holding company may include in capital shall be 100 percent of its book value. If both the application of the limits on mortgage

<sup>15</sup> Residual interests consist of balance sheet assets that: (a) Represent interests (including beneficial interests) in transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets; and (b) are structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit enhancement techniques. Residual interests do not include interests purchased from a third party. Residual interest include interest-only strips receivable, spread accounts, cash collateral accounts, retained subordinated interests, and similar on-balance sheet assets that function as a credit enhancement.

servicing assets, nonmortgage servicing assets, purchased credit card relationships, and residual interests and the adjustment of the balance sheet amount for these assets would result in an amount being deducted from capital, the bank holding company would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

e. *Tier 1 capital limitation.* i. The total amount of mortgage and nonmortgage servicing assets, purchased credit card relationships, and residual interests that may be included in capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. Nonmortgage servicing assets, purchased credit card relationships, and residual interests, in the aggregate, are subject to a separate sublimit of 25 percent of tier 1 capital.<sup>16</sup>

ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and residual interests, tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed residual interests, and any disallowed deferred-tax assets, regardless of the date acquired.

iii. Bank holding companies may elect to deduct disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, and disallowed residual interests on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income.

f. *Valuation.* Bank holding companies must review the book value of all intangible assets and residual interests at least quarterly and make adjustments to these values as necessary. The fair value of mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and residual interests also must be determined at least quarterly. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates. Examiners will review both the book value and the fair value assigned to these assets, together with supporting documentation, during the inspection

<sup>16</sup> Amounts of servicing assets, purchased credit card relationships, and residual interests in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from an organization's core capital elements in determining tier 1 capital. However, identifiable intangible assets (other than mortgage servicing assets and purchased credit card relationships) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

<sup>6</sup> [Reserved]

process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of an organization's intangible assets or residual interests.

g. *Growing organizations.* Consistent with long-standing Board policy, banking organizations experiencing substantial growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets or residual interests.

\* \* \* \* \*

4. *Deferred-tax assets.* The amount of deferred-tax assets that is dependent upon future taxable income, net of the valuation allowance for deferred-tax assets, that may be included in, that is, not deducted from, a banking organization's capital may not exceed the lesser of:

(i) The amount of these deferred-tax assets that the banking organization is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year,<sup>24</sup> or

(ii) 10 percent of tier 1 capital. The reported amount of deferred-tax assets, net of any valuation allowance for deferred-tax assets, in excess of the lesser of these two amounts is to be deducted from a banking organization's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1

capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than mortgage and nonmortgage servicing assets, purchased credit card relationships, prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed residual interests, and any disallowed deferred-tax assets. There generally is no limit in tier 1 capital on the amount of deferred-tax assets that can be realized from taxes paid in prior carry-back years or from future reversals of existing taxable temporary differences.

III. \* \* \*

A. \* \* \*

5. The Federal Reserve will, on a case-by-case basis, determine the appropriate risk weight for any asset that does not fit wholly within one of the risk categories set forth below or that imposes risks on a bank holding company that are not commensurate with the risk weight otherwise specified below for the asset.

B. \* \* \*

6. *Residual interests—*a. *General capital requirement.* All residual interests are subject to both a residual interest capital requirement and a capital concentration limitation in accordance with sections II.B.1.e. and III.B.6.b. of this appendix A. In determining the capital requirement for a residual

interest, the amount of all residual interests in excess of the capital concentration limit must be deducted from tier 1 capital, in accordance with section II.B.1.e. of this appendix A, before the residual interest capital requirement in this section is applied.

b. *Residual interest capital requirement.* Notwithstanding section III.D.1.g. of this appendix A, organizations must maintain capital for a residual interest equal to the amount of the residual interest (less any amount disallowed in accordance with section II.B.1.e. of this appendix A and net of any associated deferred tax liability), even if the amount of capital required to be maintained exceeds the standard capital charge under section IV.A. of this appendix A for the assets transferred.

c. *Multiple recourse obligations.* Where an organization holds a residual interest and another recourse obligation (such as a standby letter of credit) in connection with the same asset transfer, the organization must maintain risk-based capital equal to the greater of:

(i) The risk-based capital requirement for the residual interest as calculated under section III.B.6.b of this appendix A; or

(ii) The full risk-based capital requirement for the assets transferred, subject to the low-level recourse rules (section III.D.1.g. of this appendix A).

\* \* \* \* \*

ATTACHMENT II—SUMMARY DEFINITION OF QUALIFYING CAPITAL FOR BANK HOLDING COMPANIES\*

[Using the year-end 1992 standards]

Components	Minimum requirements after transition period
Core Capital (tier 1) .....	Must equal or exceed 4% of weighted-risk assets.
Common stockholders' equity .....	No limit.
Qualifying noncumulative perpetual preferred stock .....	No limit.
Qualifying cumulative perpetual preferred stock .....	Limited to 25% of the sum of common stock, qualifying perpetual preferred stock, and minority interests.
Minority interest in equity accounts of consolidated subsidiaries .....	Organizations should avoid using minority interests to introduce elements not otherwise qualifying for tier 1 capital.
Less: Goodwill, other intangible assets, and residual interests required to be deducted from capital <sup>1</sup> .....	
Supplementary Capital (tier 2) .....	Total of tier 2 is limited to 100% of tier 1. <sup>2</sup>
Allowance for loan and lease losses .....	Limited to 1.25% of weighted-risk assets. <sup>2</sup>
Perpetual preferred stock .....	No limit within tier 2.
Hybrid capital instruments, perpetual debt, and mandatory convertible securities .....	No limit within tier 2.
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more) .....	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1; <sup>2</sup> amortized for capital purposes as they approach maturity.
Revaluation reserves (equity and building) .....	Not included; organization encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making and overall assessment of capital.
Deductions (from sum of tier 1 and tier 2):	
Investments in unconsolidated subsidiaries .....	As a general rule, one-half of the aggregate investments will be deducted from tier 1 capital and one-half from tier 2 capital. <sup>3</sup>

<sup>24</sup> To determine the amount of expected deferred-tax assets realizable in the next 12 months, an institution should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating loss carry-forwards to be used during that year or the amount of existing

temporary differences a bank holding company expects to reverse within the year. Such projections should include the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating losses or tax-credit carry-forwards that would otherwise expire during the year. Institutions do not have to prepare

a new 12-month projection each quarter. Rather, on interim report dates, institutions may use the future-taxable income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

ATTACHMENT II—SUMMARY DEFINITION OF QUALIFYING CAPITAL FOR BANK HOLDING COMPANIES\*—Continued  
 [Using the year-end 1992 standards]

Components	Minimum requirements after transition period
Reciprocal holdings of banking organizations' capital securities Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority Total Capital (tier 1 + tier 2 – deductions) .....	Must equal or exceed 8% of weighted-risk assets.

<sup>1</sup> Requirements for the deduction of other intangible assets and residual interests are set forth in section II.B.1.e. of this appendix.

<sup>2</sup> Amounts in excess of limitations are permitted but do not qualify as capital.

<sup>3</sup> A proportionally greater amount may be deducted from tier 1 capital.

\* See discussion in section II of this appendix for a complete description of the requirements for, and the limitations on, the components of qualifying capital.

3. In appendix D to part 225, section II.b. is revised to read as follows:

**Appendix D to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Tier 1 Leverage Measure**

\* \* \* \* \*

II. \* \* \*

b. A banking organization's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital as set forth in the risk-based capital guidelines contained in appendix A of this part will be used.<sup>3</sup> As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the organization's Consolidated Financial Statements (FR Y-9C Report), less goodwill; amounts of mortgage-servicing assets, nonmortgage-servicing assets, purchased credit-card relationships, and residual interests that, in the aggregate, are in excess of 100 percent of tier 1 capital; amounts of nonmortgage-servicing assets, purchased credit-card relationships, and residual interests that, in the aggregate, are in excess of 25 percent of tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from tier 1 capital; and deferred-tax assets that are

dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of appendix A of this part.<sup>4</sup>

\* \* \* \* \*

By order of the Board of Governors of the Federal Reserve System, September 13, 2000.

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

**Federal Deposit Insurance Corporation**

*12 CFR Chapter III*

Authority and Issuance

For the reasons set out in the joint preamble, the Board of Directors of the Federal Deposit Insurance Corporation proposes to amend part 325 of chapter III of title 12 of the Code of Federal Regulations as follows:

**PART 325—CAPITAL MAINTENANCE**

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

**Authority:** 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 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).

**§ 325.2 [Amended]**

2. In § 325.2:

- A. Redesignate paragraphs (s) through (x) as paragraphs (v) through (aa), paragraphs (q) through (r) as paragraphs (s) through (t), and paragraphs (g) through (p) as paragraphs (h) through (q);
- B. Add new paragraphs (g), (r), and (u);
- C. Revise newly designated paragraphs (w) and (y) to read as follows:

C. Revise newly designated paragraphs (w) and (y) to read as follows:

**§ 325.2 Definitions.**

\* \* \* \* \*

<sup>4</sup> Deductions from tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A of this part.

(g) *Financial assets* means cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right:

(1) To receive cash or another financial instrument from a first entity; or

(2) To exchange other financial instruments on potentially favorable terms with the first entity.

\* \* \* \* \*

(r) *Residual interests* means:

(1) Balance sheet assets that:

- (i) Represent interests (including beneficial interests) in transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets; and
- (ii) Are structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit enhancement techniques.

(2) *Exclusion.* Residual interests do not include interests purchased from a third party.

(3) *Examples.* Residual interests include interest only strips receivable, spread accounts, cash collateral accounts, retained subordinated interests, and other similar forms of on-balance sheet assets that function as a credit enhancement.

\* \* \* \* \*

(u) *Securitization* means the pooling and repackaging of loans or other credit exposures into securities that can be sold to investors.

\* \* \* \* \*

(w) *Tier 1 capital* or *core capital* means the sum of common stockholders' equity, noncumulative perpetual preferred stock (including any related surplus), and minority interests in consolidated subsidiaries, minus all intangible assets (other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f) and qualifying supervisory goodwill eligible for inclusion in core capital pursuant to 12 CFR part 567), minus residual

<sup>3</sup> Tier 1 capital for banking organizations includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of tier 1 capital.) In addition, as a general matter, tier 1 capital excludes goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and residual interests that, in the aggregate, exceed 100 percent of tier 1 capital; nonmortgage servicing assets, purchased credit card relationships, and residual interests that, in the aggregate, exceed 25 percent of tier 1 capital; all other identifiable intangible assets; and deferred-tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

interests (other than residual interests eligible for inclusion in core capital pursuant to § 325.5(f)), minus deferred tax assets in excess of the limit set forth in § 325.5(g), minus identified losses (to the extent that Tier 1 capital would have been reduced if the appropriate accounting entries to reflect the identified losses had been recorded on the insured depository institution's books), and minus investments in securities subsidiaries subject to 12 CFR 337.4.

\* \* \* \* \*

(y) *Total assets* means the average of total assets required to be included in a banking institution's "Reports of Condition and Income" (Call Report) or, for savings associations, the consolidated total assets required to be included in the "Thrift Financial Report," as these reports may from time to time be revised, as of the most recent report date (and after making any necessary subsidiary adjustments for state nonmember banks as described in §§ 325.5(c) and 325.5(d) of this part), minus intangible assets (other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f) and qualifying supervisory goodwill eligible for inclusion in core capital pursuant to 12 CFR part 567), minus residual interests (other than residual interests eligible for inclusion in core capital pursuant to § 325.5(f)), minus deferred tax assets in excess of the limit set forth in § 325.5(g), and minus assets classified loss and any other assets that are deducted in determining Tier 1 capital. For banking institutions, the average of total assets is found in the Call Report schedule of quarterly averages. For savings associations, the consolidated total assets figure is found in Schedule CSC of the Thrift Financial Report.

3. In § 325.5, revise paragraphs (f) and (g)(2) to read as follows:

#### § 325.5 Miscellaneous.

\* \* \* \* \*

(f) *Treatment of mortgage servicing assets, purchased credit card relationships, nonmortgage servicing assets, and residual interests.* For purposes of determining Tier 1 capital under this part, mortgage servicing assets, purchased credit card relationships, nonmortgage servicing assets, and residual interests will be deducted from assets and from common stockholders' equity to the extent that these items do not meet the conditions, limitations, and restrictions described in this section. Banks may elect to deduct disallowed servicing assets and disallowed residual interests on a basis

that is net of any associated deferred tax liability. Any deferred tax liability netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income and calculating the maximum allowable amount of these assets under paragraph (g) of this section.

(1) *Valuation.* The fair value of mortgage servicing assets, purchased credit card relationships, nonmortgage servicing assets, and residual interests shall be estimated at least quarterly. The quarterly fair value estimate shall include adjustments for any significant changes in the original valuation assumptions, including changes in prepayment estimates or attrition rates. The FDIC in its discretion may require independent fair value estimates on a case-by-case basis where it is deemed appropriate for safety and soundness purposes.

(2) *Fair value limitation.* For purposes of calculating Tier 1 capital under this part (but not for financial statement purposes), the balance sheet assets for mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets will each be reduced to an amount equal to the lesser of:

(i) 90 percent of the fair value of these assets, determined in accordance with paragraph (f)(1) of this section; or

(ii) 100 percent of the remaining unamortized book value of these assets (net of any related valuation allowances), determined in accordance with the instructions for the preparation of the Consolidated Reports of Income and Condition (Call Reports).

(3) *Tier 1 capital limitation.* The maximum allowable amount of mortgage servicing assets, purchased credit card relationships, nonmortgage servicing assets, and residual interests in the aggregate, will be limited to the lesser of:

(i) 100 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed nonmortgage servicing assets, any disallowed residual interests, and any disallowed deferred tax assets; or

(ii) The sum of the amounts of mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets, determined in accordance with paragraph (f)(2) of this section, plus the amount of residual interests determined in accordance with paragraph (f)(1) of the section.

(4) *Tier 1 capital sublimit.* In addition to the aggregate limitation on mortgage servicing assets, purchased credit card relationships, nonmortgage servicing assets, and residual interests set forth in paragraph (f)(3) of this section, a sublimit will apply to purchased credit card relationships, nonmortgage servicing assets, and residual interests. The maximum allowable amount of the aggregate of purchased credit card relationships, nonmortgage servicing assets, and residual interests, will be limited to the lesser of:

(i) Twenty-five percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed nonmortgage servicing assets, any disallowed residual interests, and any disallowed deferred tax assets; or

(ii) The sum of the amounts of purchased credit card relationships and nonmortgage servicing assets determined in accordance with paragraph (f)(2) of this section, plus the amount of residual interests determined in accordance with paragraph (f)(1) of the section.

(g)(2) \* \* \*

(2) *Tier 1 capital limitations.* (i) The maximum allowable amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, will be limited to the lesser of:

(A) The amount of deferred tax assets that are dependent upon future taxable income that is expected to be realized within one year of the calendar quarter-end date, based on projected future taxable income for that year; or

(B) Ten percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed residual interests and any disallowed deferred tax assets.

(iii) For purposes of this limitation, all existing temporary differences should be assumed to fully reverse at the calendar quarter-end date. The recorded amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, in excess of this limitation will be deducted from assets and from equity capital for purposes of determining Tier 1 capital under this part. The amount of deferred tax assets that can be realized from taxes paid in prior carryback years and from the reversal of existing taxable temporary differences generally would not be deducted from assets and from equity



capital. However, notwithstanding the above, the amount of carryback potential that may be considered in calculating the amount of deferred tax assets that a member of a consolidated group (for tax purposes) may include in Tier 1 capital may not exceed the amount which the member could reasonably expect to have refunded by its parent.

\* \* \* \* \*

4. In appendix A to part 325:

A. Revise section I.A.1.;

B. In section II:

i. Designate the first two undesignated paragraphs as sections II.A.1. and II.A.2., respectively, and add a new section II.A.3.;

ii. Revise section II.B.5., and add new section II.B.7.;

iii. Amend paragraph II.C. by revising the second paragraph under “Category 4—100 Percent Risk Weight”;

C. Revise section III; and

D. Revise Table I to read as follows:

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

\* \* \* \* \*

I. \* \* \*

A. \* \* \*

1. Core capital elements (Tier 1) consists of:

i. Common stockholders’ equity capital (includes common stock and related surplus, undivided profits, disclosed capital reserves that represent a segregation of undivided profits, and foreign currency translation adjustments, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values);

ii. Noncumulative perpetual preferred stock,<sup>2</sup> including any related surplus; and

iii. Minority interests in the equity capital accounts of consolidated subsidiaries.

At least 50 percent of the qualifying total capital base should consist of Tier 1 capital. Core (Tier 1) capital is defined as the sum of core capital elements<sup>3</sup> minus all intangible assets (other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f))<sup>4</sup> minus residual interests (other than residual interests eligible for inclusion

in core capital pursuant to § 325.5(f) and minus any disallowed deferred tax assets.

Although nonvoting common stock, noncumulative perpetual preferred stock, and minority interests in the equity capital accounts of consolidated subsidiaries are normally included in Tier 1 capital, voting common stockholders’ equity generally will be expected to be the dominant form of Tier 1 capital. Thus, banks should avoid undue reliance on nonvoting equity, preferred stock and minority interests.

Although minority interests in consolidated subsidiaries are generally included in regulatory capital, exceptions to this general rule will be made if the minority interests fail to provide meaningful capital support to the consolidated bank. Such a situation could arise if the minority interests are entitled to a preferred claim on essentially low risk assets of the subsidiary. Similarly, although residual interests and intangible assets in the form of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships are generally recognized for risk-based capital purposes, the deduction of part or all of the residual interests, mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships may be required if the carrying amounts of these rights are excessive in relation to their market value or the level of the bank’s capital accounts.

Residual interests, mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships that do not meet the conditions, limitations and restrictions described in § 325.5(g) of this part will not be recognized for risk-based capital purposes.

\* \* \* \* \*

II. \* \* \*

A. \* \* \*

3. The Director of the Division of Supervision may, on a case-by-case basis, determine the appropriate risk weight for any asset that does not fit wholly within one of the risk categories set forth in sections II.B. and II.C. of this appendix A or that imposes risks on a bank that are not commensurate with the risk weight otherwise specified in sections II.B. and II.C. of this appendix A for the asset.

\* \* \* \* \*

B. \* \* \*

5. Mortgage-Backed Securities. Mortgage-backed securities, including pass-throughs and collateralized mortgage obligations (but not stripped mortgage-backed securities) that are issued or guaranteed by a U.S. Government agency or a U.S. Government-

sponsored agency, normally are assigned to the risk weight category appropriate to the issuer or guarantor. Generally, a privately-issued mortgage-backed security is treated as essentially an indirect holding of the underlying assets, and assigned to the same risk category as the underlying assets, in accordance with the provisions and criteria spelled out in detail in the accompanying footnote;<sup>14</sup> however, such privately-issued

mortgage-backed securities may not be assigned to the zero percent risk category. Privately-issued mortgage-backed securities whose structures do not comply with the specified provisions set forth in the footnote are assigned to the 100 percent risk category. In addition, any class of a mortgage-backed security, other than a residual interest, that can absorb more than its *pro rata* share of loss without the whole issue being in default (for example, a subordinated class) will also be assigned to the 100 percent risk weight category. All stripped mortgage-backed securities, including interest-only strips (IOs) (unless covered under section II.B.7. of this appendix A), principal-only strips (POs), and similar instruments, are assigned to the 100 percent risk weight category, regardless of the issuer or guarantor.

\* \* \* \* \*

7. Residual interests—a. General capital requirement. All residual interests are subject to both a residual interest capital requirement and a capital concentration limitation in accordance with § 325.5 of this part. In determining the general capital requirement for a residual interest, the amount of all residual interest in excess of the capital concentration limit must be deducted from Tier 1 capital, in accordance with § 325.5 of this part, before the residual interest capital requirement in this section is applied.

b. Residual interest capital requirement. Notwithstanding section III. of this appendix A, a bank must maintain risk-based capital for a residual interest equal to the amount of the residual interest that is retained on the balance sheet (less any amount disallowed in accordance with § 325.5 and net of any associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred.

c. Recourse Obligation. Where a bank holds a residual interest and another recourse obligation (such as a standby letter of credit) in connection with the same asset transfer, the bank must maintain risk-based capital equal to the greater of: The risk-based capital requirement for the residual interest as calculated under section II.B.7.b. of this appendix A; or the full risk-based capital requirement for the assets transferred, subject to the low-level recourse rules (section II.D.1. of this appendix A).

\* \* \* \* \*

C. \* \* \*

interest in the underlying assets on behalf of the holders of the security, (2) either the holder of the security has an undivided *pro rata* ownership interest in the underlying mortgage assets or the trust or single purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities (3) the security is structured such that the cash flow from the underlying assets in all cases fully meets the cash flow requirements of the security without undue reliance on any reinvestment income, and (4) there is no material reinvestment risk associated with any funds awaiting distribution to the holders of the security. In addition, if the underlying assets of a mortgage-backed security are composed of more than one type of asset, the entire mortgage-backed security is generally assigned to the category appropriate to the highest risk-weighted asset underlying the issue.

<sup>2</sup> Preferred stock issues where the dividend is reset periodically based, in whole or in part, upon the bank’s current credit standing, including but not limited to, auction rate, money market or remarketable preferred stock, are assigned to Tier 2 capital, regardless of whether the dividends are cumulative or noncumulative.

<sup>3</sup> In addition to the core capital elements, Tier 1 may also include certain supplementary capital elements during the transition period subject to certain limitations set forth in section III of this statement of policy.

<sup>4</sup> An exception is allowed for intangible assets that are explicitly approved by the FDIC as part of the bank’s regulatory capital on a specific case basis. These intangibles will be included in capital for risk-based capital purposes under the terms and conditions that are specifically approved by the FDIC.

<sup>14</sup> A privately-issued mortgage-backed security may be treated as an indirect holding of the underlying assets provided that (1) the underlying assets are held by an independent trustee and the trustee has a first priority, perfected security

Category 4—100 Percent Risk Weight

\* \* \* \* \*

This category also includes all claims on foreign and domestic private sector obligors that are not assigned to lower risk weight categories, including: loans to nondepository financial institutions and bank holding companies; claims on commercial firms owned by the bank on acceptances outstanding involving standard risk claims;<sup>34</sup> fixed assets, premises and other real estate owned; common and preferred stock of corporations, including stock acquired for debt previously contracted; commercial and consumer loans (except those loans assigned to lower risk categories due to recognized

guarantees or collateral); real estate loans and mortgage-backed securities that do not meet the criteria for assignment to a lower risk weight (including any classes of mortgage-backed securities that can absorb more than their *pro rata* share of loss without the whole issue being in-default, such as subordinated classes, but not including residual interests); and all stripped mortgage-backed securities, including interest-only (IOs) (unless covered under section II.B.7. of this appendix A) and the principal-only (POs) strips.

\* \* \* \* \*

III. Minimum Risk-Based Capital Ratio

Subject to section II.B.7. of this appendix A, banks generally will be expected to meet

a minimum ratio of qualifying total capital to risk-weighted assets of 8 percent, of which at least 4 percentage points should be in the form of core capital (Tier 1). Any bank that does not meet the minimum risk-based capital ratio, or whose capital is otherwise considered inadequate, generally will be expected to develop and implement a capital plan for achieving an adequate level of capital, consistent with the provisions of this risk-based capital framework, the specific circumstances affecting the individual bank, and the requirements of any related agreements between the bank and the FDIC.

\* \* \* \* \*

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. <sup>1</sup>
(3) Noncumulative perpetual preferred stock and any related surplus ....	No Limit. <sup>1</sup>
(4) Minority interest in equity capital accounts of consolidated subsidiaries.	No Limit. <sup>1</sup>
(5) Less: All intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships.	(2)
(6) Less: Certain residual interests .....	(3)
(7) Less: Certain deferred tax assets .....	(4)
(8) Supplementary Capital (Tier 2) .....	Total of Tier 2 is limited to 100% of Tier 1. <sup>5</sup>
(9) Allowance for loan and lease losses .....	Limited to 1.25% of risk-weighted assets. <sup>5</sup>
(10) Unrealized gains on certain equity securities <sup>6</sup> .....	Limited to 45% of pretax net unrealized gains. <sup>6</sup>
(11) Cumulative perpetual and longterm 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.
(12) Auction rate and similar preferred stock (both cumulative and non-cumulative).	No limit within Tier 2.
(13) Hybrid capital instruments (including mandatory convertible debt securities).	No limit within Tier 2.
(14) 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 <sup>5</sup> and amortized for capital purposes as they approach maturity.
(15) Deductions (from the sum of Tier 1 plus Tier 2).	
(16) Investments in banking and finance subsidiaries that are not consolidated for regulatory capital purposes.	
(17) Intentional, reciprocal cross-holdings of capital securities issued by banks.	
(18) 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.
(19) Total Capital (Tier 1 + Tier 2—Deductions). .....	Must equal or exceed 8% of risk-weighted assets.

<sup>1</sup> 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.

<sup>2</sup> The amounts of mortgage servicing assets, nonmortgage servicing assets 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.

<sup>3</sup> The amounts of residual interests that can be recognized for purposes of calculating Tier 1 capital are subject to the limitations set forth in § 325.5(f).

<sup>4</sup> Deferred tax assets are subject to the capital limitations set forth in § 325.5(g).

<sup>5</sup> Amounts in excess of limitations are permitted but do not qualify as capital.

<sup>6</sup> Unrealized gains on equity securities are subject to the capital limitations set for in paragraph I.A2.(f) of appendix A to part 325.

<sup>34</sup> Customer liabilities on acceptances outstanding involving non-standard risk claims, such as claims on U.S. depository institutions, are assigned to the identity of the obligor or, if relevant, the nature of

the collateral or guaranties backing the claim. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks should be assigned to the 20 percent

risk category that is appropriate for short-term claims guaranteed by U.S. depository institutions and foreign banks.

\* \* \* \* \*

By order of the Board of Directors.  
Dated at Washington, DC, this 14th day of August, 2000.  
Federal Deposit Insurance Corporation.  
James D. LaPierre,  
Deputy Executive Secretary.

Office of Thrift Supervision

12 CFR Chapter V

Authority and Issuance

For the reasons set out in the joint preamble, The Office of Thrift Supervision proposes to amend parts 565 and 567 of chapter V of title 12 of the Code of Federal Regulations as follows:

PART 565—PROMPT CORRECTIVE ACTION

1. The authority citation for part 565 continues to read as follows:

Authority: 12 U.S.C. 1831o.

2. Amend § 565.2 by revising paragraph (f) to read as follows:

§ 565.2 Definitions.

\* \* \* \* \*

(f) Tangible equity means the amount of a savings association's core capital as computed in part 567 of this chapter plus the amount of its outstanding cumulative perpetual preferred stock (including related surplus) and disallowed residual interests minus intangible assets as defined in § 567.1 of this chapter and nonmortgage servicing assets that have not been previously deducted in calculating core capital.

\* \* \* \* \*

PART 567—CAPITAL

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

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

4. Amend § 567.1 by adding definitions of "financial asset", "residual interests," and "securitization" to read as follows:

§ 567.1 Definitions.

\* \* \* \* \*

Financial asset. The term financial asset means cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right:

- (1) To receive cash or another financial instrument from a first entity; or
(2) To exchange other financial instruments on potentially favorable terms with the first entity.

\* \* \* \* \*

Residual interests. (1) The term residual interests means balance sheet assets that:

- (i) Beneficial interests (including interests) in transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets; and
(ii) Are structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit enhancement techniques.

(2) Residual interests do not include interests purchased from a third party.

(3) Residual interests include interest only on strips receivable, spread accounts, cash collateral accounts, retained subordinated interests, and similar on-balance sheet assets that function as a credit enhancement.

\* \* \* \* \*

Securitization. The term securitization means the pooling and repackaging of loans or other credit exposures into securities that can be sold to investors.

\* \* \* \* \*

5. Amend § 567.5 by adding new paragraph (a)(2)(iii) to read as follows:

§ 567.5 Components of capital.

- (a) \* \* \*
(2) \* \* \*
(iii) Residual interests that are not includable in core capital under § 567.12 of this part are deducted from assets and capital in computing core capital.

\* \* \* \* \*

6. Amend § 567.6 by revising paragraph (a) introductory text and paragraph (a)(1) introductory text, and adding paragraph (b) to read as follows:

§ 567.6 Risk-based capital credit risk-weight categories.

(a) Risk-weighted assets. Risk-weighted assets equal risk-weighted on-balance-sheet assets (as computed under paragraph (a)(1) of this section), plus risk-weighted off-balance-sheet activities (as computed under paragraph (a)(2) of this section). Assets not included for purposes of calculating capital under § 567.5 are not included in calculating risk-weighted assets.

(1) On-balance-sheet assets. Risk-weighted on-balance-sheet assets are computed by multiplying the on-balance-sheet asset amounts times the appropriate risk weight categories, except for residual interests, which are discussed in paragraph (b) of this section. The risk weight categories for on-balance-sheet assets are:

\* \* \* \* \*

(b) Residual interests. (1) In general. A savings association must maintain risk-

based capital for a residual interest equal to the amount of the residual interest that is retained on the balance sheet (less any amount disallowed under § 567.12(e) and net of any associated deferred tax liability), even though this risk-based capital requirement may exceed the full equivalent risk-based capital requirement for the assets transferred.

(2) Recourse obligation. Where a savings association holds a residual interest and another recourse obligation (such as a standby letter of credit) in connection with the same asset transfer, the savings association must maintain risk-based capital equal to the greater of:

- (i) The risk-based capital requirement for the residual interest as calculated under paragraph (b)(1) of this section; or
(ii) The full risk-based capital requirement for the assets transferred, subject to the low-level recourse rules (paragraph 6(a)(2)(i)(C) of this section).

7. Amend § 567.9 by revising paragraph (c)(1) to read as follows:

§ 567.9 Tangible capital requirement.

\* \* \* \* \*

(c) \* \* \*

(1) Intangible assets as defined in § 567.1 of this part, and servicing assets and residual interests not includable in tangible capital under § 567.12 of this part.

\* \* \* \* \*

8. Amend § 567.11 by redesignating paragraph (c) as paragraph (c)(1) and adding a new paragraph (c)(2) to read as follows:

§ 567.11 Reservation of authority.

\* \* \* \* \*

(c) \* \* \*

(2) If a savings association has calculated the risk-weighted asset amount under § 567.6, OTS may determine that risk-weighted asset amount does not adequately reflect the credit risk that the savings association retained in the transaction and require the institution to revise the risk-weighted asset amount to reflect the risk of, and other relevant factors associated with, the residual interest.

9. Amend § 567.12 by revising the section heading and paragraphs (a), (b), and (e) and by removing and reserving paragraph (f) to read as follows:

§ 567.12 Intangible assets, servicing assets, and residual interests.

(a) Scope. This section prescribes the maximum amount of intangible assets, servicing assets, and residual interests that savings associations may include in calculating tangible and core capital.

(b) Computation of core and tangible capital. (1) Intangible assets, as defined

in § 567.1 of this part (other than purchased credit card relationships described under paragraph (b)(2) of this section and core deposit intangibles described at paragraph (g)(3) of this section), are deducted in computing tangible and core capital.

(2) Purchase card relationships may be included (that is not deducted) in computing core capital subject to the restrictions of this section, but must be deducted in computing tangible capital.

(3) Mortgage servicing assets may be included (that is not deducted) in computing core capital subject to the restrictions in this section, and may be included in tangible capital in the same amount.

(4) Nonmortgage servicing assets may be included (that is not deducted) in computing core capital subject to the restrictions in this section. All nonmortgage servicing assets must be deducted in computing tangible capital.

(5) Residual interests may be included (that is not deducted) in computing core capital subject to the restrictions of this section, and may be included in tangible capital in the same amount.

\* \* \* \* \*

(e) *Core capital limitation.* (1) *Aggregate limit.* The maximum aggregate amount of servicing assets, purchased credit card relationships, and residual interests that may be included in core capital shall be limited to the lesser of:

(i) 100 percent of the amount of core capital computed before the deduction of any disallowed servicing assets, disallowed purchased credit card relationships, and disallowed residual interests; or

(ii) The amount of servicing assets and purchased credit card relationships determined in accordance with paragraph (d) of this section plus the amount of residual interests.

(2) *Reduction by deferred tax liability.* Associations may elect to deduct disallowed servicing assets and residual interests on a basis that is net of any associated deferred tax liability.

(3) *Sublimit for purchased credit card relationships, non mortgage-related servicing assets, and residual interests.* In addition to the aggregate limitation in paragraph (e)(1) of this section, a sublimit shall apply to purchased credit card relationships, non mortgage-related servicing assets, and residual interests. The maximum allowable amount of these three types of assets combined shall be limited to the lesser of:

(i) 25 percent of the amount of core capital computed before the deduction of any disallowed servicing assets, purchased credit card relationships, and residual interests; or

(ii) The amount of purchased credit card relationships and non mortgage-related servicing assets determined in accordance with paragraph (d) of this section plus the amount of residual interests.

(f) [Reserved]

\* \* \* \* \*

Dated: August 4, 2000.

By the Office of Thrift Supervision.

**Ellen Seidman,**

*Director.*

[FR Doc. 00-24203 Filed 9-26-00; 8:45 am]

**BILLING CODES 4810-33-P, 6210-01-P, 6714-01-P, 6720-01-P**

## DEPARTMENT OF TRANSPORTATION

### Federal Aviation Administration

#### 14 CFR Part 39

[Docket No. 2000-NM-15-AD]

RIN 2120-AA64

#### **Airworthiness Directives; Bombardier Model DHC-8-100, -200, and -300 Series Airplanes**

**AGENCY:** Federal Aviation Administration, DOT.

**ACTION:** Notice of proposed rulemaking (NPRM).

**SUMMARY:** This document proposes the adoption of a new airworthiness directive (AD) that is applicable to certain Bombardier Model DHC-8-100, -200, and -300 series airplanes. This proposal would require inspecting the endcaps of the main landing gear selector valve for leaks of hydraulic oil and, if leaks are detected, replacing the leaking endcaps or the entire selector valve. This proposal would also require eventual replacement or rework of certain selector valves, which would terminate the repetitive inspections. This action is prompted by a report of the collapse of the main landing gear due to an external leak of hydraulic oil in the landing gear selector valve, resulting from a fracture of the endcap. This action is intended to prevent leaks of hydraulic oil from the main landing gear selector valve, which could result in the collapse of the main landing gear.

**DATES:** Comments must be received by October 27, 2000.

**ADDRESSES:** Submit comments in triplicate to the Federal Aviation Administration (FAA), Transport Airplane Directorate, ANM-114, Attention: Rules Docket No. 2000-NM-15-AD, 1601 Lind Avenue, SW., Renton, Washington 98055-4056. Comments may be inspected at this

location between 9:00 am and 3:00 pm, Monday through Friday, except Federal holidays. Comments may be submitted via fax to (425) 227-1232. Comments may also be sent via the Internet using the following address: 9-anm-nprmcomment@faa.gov. Comments sent via fax or the Internet must contain "Docket No. 2000-NM-15-AD" in the subject line and need not be submitted in triplicate. Comments sent via the Internet as attached electronic files must be formatted in Microsoft Word 97 for Windows or ASCII text.

The service information referenced in the proposed rule may be examined at the FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington, or at the FAA, New York Aircraft Certification Office, 10 Fifth Street, Third Floor, Valley Stream, New York.

#### **FOR FURTHER INFORMATION CONTACT:**

James E. Delisio, Aerospace Engineer, Airframe and Propulsion Branch, ANE-171, FAA, New York Aircraft Certification Office, 10 Fifth Street, Third Floor, Valley Stream, New York 11581; telephone (516) 256-7521; fax (516) 568-2716.

#### **SUPPLEMENTARY INFORMATION:**

##### **Comments Invited**

Interested persons are invited to participate in the making of the proposed rule by submitting such written data, views, or arguments as they may desire. Communications shall identify the Rules Docket number and be submitted in triplicate to the address specified above. All communications received on or before the closing date for comments, specified above, will be considered before taking action on the proposed rule. The proposals contained in this notice may be changed in light of the comments received.

Submit comments using the following format:

- Organize comments issue-by-issue. For example, discuss a request to change the compliance time and a request to change the service bulletin reference as two separate issues.
- For each issue, state what specific change to the proposed AD is being requested.
- Include justification (e.g., reasons or data) for each request.

Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the proposed rule. All comments submitted will be available, both before and after the closing date for comments, in the Rules Docket for examination by interested persons. A report summarizing each FAA-public contact