

## § 208.110

loan application by presenting to the consumer a revised loan offer, either verbally or in writing, that includes a lower interest rate or lower points than the original offer.

(2) Offering or negotiating terms of a loan does not include solely or in combination:

(i) Providing general explanations or descriptions in response to consumer queries regarding qualification for a specific loan product, such as explaining loan terminology (*i.e.*, debt-to-income ratio); lending policies (*i.e.*, the loan-to-value ratio policy of the bank); or product-related services;

(ii) In response to a consumer's request, informing a consumer of the loan rates that are publicly available, such as on the bank's Web site, for specific types of loan products without communicating to the consumer whether qualifications are met for that loan product;

(iii) Collecting information about a consumer in order to provide the consumer with information on loan products for which the consumer generally may qualify, without presenting a specific loan offer to the consumer for acceptance, either verbally or in writing;

(iv) Arranging the loan closing or other aspects of the loan process, including communicating with a consumer about those arrangements, provided that communication with the consumer only verifies loan terms already offered or negotiated;

(v) Providing a consumer with information unrelated to loan terms, such as the best days of the month for scheduling loan closings at the bank;

(vi) Making an underwriting decision about whether the consumer qualifies for a loan;

(vii) Explaining or describing the steps or process that a consumer would need to take in order to obtain a loan offer, including qualifications or criteria that would need to be met without providing guidance specific to that consumer's circumstances; or

(viii) Communicating on behalf of a mortgage loan originator that a written offer, including disclosures provided pursuant to the Truth in Lending Act, has been sent to a consumer without providing any details of that offer.

(c) *Offering or negotiating a loan for compensation or gain.* The following examples illustrate when an employee does or does not offer or negotiate terms of a loan "for compensation or gain."

(1) Offering or negotiating terms of a loan for compensation or gain includes engaging in any of the activities in paragraph (b)(1) of this Appendix in the course of carrying out employment duties, even if the employee does not receive a referral fee or commission or other special compensation for the loan.

(2) Offering or negotiating terms of a loan for compensation or gain does not include engaging in a seller-financed transaction for

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the employee's personal property that does not involve the bank.

### Subpart J—Interpretations

SOURCE: Reg. H, 63 FR 37658, July 13, 1998, unless otherwise noted. Redesignated at 65 FR 14814, Mar. 20, 2000. Redesignated further at 65 FR 75841, Dec. 4, 2000. Redesignated further at 75 FR 44688, July 28, 2010.

#### § 208.110 Sale of bank's money orders off premises as establishment of branch office.

(a) The Board of Governors has been asked to consider whether the appointment by a member bank of an agent to sell the bank's money orders, at a location other than the premises of the bank, constitutes the establishment of a branch office.

(b) Section 5155 of the Revised Statutes (12 U.S.C. 36), which is also applicable to member banks, defines the term branch as including "any branch bank, branch office, branch agency, additional office, or any branch place of business \* \* \* at which deposits are received, or checks paid, or money lent." The basic question is whether the sale of a bank's money orders by an agent amounts to the receipt of deposits at a branch place of business within the meaning of this statute.

(c) Money orders are classified as deposits for certain purposes. However, they bear a strong resemblance to traveler's checks that are issued by banks and sold off premises. In both cases, the purchaser does not intend to establish a deposit account in the bank, although a liability on the bank's part is created. Even though they result in a deposit liability, the Board is of the opinion that the issuance of a bank's money orders by an authorized agent does not involve the receipt of deposits at a "branch place of business" and accordingly does not require the Board's permission to establish a branch.

#### § 208.111 Obligations concerning institutional customers.

(a) As a result of broadened authority provided by the Government Securities Act Amendments of 1993 (15 U.S.C. 78o–3 and 78o–5), the Board is adopting sales practice rules for the government securities market, a market with a

particularly broad institutional component. Accordingly, the Board believes it is appropriate to provide further guidance to banks on their suitability obligations when making recommendations to institutional customers.

(b) The Board's Suitability Rule, § 208.37(d), is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct. Banks' responsibilities include having a reasonable basis for recommending a particular security or strategy, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made. Banks are expected to meet the same high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer.

(c) In recommending to a customer the purchase, sale, or exchange of any government security, the bank shall have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of the facts, if any, disclosed by the customer as to the customer's other security holdings and financial situation and needs.

(d) The interpretation in this section concerns only the manner in which a bank determines that a recommendation is suitable for a particular institutional customer. The manner in which a bank fulfills this suitability obligation will vary, depending on the nature of the customer and the specific transaction. Accordingly, the interpretation in this section deals only with guidance regarding how a bank may fulfill customer-specific suitability obligations under § 208.37(d).<sup>17</sup>

(e) While it is difficult to define in advance the scope of a bank's suitability obligation with respect to a specific institutional customer trans-

action recommended by a bank, the Board has identified certain factors that may be relevant when considering compliance with § 208.37(d). These factors are not intended to be requirements or the only factors to be considered but are offered merely as guidance in determining the scope of a bank's suitability obligations.

(f) The two most important considerations in determining the scope of a bank's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently and the extent to which the customer is exercising independent judgement in evaluating a bank's recommendation. A bank must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the bank may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. This is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a bank's customer-specific obligations under § 208.37(d) would not be diminished by the fact that the bank was dealing with an institutional customer. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision.

(g) A bank may conclude that a customer is exercising independent judgement if the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. Where the bank has reasonable grounds for concluding that the institutional customer

<sup>17</sup>The interpretation in this section does not address the obligation related to suitability that requires that a bank have "a reasonable basis" to believe that the recommendation could be suitable for at least some customers." In the Matter of the Application of F.J. Kaufman and Company of Virginia and Frederick J. Kaufman, Jr., 50 SEC 164 (1989).

is making independent investment decisions and is capable of independently evaluating investment risk, then a bank's obligations under §208.25(d) for a particular customer are fulfilled.<sup>18</sup> Where a customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, the interpretation in this section shall be applied to the agent.

(h) A determination of capability to evaluate investment risk independently will depend on an examination of the customer's capability to make its own investment decisions, including the resources available to the customer to make informed decisions. Relevant considerations could include:

(1) The use of one or more consultants, investment advisers, or bank trust departments;

(2) The general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration;

(3) The customer's ability to understand the economic features of the security involved;

(4) The customer's ability to independently evaluate how market developments would affect the security; and

(5) The complexity of the security or securities involved.

(i) A determination that a customer is making independent investment decisions will depend on the nature of the relationship that exists between the bank and the customer. Relevant considerations could include:

(1) Any written or oral understanding that exists between the bank and the customer regarding the nature of the relationship between the bank and the customer and the services to be rendered by the bank;

(2) The presence or absence of a pattern of acceptance of the bank's recommendations;

(3) The use by the customer of ideas, suggestions, market views and information obtained from other government securities brokers or dealers or market professionals, particularly

those relating to the same type of securities; and

(4) The extent to which the bank has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.

(j) Banks are reminded that these factors are merely guidelines that will be utilized to determine whether a bank has fulfilled its suitability obligation with respect to a specific institutional customer transaction and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability. Such a determination can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular bank/customer relationship, assessed in the context of a particular transaction.

(k) For purposes of the interpretation in this section, an institutional customer shall be any entity other than a natural person. In determining the applicability of the interpretation in this section to an institutional customer, the Board will consider the dollar value of the securities that the institutional customer has in its portfolio and/or under management. While the interpretation in this section is potentially applicable to any institutional customer, the guidance contained in this section is more appropriately applied to an institutional customer with at least \$10 million invested in securities in the aggregate in its portfolio and/or under management.

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#### APPENDIX A TO PART 208—CAPITAL ADEQUACY GUIDELINES FOR STATE MEMBER BANKS: RISK-BASED MEASURE

##### *I. Overview*

The Board of Governors of the Federal Reserve System has adopted a risk-based capital measure to assist in the assessment of the capital adequacy of state member

<sup>18</sup> See footnote 8 in paragraph (d) of this section.

banks.<sup>1</sup> The principal objectives of this measure are to: (i) Make regulatory capital requirements more sensitive to differences in risk profiles among banks; (ii) factor off-balance sheet exposures into the assessment of capital adequacy; (iii) minimize disincentives to holding liquid, low-risk assets; and (iv) achieve greater consistency in the evaluation of the capital adequacy of major banks throughout the world.<sup>2</sup>

The risk-based capital guidelines include both a definition of capital and a framework for calculating weighted risk assets by assigning assets and off-balance sheet items to broad risk categories. A bank's risk-based capital ratio is calculated by dividing its qualifying capital (the numerator of the ratio) by its weighted risk assets (the denominator).<sup>3</sup> The definition of qualifying capital is outlined below in section II, and the procedures for calculating weighted risk assets are discussed in Section III. Attachment I illustrates a sample calculation of weighted risk assets and the risk-based capital ratio.

In addition, when certain banks that engage in trading activities calculate their risk-based capital ratio under this appendix A, they must also refer to appendix E of this part, which incorporates capital charges for certain market risks into the risk-based capital ratio. When calculating their risk-based capital ratio under this appendix A, such banks are required to refer to appendix E of this part for supplemental rules to determine qualifying and excess capital, calculate risk-weighted assets, calculate market risk equivalent assets, and calculate risk-based capital ratios adjusted for market risk.

<sup>1</sup>Supervisory ratios that relate capital to total assets for state member banks are outlined in appendix B of this part and in appendix B to part 225 of the Federal Reserve's Regulation Y, 12 CFR part 225.

<sup>2</sup>The risk-based capital measure is based upon a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Regulations and Supervisory Practices (Basle Supervisors' Committee) and endorsed by the Group of Ten Central Bank Governors. The framework is described in a paper prepared by the BSC entitled "International Convergence of Capital Measurement," July 1988.

<sup>3</sup>Banks will initially be expected to utilize period-end amounts in calculating their risk-based capital ratios. When necessary and appropriate, ratios based on average balances may also be calculated on a case-by-case basis. Moreover, to the extent banks have data on average balances that can be used to calculate risk-based ratios, the Federal Reserve will take such data into account.

The risk-based capital guidelines also establish a schedule for achieving a minimum supervisory standard for the ratio of qualifying capital to weighted risk assets and provide for transitional arrangements during a phase-in period to facilitate adoption and implementation of the measure at the end of 1992. These interim standards and transitional arrangements are set forth in section IV.

The risk-based guidelines apply to all state member banks on a consolidated basis. They are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. Thus, in considering an application filed by a state member bank, the Federal Reserve will take into account the bank's risk-based capital ratio, the reasonableness of its capital plans, and the degree of progress it has demonstrated toward meeting the interim and final risk-based capital standards.

The risk-based capital ratio focuses principally on broad categories of credit risk, although the framework for assigning assets and off-balance-sheet items to risk categories does incorporate elements of transfer risk, as well as limited instances of interest rate and market risk. The framework incorporates risks arising from traditional banking activities as well as risks arising from nontraditional activities. The risk-based ratio does not, however, incorporate other factors that can affect an institution's financial condition. These factors include overall interest-rate exposure; liquidity, funding and market risks; the quality and level of earnings; investment, loan portfolio, and other concentrations of credit; certain risks arising from nontraditional activities; the quality of loans and investments; the effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operating risks, including the risks presented by concentrations of credit and nontraditional activities.

In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of those factors, including, in particular, the level and severity of problem and classified assets as well as a bank's exposure to declines in the economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgment on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio.

The risk-based capital guidelines establish *minimum* ratios of capital to weighted risk assets. In light of the considerations just discussed, banks generally are expected to operate well above the minimum risk-based ratios. In particular, banks contemplating significant expansion proposals are expected to maintain strong capital levels substantially

above the minimum ratios and should not allow significant diminution of financial strength below these strong levels to fund their expansion plans. Institutions with high or inordinate levels of risk are also expected to operate well above minimum capital standards. In all cases, institutions should hold capital commensurate with the level and nature of the risks to which they are exposed. Banks that do not meet the minimum risk-based standard, or that are otherwise considered to be inadequately capitalized, are expected to develop and implement plans acceptable to the Federal Reserve for achieving adequate levels of capital within a reasonable period of time.

The Federal Reserve may determine that the regulatory capital treatment for a bank's exposure or other relationship to an entity not consolidated on the bank's balance sheet is not commensurate with the actual risk relationship of the bank to the entity. In making this determination, the Federal Reserve may require the bank to treat the entity as if it were consolidated onto the balance sheet of the bank for risk-based capital purposes and calculate the appropriate risk-based capital ratios accordingly, all as specified by the Federal Reserve.

The Board will monitor the implementation and effect of these guidelines in relation to domestic and international developments in the banking industry. When necessary and appropriate, the Board will consider the need to modify the guidelines in light of any significant changes in the economy, financial markets, banking practices, or other relevant factors.

## *II. Definition of Qualifying Capital for the Risk-Based Capital Ratio*

A bank's qualifying total capital consists of two types of capital components: "core capital elements" (comprising tier 1 capital) and "supplementary capital elements" (comprising tier 2 capital). These capital elements and the various limits, restrictions, and deductions to which they are subject, are discussed below and are set forth in Attachment II.

The Federal Reserve will, on a case-by-case basis, determine whether and, if so, how much of any instrument that does not fit wholly within the terms of one of the capital categories set forth below or that does not have an ability to absorb losses commensurate with the capital treatment otherwise specified below will be counted as an element of tier 1 or tier 2 capital. In making such a determination, the Federal Reserve will consider the similarity of the instrument to instruments explicitly treated in the guidelines, the ability of the instrument to absorb losses while the bank operates as a going concern, the maturity and redemption features of the instrument, and other relevant terms and factors. To qualify as an element

of tier 1 or tier 2 capital, a capital instrument may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on a bank's overall capital structure. Consequently, a bank considering such a step should consult with the Federal Reserve before redeeming any equity or debt capital instrument (prior to maturity) if such redemption could have a material effect on the level or composition of the institution's capital base.<sup>4</sup>

### *A. The Components of Qualifying Capital*

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); and
- (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 any amounts of goodwill, other intangible assets, interest-only strips receivables and non-financial equity investments that are required to be deducted in accordance with section II.B. of this appendix A.

a. *Common stockholders' equity.* For purposes of calculating the risk-based capital ratio, common stockholders' equity is limited to common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any treasury stock; less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized holding gains (losses) on available-for-sale debt securities are not included in common stockholders' equity.

b. *Perpetual preferred stock.* Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder of the instrument, and that has no

<sup>4</sup>Consultation would not ordinarily be necessary if an instrument were redeemed with the proceeds of, or replaced by, a like amount of a similar or higher quality capital instrument and the organization's capital position is considered fully adequate by the Federal Reserve.

<sup>5</sup>[Reserved]

other provisions that will require future redemption of the issue. Consistent with these provisions, any perpetual preferred stock with a feature permitting redemption at the option of the issuer may qualify as capital only if the redemption is subject to prior approval of the Federal Reserve. In general, preferred stock will qualify for inclusion in capital only if it can absorb losses while the issuer operates as a going concern (a fundamental characteristic of equity capital) and only if the issuer has the ability and legal right to defer or eliminate preferred dividends.

The only form of perpetual preferred stock that state member banks may consider as an element of Tier 1 capital is noncumulative perpetual preferred. While the guidelines allow for the inclusion of noncumulative perpetual preferred stock in Tier 1, it is desirable from a supervisory standpoint that voting common stockholders' equity remain the dominant form of Tier 1 capital. Thus, state member banks should avoid overreliance on preferred stock or non-voting equity elements within Tier 1.

Perpetual preferred stock in which the dividend is reset periodically based, in whole or in part, upon the bank's current credit standing (that is, auction rate perpetual preferred stock, including so-called Dutch auction, money market, and remarketable preferred) will not qualify for inclusion in Tier 1 capital.<sup>7</sup> Such instruments, however, qualify for inclusion in Tier 2 capital.

c. *Minority interest in equity accounts of consolidated subsidiaries.* This element is included in tier 1 capital because, as a general rule, it represents equity that is freely available to absorb losses in operating subsidiaries whose assets are included in a bank's risk-weighted asset base. While not subject to an explicit sublimit within tier 1, banks are expected to avoid using minority interest in the equity accounts of consolidated subsidiaries as an avenue for introducing into their capital structures elements that might not otherwise qualify as tier 1 capital or that would, in effect, result in an excessive reliance on preferred stock within tier 1. Minority interests in small business investment companies, investment funds that hold non-financial equity investments (as defined in section II.B.5.b. of this appendix A), and subsidiaries engaged in nonfinancial activities, are not included in the bank's tier 1 or total

capital base if the bank's interest in the company or fund is held under one of the legal authorities listed in section II.B.5.b.

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).

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, interest-only strips receivables and nonfinancial equity investments that are required to be deducted in accordance with section II.B. of this appendix A).

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

a. *Allowance for loan and lease losses.* Allowances for loan and lease losses are reserves that have been established through a charge against earnings to absorb future losses on loans or lease financing receivables. Allowances for loan and lease losses exclude "allocated transfer risk reserves,"<sup>9</sup> and reserves created against identified losses.

During the transition period, the risk-based capital guidelines provide for reducing the amount of this allowance that may be included in an institution's total capital. Initially, it is unlimited. However, by year-end 1990, the amount of the allowance for loan and lease losses that will qualify as capital will be limited to 1.5 percent of an institution's weighted risk assets. By the end of the transition period, the amount of the allowance qualifying for inclusion in Tier 2 capital may not exceed 1.25 percent of weighted risk assets.<sup>10</sup>

<sup>8</sup>[Reserved]

<sup>9</sup>Allocated transfer risk reserves are reserves that have been established in accordance with Section 905(a) of the International Lending Supervision Act of 1983, 12 U.S.C. 3904(a), against certain assets whose value U.S. supervisory authorities have found to be significantly impaired by protracted transfer risk problems.

<sup>10</sup>The amount of the allowance for loan and lease losses that may be included in Tier

*Continued*

<sup>6</sup>[Reserved]

<sup>7</sup>Adjustable rate noncumulative perpetual preferred stock (that is, perpetual preferred stock in which the dividend rate is not affected by the issuer's credit standing or financial condition but is adjusted periodically according to a formula based solely on general market interest rates) may be included in Tier 1.

b. *Perpetual preferred stock.* Perpetual preferred stock, as noted above, is defined as preferred stock that has no maturity date, that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. Such instruments are eligible for inclusion in Tier 2 capital without limit.<sup>11</sup>

c. *Hybrid capital instruments and mandatory convertible debt securities.* Hybrid capital instruments include instruments that are essentially permanent in nature and that have certain characteristics of both equity and debt. Such instruments may be included in Tier 2 without limit. The general criteria hybrid capital instruments must meet in order to qualify for inclusion in Tier 2 capital are listed below:

(1) The instrument must be unsecured; fully paid-up; and subordinated to general creditors and must also be subordinated to claims of depositors.

(2) The instrument must not be redeemable at the option of the holder prior to maturity, except with the prior approval of the Federal Reserve. (Consistent with the Board's criteria for perpetual debt and mandatory convertible securities, this requirement implies that holders of such instruments may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.)

(3) The instrument must be available to participate in losses while the issuer is operating as a going concern. (Term subordinated debt would not meet this requirement.) To satisfy this requirement, the instrument must convert to common or perpetual preferred stock in the event that the accumulated losses exceed the sum of the retained earnings and capital surplus accounts of the issuer.

(4) The instrument must provide the option for the issuer to defer interest payments if:

(a) The issuer does not report a profit in the

2 capital is based on a percentage of gross weighted risk assets. A bank may deduct reserves for loan and lease losses in excess of the amount permitted to be included in Tier 2 capital, as well as allocated transfer risk reserves, from the sum of gross weighted risk assets and use the resulting net sum of weighted risk assets in computing the denominator of the risk-based capital ratio.

<sup>11</sup> Long-term preferred stock with an original maturity of 20 years or more (including related surplus) will also qualify in this category as an element of Tier 2. If the holder of such an instrument has a right to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing bank.

preceding annual period (defined as combined profits for the most recent four quarters), and (b) the issuer eliminates cash dividends on common and preferred stock.

Mandatory convertible debt securities in the form of equity contract notes that meet the criteria set forth in 12 CFR part 225, appendix B, also qualify as unlimited elements of Tier 2 capital. In accordance with that appendix, equity commitment notes issued prior to May 15, 1985 also qualify for inclusion in Tier 2.

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

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

e. *Unrealized gains on equity securities and unrealized gains (losses) on other assets.* Up to 45 percent of pretax net unrealized holding gains (that is, the excess, if any, of the fair

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

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

f. *Revaluation reserves.* i. Such reserves reflect the formal balance sheet restatement or revaluation for capital purposes of asset carrying values to reflect current market values. The federal banking agencies generally have not included unrealized asset appreciation in capital ratio calculations, although they have long taken such values into account as a separate factor in assessing the overall financial strength of a bank.

ii. Consistent with long-standing supervisory practice, the excess of market values over book values for assets held by state member banks will generally not be recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all banks are encouraged to disclose their equivalent of premises (building) and security revaluation reserves. The Federal Reserve will consider any appreciation, as well as any depreciation, in specific asset values as additional considerations in assessing overall capital strength and financial condition.

#### B. Deductions from Capital and Other Adjustments

Certain assets are deducted from a bank's capital for the purpose of calculating the risk-based capital ratio.<sup>13</sup> These assets include:

(i)(a) Goodwill—deducted from the sum of core capital elements.

(b) Certain identifiable intangible assets, that is, intangible assets other than goodwill—deducted from the sum of core capital elements in accordance with section II.B.1.b. of this appendix.

(c) Certain credit-enhancing interest-only strips receivables—deducted from the sum of core capital elements in accordance with sections II.B.1.c. through e. of this appendix.

(ii) Investments in banking and finance subsidiaries that are not consolidated for accounting or supervisory purposes and, on a case-by-case basis, investments in other des-

ignated subsidiaries or associated companies at the discretion of the Federal Reserve—deducted from total capital components.

(iii) Reciprocal holdings of capital instruments of banking organizations—deducted from total capital components.

(iv) Deferred tax assets—portions are deducted from the sum of core capital elements in accordance with section II.B.4. of this Appendix A.

(v) Nonfinancial equity investments—portions are deducted from the sum of core capital elements in accordance with section II.B.5 of this appendix.

1. *Goodwill and other intangible assets—*a. *Goodwill.* Goodwill is an intangible asset that represents the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. Goodwill is deducted from the sum of core capital elements in determining Tier 1 capital.

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.

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. *Credit-enhancing interest-only strips receivables (I/Os).* i. Credit-enhancing I/Os are on-balance sheet assets that, in form or in substance, represent the contractual right to receive some or all of the interest due on transferred assets and expose the bank to credit risk directly or indirectly associated with transferred assets that exceeds a *pro rata* share of the bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Such I/Os, whether purchased or retained, including other similar "spread" assets, 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.

ii. Both purchased and retained credit-enhancing I/Os, on a non-tax adjusted basis, are

<sup>13</sup> Any assets deducted from capital in computing the numerator of the ratio are not included in weighted risk assets in computing the denominator of the ratio.



included in the total amount that is used for purposes of determining whether a bank exceeds the tier 1 limitation described below in this section. In determining whether an I/O or other types of spread assets serve as a credit enhancement, the Federal Reserve will look to the economic substance of the transaction.

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, 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 I/Os that a bank may include in capital shall be its fair value. If both the application of the limits on mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships 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 from its core capital elements in determining tier 1 capital.

e. *Tier 1 capital limitation.* i. The total amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that may be included in capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. The aggregate of nonmortgage servicing assets and purchased credit card relationships are subject to a separate sublimit of 25 percent of tier 1 capital. In addition, the total amount of credit-enhancing I/Os (both purchased and retained) that may be included in capital cannot exceed 25 percent of tier 1 capital.<sup>14</sup>

ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing I/Os, 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, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any non-financial equity investments.

iii. Banks may elect to deduct goodwill, disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, and disallowed credit-enhancing I/Os (both purchased and retained) 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 goodwill and other intangible assets 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 credit-enhancing I/Os 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 goodwill, other intangible assets, or credit-enhancing I/Os.

g. *Growing organizations.* Consistent with long-standing Board policy, banks 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 credit-enhancing I/Os.

2. *Investments in certain subsidiaries.* The aggregate amount of investments in banking or finance subsidiaries<sup>15</sup> whose financial statements are not consolidated for accounting or bank regulatory reporting purposes will be

<sup>14</sup>Amounts of servicing assets, purchased credit card relationships, and credit-enhancing I/Os (both retained and purchased) 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.

<sup>15</sup>For this purpose, a banking and finance subsidiary generally is defined as any company engaged in banking or finance in which the parent institution holds directly or indirectly more than 50 percent of the outstanding voting stock, or which is otherwise controlled or capable of being controlled by the parent institution.

deducted from a bank's total capital components.<sup>16</sup> Generally, investments for this purpose are defined as equity and debt capital investments and any other instruments that are deemed to be capital in the particular subsidiary.

Advances (that is, loans, extensions of credit, guarantees, commitments, or any other forms of credit exposure) to the subsidiary that are not deemed to be capital will generally not be deducted from a bank's capital. Rather, such advances generally will be included in the bank's consolidated assets and be assigned to the 100 percent risk category, unless such obligations are backed by recognized collateral or guarantees, in which case they will be assigned to the risk category appropriate to such collateral or guarantees. These advances may, however, also be deducted from the bank's capital if, in the judgment of the Federal Reserve, the risks stemming from such advances are comparable to the risks associated with capital investments or if the advances involve other risk factors that warrant such an adjustment to capital for supervisory purposes. These other factors could include, for example, the absence of collateral support.

Inasmuch as the assets of unconsolidated banking and finance subsidiaries are not fully reflected in a bank's consolidated total assets, such assets may be viewed as the equivalent of off-balance sheet exposures since the operations of an unconsolidated subsidiary could expose the bank to considerable risk. For this reason, it is generally appropriate to view the capital resources invested in these unconsolidated entities as primarily supporting the risks inherent in these off-balance sheet assets, and not generally available to support risks or absorb losses elsewhere in the bank.

The Federal Reserve may, on a case-by-case basis, also deduct from a bank's capital, investments in certain other subsidiaries in order to determine if the consolidated bank meets minimum supervisory capital requirements without reliance on the resources invested in such subsidiaries.

The Federal Reserve will not automatically deduct investments in other consolidated subsidiaries or investments in joint ventures and associated companies.<sup>17</sup> None-

theless, the resources invested in these entities, like investments in unconsolidated banking and finance subsidiaries, support assets not consolidated with the rest of the bank's activities and, therefore, may not be generally available to support additional leverage or absorb losses elsewhere in the bank. Moreover, experience has shown that banks stand behind the losses of affiliated institutions, such as joint ventures and associated companies, in order to protect the reputation of the organization as a whole. In some cases, this has led to losses that have exceeded the investments in such organizations.

For this reason, the Federal Reserve will monitor the level and nature of such investments for individual banks and, on a case-by-case basis may, for risk-based capital purposes, deduct such investments from total capital components, apply an appropriate risk-weighted capital charge against the bank's proportionate share of the assets of its associated companies, require a line-by-line consolidation of the entity (in the event that the bank's control over the entity makes it the functional equivalent of a subsidiary), or otherwise require the bank to operate with a risk-based capital ratio above the minimum.

In considering the appropriateness of such adjustments or actions, the Federal Reserve will generally take into account whether:

- (1) The bank has significant influence over the financial or managerial policies or operations of the subsidiary, joint venture, or associated company;
- (2) The bank is the largest investor in the affiliated company; or
- (3) Other circumstances prevail that appear to closely tie the activities of the affiliated company to the bank.

3. *Reciprocal holdings of banking organizations' capital instruments.* Reciprocal holdings of banking organizations' capital instruments (that is, instruments that qualify as Tier 1 or Tier 2 capital)<sup>18</sup> will be deducted from a bank's total capital components for the purpose of determining the numerator of the risk-based capital ratio.

Reciprocal holdings are cross-holdings resulting from formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other's capital instruments. Generally, deductions will be limited to intentional cross-holdings. At present, the

panies in which the bank owns 20 to 50 percent of the voting stock.

<sup>18</sup>See 12 CFR part 225, appendix A for instruments that qualify as Tier 1 and Tier 2 capital for bank holding companies.

<sup>16</sup>An exception to this deduction would be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith. The requirements for consolidation are spelled out in the instructions to the Call Report.

<sup>17</sup>The definition of such entities is contained in the instructions to the commercial bank Call Report. Under regulatory reporting procedures, associated companies and joint ventures generally are defined as com-

Board does not intend to require banks to deduct non-reciprocal holdings of such capital instruments.<sup>19</sup>

4. *Deferred-tax assets.* a. 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>20</sup> or

ii. 10 percent of tier 1 capital.

b. 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 servicing

assets, nonmortgage servicing assets, and purchased credit card relationships, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os, any disallowed deferred-tax assets, and any non-financial equity investments. 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.

5. *Nonfinancial equity investments—*a. *General.* A bank must deduct from its core capital elements the sum of the appropriate percentages (as determined below) of the adjusted carrying value of all nonfinancial equity investments held by the bank or by its direct or indirect subsidiaries. For purposes of this section II.B.5, investments held by a bank include all investments held directly or indirectly by the bank or any of its subsidiaries.

b. *Scope of nonfinancial equity investments.* A nonfinancial equity investment means any equity investment held by the bank in a non-financial company: through a small business investment company (SBIC) under section 302(b) of the Small Business Investment Act of 1958 (15 U.S.C. 682(b));<sup>21</sup> or under the portfolio investment provisions of the Board's Regulation K (12 CFR 211.8(c)(3)). A non-financial company is an entity that engages in any activity that has not been determined to be permissible for the bank to conduct directly, or to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act (12 U.S.C. 1843(k)).

c. *Amount of deduction from core capital.* i. The bank must deduct from its core capital elements the sum of the appropriate percentages, as set forth in Table 1, of the adjusted carrying value of all nonfinancial equity investments held by the bank. The amount of the percentage deduction increases as the aggregate amount of nonfinancial equity investments held by the bank increases as a percentage of the bank's Tier 1 capital.

TABLE 1—DEDUCTION FOR NONFINANCIAL EQUITY INVESTMENTS

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank (as a percentage of the Tier 1 capital of the bank) <sup>1</sup>	Deduction from Core Capital Elements (as a percentage of the adjusted carrying value of the investment)
Less than 15 percent .....	8 percent.

<sup>21</sup> An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in an SBIC that is not consolidated with the bank is treated as a non-financial equity investment.

<sup>19</sup> Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's Policy Statement on Nonvoting Equity Investments, 12 CFR 225.143 (Federal Reserve Regulatory Service 4-172.1; 68 Federal Reserve Bulletin 413 (1982)). In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital. The Board intends to monitor nonreciprocal holdings of other banking organizations' capital instruments and to provide information on such holdings to the Basle Supervisors' Committee as called for under the Basle capital framework.

<sup>20</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.

TABLE 1—DEDUCTION FOR NONFINANCIAL EQUITY INVESTMENTS—Continued

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank (as a percentage of the Tier 1 capital of the bank) <sup>1</sup>	Deduction from Core Capital Elements (as a percentage of the adjusted carrying value of the investment)
15 percent to 24.99 percent .....	12 percent.
25 percent and above .....	25 percent.

<sup>1</sup>For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of Tier 1 capital, 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, but prior to the deduction for any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

ii. These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent bank's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank equals 20 percent of the Tier 1 capital of the bank, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the bank's Tier 1 capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the bank's Tier 1 capital.

iii. The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under this paragraph is excluded from the bank's risk-weighted assets for purposes of computing the denominator of the bank's risk-based capital ratio.<sup>22</sup>

iv. As noted in section I, this appendix establishes *minimum* risk-based capital ratios and banks are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a bank from nonfinancial equity investments increases with its concentration in such investments and strong capital levels above the minimum requirements are particularly important when a bank has a high degree of concentration in nonfinancial equity investments (*e.g.*, in excess of 50 percent of Tier 1 capital). The Federal Reserve intends to monitor banks and apply heightened supervision to equity investment activities as appropriate, including where the bank has a high degree of con-

centration in nonfinancial equity investments, to ensure that each bank maintains capital levels that are appropriate in light of its equity investment activities. The Federal Reserve also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the bank, or other information, indicate that a higher minimum capital requirement is appropriate.

d. *SBIC investments.* i. No deduction is required for nonfinancial equity investments that are held by a bank through one or more SBICs that are consolidated with the bank or in one or more SBICs that are not consolidated with the bank to the extent that all such investments, in the aggregate, do not exceed 15 percent of the bank's Tier 1 capital. Any nonfinancial equity investment that is held through or in an SBIC and that is not required to be deducted from Tier 1 capital under this section II.B.5.d. will be assigned a 100 percent risk-weight and included in the bank's consolidated risk-weighted assets.<sup>23</sup>

ii. To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holds through one or more SBICs that are consolidated with the bank or in one or more SBICs that are not consolidated with the bank exceeds, in the aggregate, 15 percent of the bank's Tier 1 capital, the appropriate percentage of such amounts (as set forth in Table 1) must be deducted from the

<sup>23</sup>If a bank has an investment in an SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank, the adjusted carrying value of the bank's nonfinancial equity investments through the SBIC is equal to the bank's proportionate share of the adjusted carrying value of the SBIC's equity investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (*i.e.*, the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank. If a bank has an investment in an SBIC that is not consolidated for accounting purposes and has current information that identifies the percentage of the SBIC's assets that are equity investments in nonfinancial companies, the bank may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. If a bank reduces the adjusted carrying value of its investment in a non-consolidated SBIC to reflect financial investments of the SBIC, the amount of the adjustment will be risk weighted at 100 percent and included in the bank's risk-weighted assets.

<sup>22</sup>For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from Tier 1 capital, the entire adjusted carrying value of the investment will be excluded from risk-weighted assets in calculating the denominator for the risk-based capital ratio.

bank's core capital elements. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held through a consolidated SBIC and in a non-consolidated SBIC (including any investments for which no deduction is required) must be included in determining, for purposes of Table 1, the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital.

e. *Transition provisions.* No deduction under this section II.B.5 is required to be made with respect to the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that was made by the bank prior to March 13, 2000, or that was made by the bank after such date pursuant to a binding written commitment<sup>24</sup> entered into prior to March 13, 2000, provided that in either case the bank has continuously held the investment since the relevant investment date.<sup>25</sup> For purposes of this section II.B.5.e., a nonfinancial equity investment made prior to March 13, 2000, includes any shares or other interests received by the bank through a stock split or stock dividend on an investment made prior to March 13, 2000, provided the bank provides no consideration for the shares or interests received and the transaction does not materially increase

the bank's proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired prior to March 13, 2000, is *not* considered to be an investment made prior to March 13, 2000, if the bank provides any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.5.e. must be included in determining the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital for purposes of Table 1. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.5.e. will be assigned a 100-percent risk weight and included in the bank's consolidated risk-weighted assets.

f. *Adjusted carrying value.* i. For purposes of this section II.B.5., the "adjusted carrying value" of investments is the aggregate value at which the investments are carried on the balance sheet of the bank reduced by any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank's Tier 1 capital and associated deferred tax liabilities. For example, for investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank) *less* any unrealized gains on those investments that are included in other comprehensive income and not reflected in Tier 1 capital, and associated deferred tax liabilities.<sup>26</sup>

ii. As discussed above with respect to consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial company that is consolidated for accounting purposes under generally accepted accounting principles, the bank's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the bank's core capital in accordance with section II.B.1. of this appendix A). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit equivalent amounts of the company's off-balance sheet items) should be excluded from

<sup>24</sup> A "binding written commitment" means a legally binding written agreement that requires the bank to acquire shares or other equity of the company, or make a capital contribution to the company, under terms and conditions set forth in the agreement. Options, warrants, and other agreements that give a bank the right to acquire equity or make an investment, but do not require the bank to take such actions, are not considered a binding written commitment for purposes of this section II.B.5.

<sup>25</sup> For example, if a bank made an equity investment in 100 shares of a nonfinancial company prior to March 13, 2000, the adjusted carrying value of that investment would not be subject to a deduction under this section II.B.5. However, if the bank made any additional equity investment in the company after March 13, 2000, such as by purchasing additional shares of the company (including through the exercise of options or warrants acquired before or after March 13, 2000) or by making a capital contribution to the company and such investment was not made pursuant to a binding written commitment entered into before March 13, 2000, the adjusted carrying value of the additional investment would be subject to a deduction under this section II.B.5. In addition, if the bank sold and repurchased, after March 13, 2000, 40 shares of the company, the adjusted carrying value of those 40 shares would be subject to a deduction under this section II.B.5.

<sup>26</sup> Unrealized gains on AFS equity investments may be included in supplementary capital to the extent permitted under section II.A.2.e. of this appendix A. In addition, the unrealized losses on AFS equity investments are deducted from Tier 1 capital in accordance with section II.A.1.a. of this appendix A.

the bank's risk-weighted assets for regulatory capital purposes.

g. *Equity investments.* For purposes of this section II.B.5., an equity investment means any equity instrument (including common stock, preferred stock, partnership interests, interests in limited liability companies, trust certificates and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity where the instrument or feature is held under one of the legal authorities listed in section II.B.5.b. of this appendix A. An investment in any other instrument (including subordinated debt) may be treated as an equity investment if, in the judgment of the Federal Reserve, the instrument is the functional equivalent of equity or exposes the state member bank to essentially the same risks as an equity instrument.

### III. Procedures for Computing Weighted Risk Assets and Off-Balance Sheet Items

#### A. Procedures

Assets and credit equivalent amounts of off-balance sheet items of state member banks are assigned to one of several broad risk categories, according to the obligor, or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar value of the amount in each category is then multiplied by the risk weight associated with that category. The resulting weighted values from each of the risk categories are added together, and this sum is the bank's total weighted risk assets that comprise the denominator of the risk-based capital ratio. Attachment I provides a sample calculation.

Risk weights for all off-balance sheet items are determined by a two-step process. First, the "credit equivalent amount" of off-balance sheet items is determined, in most cases by multiplying the off-balance sheet item by a credit conversion factor. Second, the credit equivalent amount is treated like any balance sheet asset and generally is assigned to the appropriate risk category according to the obligor, or, if relevant, the guarantor or the nature of the collateral.

In general, if a particular item qualifies for placement in more than one risk category, it is assigned to the category that has the lowest risk weight. A holding of a U.S. municipal revenue bond that is fully guaranteed by a U.S. bank, for example, would be assigned the 20 percent risk weight appropriate to claims guaranteed by U.S. banks, rather than the 50 percent risk weight appropriate to U.S. municipal revenue bonds.<sup>27</sup>

The terms *claims* and *securities* used in the context of the discussion of risk weights, unless otherwise specified, refer to loans or debt obligations of the entity on whom the claim is held. Assets in the form of stock or equity holdings in commercial or financial firms are assigned to the 100 percent risk category, unless some other treatment is explicitly permitted.

The Federal Reserve will, on a case-by-case basis, determine the appropriate risk weight for any asset or credit equivalent amount of an off-balance sheet item that does not fit wholly within one of the risk weight categories set forth below or that imposes risks on a bank that are incommensurate with the risk weight otherwise specified below for the asset or off-balance sheet item. In addition, the Federal Reserve will, on a case-by-case basis, determine the appropriate credit conversion factor for any off-balance sheet item that does not fit wholly within one of the credit conversion factors set forth below or

rities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the stated investment objectives set forth in its prospectus. A bank may, at its option, assign a fund investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus. In no case will an investment in shares in any fund be assigned to a total risk weight less than 20 percent. If a bank chooses to assign a fund investment on a pro rata basis, and the sum of the investment limits of assets in the fund's prospectus exceeds 100 percent, the bank must assign risk weights in descending order. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities generally will be disregarded when determining the risk category into which the bank's holding in the overall fund should be assigned. The prudent use of hedging instruments by a fund to reduce the risk of its assets also will not increase the risk weighting of the fund investment. For example, the use of hedging instruments by a fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if a fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

<sup>27</sup> An investment in shares of a fund whose portfolio consists primarily of various secu-

that imposes risks on a bank that are incommensurate with the credit conversion factors otherwise specified below for the off-balance sheet item. In making such a determination, the Federal Reserve will consider the similarity of the asset or off-balance sheet item to assets or off-balance sheet items explicitly treated in the guidelines, as well as other relevant factors.

**B. Collateral, Guarantees, and Other Considerations**

1. *Collateral.* The only forms of collateral that are formally recognized by the risk-based capital framework are: Cash on deposit in the bank; securities issued or guaranteed by the central governments of the OECD-based group of countries,<sup>28</sup> U.S. Government agencies, or U.S. Government-sponsored agencies; and securities issued by multilateral lending institutions or regional development banks. Claims fully secured by such collateral generally are assigned to the 20 percent risk-weight category. Collateralized transactions meeting all the conditions described in section III.C.1. may be assigned a zero percent risk weight.

With regard to collateralized claims that may be assigned to the 20 percent risk-weight category, the extent to which qualifying securities are recognized as collateral is determined by their current market value. If such a claim is only partially secured, that is, the market value of the pledged securities

is less than the face amount of a balance-sheet asset or an off-balance-sheet item, the portion that is covered by the market value of the qualifying collateral is assigned to the 20 percent risk category, and the portion of the claim that is not covered by collateral in the form of cash or a qualifying security is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor. For example, to the extent that a claim on a private sector obligor is collateralized by the current market value of U.S. Government securities, it would be placed in the 20 percent risk category, and the balance would be assigned to the 100 percent risk category.

2. *Guarantees.* Guarantees of the OECD and non-OECD central governments, U.S. Government agencies, U.S. Government-sponsored agencies, state and local governments of the OECD-based group of countries, multilateral lending institutions and regional development banks, U.S. depository institutions, and foreign banks are also recognized. If a claim is partially guaranteed, that is, coverage of the guarantee is less than the face amount of a balance sheet asset or an off-balance sheet item, the portion that is not fully covered by the guarantee is assigned to the risk category appropriate to the obligor or, if relevant, to any collateral. The face amount of a claim covered by two types of guarantees that have different risk weights, such as a U.S. Government guarantee and a state guarantee, is to be apportioned between the two risk categories appropriate to the guarantors.

The existence of other forms of collateral or guarantees that the risk-based capital framework does not formally recognize may be taken into consideration in evaluating the risks inherent in a bank's loan portfolio—which, in turn, would affect the overall supervisory assessment of the bank's capital adequacy.

3. *Recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities.* Direct credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations and structured financings are treated as described below. The term “asset securitizations” or “securitizations” in this rule includes structured financings, as well as asset securitization transactions.

a. *Definitions*—i. *Credit derivative* means a contract that allows one party (the “protection purchaser”) to transfer the credit risk of an asset or off-balance sheet credit exposure to another party (the “protection provider”). The value of a credit derivative is dependent, at least in part, on the credit performance of the “reference asset.”

ii. *Credit-enhancing representations and warranties* means representations and warranties that are made or assumed in connection with a transfer of assets (including loan servicing

<sup>28</sup> The OECD-based group of countries comprises all full members of the Organization for Economic Cooperation and Development (OECD) regardless of entry date, as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow, but excludes any country that has rescheduled its external sovereign debt within the previous five years. As of November 1995, the OECD included the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States; and Saudi Arabia had concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow. A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal course of business, such as a renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

assets) and that obligate the bank to protect investors from losses arising from credit risk in the assets transferred or the loans serviced. Credit-enhancing representations and warranties include promises to protect a party from losses resulting from the default or nonperformance of another party or from an insufficiency in the value of the collateral. Credit-enhancing representations and warranties do not include:

1. Early default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1-4 family residential first mortgage loans that qualify for a 50 percent risk weight for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer;

2. Premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency or a government-sponsored enterprise, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or

3. Warranties that permit the return of assets in instances of misrepresentation, fraud or incomplete documentation.

iii. *Direct credit substitute* means an arrangement in which a bank assumes, in form or in substance, credit risk associated with an on- or off-balance sheet credit exposure that was not previously owned by the bank (third-party asset) and the risk assumed by the bank exceeds the pro rata share of the bank's interest in the third-party asset. If the bank has no claim on the third-party asset, then the bank's assumption of any credit risk with respect to the third party asset is a direct credit substitute. Direct credit substitutes include, but are not limited to:

1. Financial standby letters of credit that support financial claims on a third party that exceed a bank's pro rata share of losses in the financial claim;

2. Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed a bank's pro rata share in the financial claim;

3. Purchased subordinated interests or securities that absorb more than their pro rata share of losses from the underlying assets;

4. Credit derivative contracts under which the bank assumes more than its pro rata share of credit risk on a third party exposure;

5. Loans or lines of credit that provide credit enhancement for the financial obligations of an account party;

6. Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Mortgage servicer cash advances that meet the condi-

tions of section III.B.3.a.viii. of this appendix are not direct credit substitutes;

7. Clean-up calls on third party assets. Clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option of the bank are not direct credit substitutes; and

8. Liquidity facilities that provide liquidity support to ABCP (other than eligible ABCP liquidity facilities).

iv. *Eligible ABCP liquidity facility* means a liquidity facility supporting ABCP, in form or in substance, that is subject to an asset quality test at the time of draw that precludes funding against assets that are 90 days or more past due or in default. In addition, if the assets that an eligible ABCP liquidity facility is required to fund against are externally rated assets or exposures at the inception of the facility, the facility can be used to fund only those assets or exposures that are externally rated investment grade at the time of funding. Notwithstanding the eligibility requirements set forth in the two preceding sentences, a liquidity facility will be considered an eligible ABCP liquidity facility if the assets that are funded under the liquidity facility and which do not meet the eligibility requirements are guaranteed, either conditionally or unconditionally, by the U.S. government or its agencies, or by the central government of an OECD country.

v. *Externally rated* means that an instrument or obligation has received a credit rating from a nationally recognized statistical rating organization.

vi. *Face amount* means the notional principal, or face value, amount of an off-balance sheet item; the amortized cost of an asset not held for trading purposes; and the fair value of a trading asset.

vii. *Financial asset* means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

viii. *Financial standby letter of credit* means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

1. To repay money borrowed by, or advanced to, or for the account of, a second party (the account party), or

2. To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

ix. *Liquidity Facility* means a legally binding commitment to provide liquidity support to ABCP by lending to, or purchasing assets from, any structure, program, or conduit in the event that funds are required to repay maturing ABCP.

x. *Mortgage servicer cash advance* means funds that a residential mortgage loan



servicer advances to ensure an uninterrupted flow of payments, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the loan. A mortgage servicer cash advance is not a recourse obligation or a direct credit substitute if:

1. The servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or

2. For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal balance of that loan.

xi. *Nationally recognized statistical rating organization (NRSRO)* means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (or any successor Division) (Commission) as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers.

xii. *Recourse* means the retention, by a bank, in form or in substance, of any credit risk directly or indirectly associated with an asset it has transferred and sold that exceeds a pro rata share of the bank's claim on the asset. If a bank has no claim on a transferred asset, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when a bank transfers assets and retains an explicit obligation to repurchase the assets or absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

1. Credit-enhancing representations and warranties made on the transferred assets;

2. Loan servicing assets retained pursuant to an agreement under which the bank will be responsible for credit losses associated with the loans being serviced. Mortgage servicer cash advances that meet the conditions of section III.B.3.a.x. of this appendix are not recourse arrangements;

3. Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets;

4. Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;

5. Loan strips sold without contractual recourse where the maturity of the transferred loan is shorter than the maturity of the commitment under which the loan is drawn;

6. Credit derivatives issued that absorb more than the bank's pro rata share of losses from the transferred assets;

7. Clean-up calls at inception that are greater than 10 percent of the balance of the original pool of transferred loans. Clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option of the bank are not recourse arrangements; and

8. Liquidity facilities that provide liquidity support to ABCP (other than eligible ABCP liquidity facilities).

xiii. *Residual interest* means any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise, and that exposes the bank to credit risk directly or indirectly associated with the transferred assets that exceeds a pro rata share of the bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Residual interests generally include credit-enhancing I/Os, spread accounts, cash collateral accounts, retained subordinated interests, other forms of over-collateralization, and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the bank to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include interests purchased from a third party, except that purchased credit-enhancing I/Os are residual interests for purposes of this appendix.

xiv. *Risk participation* means a participation in which the originating party remains liable to the beneficiary for the full amount of an obligation (e.g., a direct credit substitute) notwithstanding that another party has acquired a participation in that obligation.

xv. *Securitization* means the pooling and repackaging by a special purpose entity of assets or other credit exposures into securities that can be sold to investors. Securitization includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

xvi. *Sponsor* means a bank that establishes an ABCP program; approves the sellers permitted to participate in the program; approves the asset pools to be purchased by the program; or administers the program by monitoring the assets, arranging for debt placement, compiling monthly reports, or ensuring compliance with the program documents and with the program's credit and investment policy.

xvii. *Structured finance program* means a program where receivable interests and asset-backed securities issued by multiple

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participants are purchased by a special purpose entity that repackages those exposures into securities that can be sold to investors. Structured finance programs allocate credit risks, generally, between the participants and credit enhancement provided to the program.

xviii. *Traded position* means a position that is externally rated and is retained, assumed, or issued in connection with an asset securitization, where there is a reasonable expectation that, in the near future, the rating will be relied upon by unaffiliated investors to purchase the position; or an unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

b. *Credit equivalent amounts and risk weight of recourse obligations and direct credit substitutes.* i. *Credit equivalent amount.* Except as otherwise provided in sections III.B.3.c. through f. and III.B.5. of this appendix, the credit equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit-enhanced assets for which the bank directly or indirectly retains or assumes credit risk multiplied by a 100 percent conversion factor.

ii. *Risk-weight factor.* To determine the bank's risk-weight factor for off-balance sheet recourse obligations and direct credit substitutes, the credit equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct credit substitute that is an on-balance sheet asset (e.g., a purchased subordinated security), a bank must calculate risk-weighted assets using the amount of the direct credit substitute and the full amount of the assets it supports, i.e., all the more senior positions in the structure. The treatment of direct credit substitutes that have been syndicated or in which risk participations have been conveyed or acquired is set forth in section III.D.1 of this appendix.

c. *Externally-rated positions: credit equivalent amounts and risk weights of recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities (including asset-backed commercial paper).* i. *Traded positions.* With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing I/O strip) or asset- and mortgage-backed security (including asset-backed commercial paper) that is a traded position and that has received an external rating on a long-term position that is one grade below investment grade or better or a short-term rating that is investment grade, the bank may multiply the face amount of the position by the appropriate risk weight, determined in accordance with the tables below. Stripped mortgage-backed securities and other similar instruments, such as interest-only or principal-

only strips that are not credit enhancements, must be assigned to the 100 percent risk category. If a traded position has received more than one external rating, the lowest single rating will apply.

Long-term rating category	Examples	Risk weight (In percent)
Highest or second highest investment grade.	AAA, AA ..	20
Third highest investment grade ...	A .....	50
Lowest investment grade .....	BBB .....	100
One category below investment grade.	BB .....	200

  

Short-term rating	Examples	Risk weight (In percent)
Highest investment grade .....	A-1, P-1 ..	20
Second highest investment grade ..	A-2, P-2 ..	50
Lowest investment grade .....	A-3, P-3 ..	100

ii. *Non-traded positions.* A recourse obligation, direct credit substitute, or residual interest (but not a credit-enhancing I/O strip) extended in connection with a securitization that is not a traded position may be assigned a risk weight in accordance with section III.B.3.c.i. of this appendix if:

1. It has been externally rated by more than one NRSRO;
2. It has received an external rating on a long-term position that is one grade below investment grade or better or on a short-term position that is investment grade by all NRSROs providing a rating;
3. The ratings are publicly available; and
4. The ratings are based on the same criteria used to rate traded positions.

If the ratings are different, the lowest rating will determine the risk category to which the recourse obligation, direct credit substitute, or residual interest will be assigned.

d. *Senior positions not externally rated.* For a recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security that is not externally rated but is senior or preferred in all features to a traded position (including collateralization and maturity), a bank may apply a risk weight to the face amount of the senior position in accordance with section III.B.3.c.i. of this appendix, based on the traded position, subject to any current or prospective supervisory guidance and the bank satisfying the Federal Reserve that this treatment is appropriate. This section will apply only if the traded subordinated position provides substantive credit support to the unrated position until the unrated position matures.

e. *Capital requirement for residual interests—* i. *Capital requirement for credit-enhancing I/O strips.* After applying the concentration limit to credit-enhancing I/O strips (both purchased and retained) in accordance with sections II.B.2.c. through e. of this appendix, a bank must maintain risk-based capital for a credit-enhancing I/O strip (both purchased

and retained), regardless of the external rating on that position, equal to the remaining amount of the credit-enhancing I/O strip (net of any existing 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. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing I/O strip will be treated as if the credit-enhancing I/O strip was retained by the bank and not transferred.

ii. *Capital requirement for other residual interests.* 1. If a residual interest does not meet the requirements of sections III.B.3.c. or d. of this appendix, a bank must maintain risk-based capital equal to the remaining amount of the residual interest that is retained on the balance sheet (net of any existing 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. Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest was retained by the bank and not transferred.

2. Where the aggregate capital requirement for residual interests and other recourse obligation in connection with the same transfer of assets exceed the full risk-based capital requirement for those assets, a bank must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under section III.B.3.e.ii.1 of this appendix or the full risk-based capital requirement for the assets transferred.

f. *Positions that are not rated by an NRSRO.* A position (but not a residual interest) maintained in connection with a securitization and that is not rated by a NRSRO may be risk-weighted based on the bank's determination of the credit rating of the position, as specified in the table below, multiplied by the face amount of the position. In order to obtain this treatment, the bank's system for determining the credit rating of the position must meet one of the three alternative standards set out in sections III.B.3.f.i. through III.B.3.f.iii. of this appendix.

Rating category	Examples	Risk weight (In percent)
Highest or second highest investment grade.	AAA,AA ....	100
Third highest investment grade ....	A .....	100
Lowest investment grade .....	BBB .....	100
One category below investment grade.	BB .....	200

1. *Internal risk rating used for asset-backed programs.* A direct credit substitute (other than a purchased credit-enhancing I/O) is assumed in connection with an asset-backed

commercial paper program sponsored by the bank and the bank is able to demonstrate to the satisfaction of the Federal Reserve, prior to relying upon its use, that the bank's internal credit risk rating system is adequate. Adequate internal credit risk rating systems usually contain the following criteria:

1. The internal credit risk system is an integral part of the bank's risk management system, which explicitly incorporates the full range of risks arising from a bank's participation in securitization activities;

2. Internal credit ratings are linked to measurable outcomes, such as the probability that the position will experience any loss, the position's expected loss given default, and the degree of variance in losses given default on that position;

3. The bank's internal credit risk system must separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of a particular securitization transaction;

4. The bank's internal credit risk system must identify gradations of risk among "pass" assets and other risk positions;

5. The bank must have clear, explicit criteria that are used to classify assets into each internal risk grade, including subjective factors;

6. The bank must have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

7. The bank must have an internal audit procedure that periodically verifies that the internal credit risk ratings are assigned in accordance with the established criteria;

8. The bank must monitor the performance of the internal credit risk ratings assigned to nonrated, nontraded direct credit substitutes over time to determine the appropriateness of the initial credit risk rating assignment and adjust individual credit risk ratings, or the overall internal credit risk ratings system, as needed; and

9. The internal credit risk system must make credit risk rating assumptions that are consistent with, or more conservative than, the credit risk rating assumptions and methodologies of NRSROs.

ii. *Program Ratings.* A direct credit substitute or recourse obligation (other than a residual interest) is assumed or retained in connection with a structured finance program and a NRSRO has reviewed the terms of the program and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal credit enhancements and other relevant factors, and the NRSRO specifies ranges of rating categories to them, the bank may apply the rating category that corresponds to the bank's position. In order to rely on a program rating, the bank must demonstrate to the Federal Reserve's satisfaction that the credit

risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The bank must also demonstrate to the Federal Reserve's satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular position. If a bank participates in a securitization sponsored by another party, the Federal Reserve may authorize the bank to use this approach based on a programmatic rating obtained by the sponsor of the program.

iii. *Computer Program.* The bank is using an acceptable credit assessment computer program to determine the rating of a direct credit substitute or recourse obligation (but not residual interest) issued in connection with a structured finance program. A NRSRO must have developed the computer program, and the bank must demonstrate to the Federal Reserve's satisfaction that ratings under the program correspond credibly and reliably with the rating of traded positions.

g. *Limitations on risk-based capital requirements—i. Low-level exposure.* If the maximum contractual exposure to loss retained or assumed by a bank in connection with a recourse obligation or a direct credit substitute is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual exposure, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply when a bank provides credit enhancement beyond any contractual obligation to support assets it has sold.

ii. *Mortgage-related securities or participation certificates retained in a mortgage loan swap.* If a bank holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the bank continued to hold these loans as on-balance sheet assets.

iii. *Related on-balance sheet assets.* If a recourse obligation or direct credit substitute subject to section III.B.3. of this appendix also appears as a balance sheet asset, the balance sheet asset is not included in a bank's risk-weighted assets to the extent the value of the balance sheet asset is already included in the off-balance sheet credit equivalent amount for the recourse obligation or direct credit substitute, except in the case of loan servicing assets and similar arrangements with embedded recourse obliga-

tions or direct credit substitutes. In that case, both the on-balance sheet assets and the related recourse obligations and direct credit substitutes must be separately risk-weighted and incorporated into the risk-based capital calculation.

4. *Maturity.* Maturity is generally not a factor in assigning items to risk categories with the exception of claims on non-OECD banks, commitments, and interest rate and foreign exchange rate contracts. Except for commitments, short-term is defined as one year or less *remaining* maturity and long-term is defined as over one year *remaining* maturity. In the case of commitments, short-term is defined as one year or less *original* maturity and long-term is defined as over one year *original* maturity.

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

b. For purposes of this appendix A, a bank is qualifying if it meets the criteria set forth in the Board's prompt corrective action regulation (12 CFR 208.40) for well capitalized or, by order of the Board, adequately capitalized. For purposes of determining whether a bank meets the criteria, its capital ratios must be calculated without regard to the preferential capital treatment for transfers of small business obligations with recourse specified in section III.B.5.a. of this appendix A. The total outstanding amount of recourse retained by a qualifying bank on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the bank's total risk-based capital. By order, the Board may approve a higher limit.

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

d. The risk-based capital ratios of the bank shall be calculated without regard to the preferential capital treatment for transfers

of small business obligations with recourse specified in section III.B.5.a. of this appendix A for purposes of:

(i) Determining whether a bank is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under prompt corrective action (12 CFR 208.43(b)(1)); and

(ii) Reclassifying a well capitalized bank to adequately capitalized and requiring an adequately capitalized bank to comply with certain mandatory or discretionary supervisory actions as if the bank were in the next lower prompt corrective action capital category (12 CFR 208.43(c)).

6. *Asset-backed commercial paper programs.* a. An asset-backed commercial paper (ABCP) program means a program that primarily issues externally rated commercial paper backed by assets or other exposures held in a bankruptcy-remote, special purpose entity.

b. If a bank has multiple overlapping exposures (such as a program-wide credit enhancement and multiple pool-specific liquidity facilities) to an ABCP program that is not consolidated for risk-based capital purposes, the bank is not required to hold duplicative risk-based capital under this appendix against the overlapping position. Instead, the bank should apply to the overlapping position the applicable risk-based capital treatment that results in the highest capital charge.

#### C. Risk Weights

Attachment III contains a listing of the risk categories, a summary of the types of assets assigned to each category and the weight associated with each category, that is, 0 percent, 20 percent, 50 percent, and 100 percent. A brief explanation of the components of each category follows.

1. *Category 1: zero percent.* This category includes cash (domestic and foreign) owned and held in all offices of the bank or in transit and gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis, to the extent it is offset by gold bullion liabilities.<sup>29</sup> The category also includes all direct claims (including securities, loans, and leases) on, and the portions of claims that are directly and unconditionally guaranteed by, the central governments<sup>30</sup> of

the OECD countries and U.S. Government agencies,<sup>31</sup> as well as all direct local currency claims on, and the portions of local currency claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that the bank has liabilities booked in that currency. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. Government or its agencies that are actively traded in financial markets, such as GNMA securities, are considered to be unconditionally guaranteed.

This category also includes claims collateralized by cash on deposit in the bank or by securities issued or guaranteed by OECD central governments or U.S. government agencies for which a positive margin of collateral is maintained on a daily basis, fully taking into account any change in the bank's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim.

This category also includes ABCP (i) purchased on or after September 19, 2008, by a bank from an SEC-registered open-end investment company that holds itself out as a money market mutual fund under SEC Rule 2a-7 (17 CFR 270.2a-7) and (ii) pledged by the bank to a Federal Reserve Bank to secure financing from the ABCP lending facility

the central government. In addition, it does not include local government entities or commercial enterprises whose obligations are guaranteed by the central government, although any claims on such entities guaranteed by central governments are placed in the same general risk category as other claims guaranteed by central governments. OECD central governments are defined as central governments of the OECD-based group of countries; non-OECD central governments are defined as central governments that do not belong to the OECD-based group of countries.

<sup>31</sup> A U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government. Such agencies include the Government National Mortgage Association (GNMA), the Veterans Administration (VA), the Federal Housing Administration (FHA), the Export-Import Bank (Exim Bank), the Overseas Private Investment Corporation (OPIC), the Commodity Credit Corporation (CCC), and the Small Business Administration (SBA).

<sup>29</sup> All other holdings of bullion are assigned to the 100 percent risk category.

<sup>30</sup> A central government is defined to include departments and ministries, including the central bank, of the central government. The U.S. central bank includes the 12 Federal Reserve Banks, and the stock held in these banks as a condition of membership is assigned to the zero percent risk category. The definition of central government does not include state, provincial, or local governments; or commercial enterprises owned by

(AMLF) established by the Board on September 19, 2008.

2. *Category 2: 20 percent.* a. This category includes cash items in the process of collection, both foreign and domestic; short-term claims (including demand deposits) on, and the portions of short-term claims that are guaranteed<sup>32</sup> by, U.S. depository institutions<sup>33</sup> and foreign banks;<sup>34</sup> and long-term claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions and OECD banks.<sup>35</sup>

b. This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. Government agencies, as well as the portions of

local currency claims that are conditionally guaranteed by non-OECD central governments, to the extent that the bank has liabilities booked in that currency. In addition, this category also includes claims on, and the portions of claims that are guaranteed by, U.S. government-sponsored<sup>36</sup> agencies and claims on, and the portions of claims guaranteed by, the International Bank for Reconstruction and Development (World Bank), the International Finance Corporation, the Interamerican Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. General obligation claims on, or portions of claims guaranteed by the full faith and credit of, states or other political subdivisions of the U.S. or other countries of the OECD-based group are also assigned to this category.<sup>37</sup>

c. This category also includes the portions of claims (including repurchase transactions) collateralized by cash on deposit in the bank or by securities issued or guaranteed by OECD central governments or U.S. government agencies that do not qualify for the zero percent risk-weight category; collateralized by securities issued or guaranteed by U.S. government-sponsored agencies; or collateralized by securities issued by multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member.

<sup>32</sup> Claims guaranteed by U.S. depository institutions and foreign banks include risk participations in both bankers acceptances and standby letters of credit, as well as participations in commitments, that are conveyed to other U.S. depository institutions or foreign banks.

<sup>33</sup> U.S. depository institutions are defined to include branches (foreign and domestic) of federally-insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, and international banking facilities of domestic banks. U.S.-chartered depository institutions owned by foreigners are also included in the definition. However, branches and agencies of foreign banks located in the U.S., as well as all bank holding companies, are excluded.

<sup>34</sup> Foreign banks are distinguished as either OECD banks or non-OECD banks. OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries (other than the U.S.) that belong to the OECD-based group of countries. Non-OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries that do not belong to the OECD-based group of countries. For this purpose, a bank is defined as an institution that engages in the business of banking; is recognized as a bank by the bank supervisory or monetary authorities of the country of its organization or principal banking operations; receives deposits to a substantial extent in the regular course of business; and has the power to accept demand deposits.

<sup>35</sup> Long-term claims on, or guaranteed by, non-OECD banks and all claims on bank holding companies are assigned to the 100 percent risk category, as are holdings of bank-issued securities that qualify as capital of the issuing banks.

<sup>36</sup> For this purpose, U.S. government-sponsored agencies are defined as agencies originally established or chartered by the Federal government to serve public purposes specified by the U.S. Congress but whose obligations are *not explicitly* guaranteed by the full faith and credit of the U.S. government. These agencies include the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), the Farm Credit System, the Federal Home Loan Bank System, and the Student Loan Marketing Association (SLMA). Claims on U.S. government-sponsored agencies include capital stock in a Federal Home Loan Bank that is held as a condition of membership in that Bank.

<sup>37</sup> Claims on, or guaranteed by, states or other political subdivisions of countries that do not belong to the OECD-based group of countries are placed in the 100 percent risk category.

d. This category also includes claims<sup>38</sup> on, or guaranteed by, a qualifying securities firm incorporated in the United States or other member of the OECD-based group of countries<sup>39</sup> provided that: The qualifying securities firm has a long-term issuer credit rating, or a rating on at least one issue of long-term debt, in one of the three highest investment grade rating categories from a nationally recognized statistical rating organization; or the claim is guaranteed by the firm's parent company and the parent company has such a rating. If ratings are available from more than one rating agency, the lowest rating will be used to determine whether the rating requirement has been met. This category also includes a collateralized claim on a qualifying securities firm in such a country, without regard to satisfaction of the rating standard, provided that the claim arises under a contract that:

- (1) Is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed using standard industry documentation;
- (2) Is collateralized by debt or equity securities that are liquid and readily marketable;
- (3) Is marked-to-market daily;
- (4) Is subject to a daily margin maintenance requirement under the standard industry documentation; and
- (5) Can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or avoided,

<sup>38</sup>Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirements are not eligible for this risk weight.

<sup>39</sup>With regard to securities firms incorporated in the United States, qualifying securities firms are those securities firms that are broker-dealers registered with the Securities and Exchange Commission (SEC) and are in compliance with the SEC's net capital rule, 17 CFR 240.15c3-1. With regard to securities firms incorporated in any other country in the OECD-based group of countries, qualifying securities firms are those securities firms that a bank is able to demonstrate are subject to consolidated supervision and regulation (covering their direct and indirect subsidiaries, but not necessarily their parent organizations) comparable to that imposed on banks in OECD countries. Such regulation must include risk-based capital requirements comparable to those applied to banks under the Accord on International Convergence of Capital Measurement and Capital Standards (1988, as amended in 1998) (Basel Accord).

under applicable law of the relevant jurisdiction.<sup>40</sup>

3. *Category 3: 50 percent.* This category includes loans fully secured by first liens<sup>41</sup> on 1- to 4-family residential properties, either owner-occupied or rented, or on multifamily residential properties,<sup>42</sup> that meet certain

<sup>40</sup>For example, a claim is exempt from the automatic stay in bankruptcy in the United States if it arises under a securities contract or a repurchase agreement subject to section 555 or 559 of the Bankruptcy Code, respectively (11 U.S.C. 555 or 559), a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407), or the Board's Regulation EE (12 CFR Part 231).

<sup>41</sup>If a bank holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purposes of determining the loan-to-value ratio and assigning a risk weight.

<sup>42</sup>Loans that qualify as loans secured by 1- to 4-family residential properties or multifamily residential properties are listed in the instructions to the commercial bank Call Report. In addition, for risk-based capital purposes, loans secured by 1- to 4-family residential properties include loans to builders with substantial project equity for the construction of 1- to 4-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest money deposits. Such loans to builders will be considered prudently underwritten only if the bank has obtained sufficient documentation that the buyer of the home intends to purchase the home (*i.e.*, has a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (*i.e.*, has a firm written commitment for permanent financing of the home upon completion).

The instructions to the Call Report also discuss the treatment of loans, including multifamily housing loans, that are sold subject to a pro rata loss sharing arrangement. Such an arrangement should be treated by the selling bank as sold (and excluded from balance sheet assets) to the extent that the sales agreement provides for the purchaser of the loan to share in any loss incurred on the loan on a pro rata basis with the selling bank. In such a transaction, from the standpoint of the selling bank, the portion of the loan that is treated as sold is not subject to

criteria.<sup>43</sup> Loans included in this category must have been made in accordance with prudent underwriting standards;<sup>44</sup> be performing in accordance with their original terms; and not be 90 days or more past due or carried in nonaccrual status. For purposes of this 50 percent risk weight category, a loan modified on a permanent or trial basis solely pursuant to the U.S. Department of Treasury's Home Affordable Mortgage Program will be considered to be performing in accordance with its original terms. The following additional criteria must also be applied to a loan secured by a multifamily residential property that is included in this category: all principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or in the case where the existing property owner is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; amortization of

the risk-based capital standards. In connection with sales of multifamily housing loans in which the purchaser of a loan shares in any loss incurred on the loan with the selling institution on other than a pro rata basis, these other loss sharing arrangements are taken into account for purposes of determining the extent to which such loans are treated by the selling bank as sold (and excluded from balance sheet assets) under the risk-based capital framework in the same as prescribed for reporting purposes in the instructions to the Call Report.

<sup>43</sup>Residential property loans that do not meet all the specified criteria or that are made for the purpose of speculative property development are placed in the 100 percent risk category.

<sup>44</sup>Prudent underwriting standards include a conservative ratio of the current loan balance to the value of the property. In the case of a loan secured by multifamily residential property, the loan-to-value ratio is not conservative if it exceeds 80 percent (75 percent if the loan is based on a floating interest rate). Prudent underwriting standards also dictate that a loan-to-value ratio used in the case of originating a loan to acquire a property would not be deemed conservative unless the value is based on the lower of the acquisition cost of the property or appraised (or if appropriate, evaluated) value. Otherwise, the loan-to-value ratio generally would be based upon the value of the property as determined by the most current appraisal, or if appropriate, the most current evaluation. All appraisals must be made in a manner consistent with the Federal banking agencies' real estate appraisal regulations and guidelines and with the bank's own appraisal guidelines.

the principal and interest must occur over a period of not more than 30 years and the minimum original maturity for repayment of principal must not be less than 7 years; and the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in this category are privately-issued mortgage-backed securities provided that:

(1) The structure of the security meets the criteria described in section III(B)(3) above;

(2) If the security is backed by a pool of conventional mortgages, on 1- to 4-family residential or multifamily residential properties each underlying mortgage meets the criteria described above in this section for eligibility for the 50 percent risk category at the time the pool is originated;

(3) If the security is backed by privately issued mortgage-backed securities, *each* underlying security qualifies for the 50 percent risk category; and

(4) If the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due.

Privately-issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

Also assigned to this category are *revenue* (non-general obligation) bonds or similar obligations, including loans and leases, that are obligations of states or other political subdivisions of the U.S. (for example, municipal revenue bonds) or other countries of the OECD-based group, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds.

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

4. *Category 4: 100 percent.* a. Except as provided in section III.C. 4.e of this appendix, all assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

b. This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all



claims on non-OECD central governments that entail some degree of transfer risk.<sup>45</sup> This category includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding involving standard risk claims;<sup>46</sup> investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; all stripped mortgage-backed securities and similar instruments; and commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight). This category also includes claims representing capital of a qualifying securities firm.

c. Also included in this category are industrial-development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest, and all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

d. The following assets also are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.

e. Subject to the requirements below, a bank may assign an asset not included in the

categories above to the risk weight category applicable under the capital guidelines for bank holding companies (*See* 12 CFR part 225, appendix A), provided that all of the following conditions apply

i. The bank is not authorized to hold the asset under applicable law other than under debt previously contracted or other similar authority; and

ii. The risks associated with the asset are substantially similar to the risks of assets that are otherwise assigned to a risk weight category of less than 100 percent under this appendix.

#### D. Off-Balance Sheet Items

The face amount of an off-balance sheet item is generally incorporated into risk-weighted assets in two steps. The face amount is first multiplied by a credit conversion factor, except for direct credit substitutes and recourse obligations as discussed in section III.D.1. of this appendix. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor, the nature of any collateral, or external credit ratings.<sup>47</sup>

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

a. Except as otherwise provided in section III.B.3. of this appendix, the full amount of an asset or transaction supported, in whole or in part, by a direct credit substitute or a recourse obligation. Direct credit substitutes and recourse obligations are defined in section III.B.3. of this appendix.

b. Sale and repurchase agreements and forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,<sup>48</sup> and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

c. Securities lent by a bank are treated in one of two ways, depending upon whether the lender is at risk of loss. If a bank, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded

<sup>45</sup> Such assets include all nonlocal currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local currency claims on, or guaranteed by, non-OECD central governments that exceed the local currency liabilities held by the bank.

<sup>46</sup> Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

<sup>47</sup> The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B of this appendix A.

<sup>48</sup> Forward forward deposits accepted are treated as interest rate contracts.

from the risk-based capital calculation. If, alternatively, a bank lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor, or, if applicable, to any collateral delivered to the lending bank, or the independent custodian acting on the lending bank's behalf. Where a bank is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the bank, the transaction is deemed to be collateralized by cash on deposit in the bank for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

d. In the case of direct credit substitutes in which a risk participation<sup>49</sup> has been conveyed, the full amount of the assets that are supported, in whole or in part, by the credit enhancement are converted to a credit equivalent amount at 100 percent. However, the *pro rata* share of the credit equivalent amount that has been conveyed through a risk participation is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after considering any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation.<sup>50</sup> Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the *pro rata* share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the 20 percent risk category.<sup>51</sup>

<sup>49</sup>That is, a participation in which the originating bank remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

<sup>50</sup>A risk participation in bankers acceptances conveyed to other institutions is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

<sup>51</sup>Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

e. In the case of direct credit substitutes in which a risk participation has been acquired, the acquiring bank's percentage share of the direct credit substitute is multiplied by the full amount of the assets that are supported, in whole or in part, by the credit enhancement and converted to a credit equivalent amount at 100 percent. The credit equivalent amount of an acquisition of a risk participation in a direct credit substitute is assigned to the risk category appropriate to the account party obligor or, if relevant, the nature of the collateral or guarantees.

f. In the case of direct credit substitutes that take the form of a syndication where each bank is obligated only for its *pro rata* share of the risk and there is no recourse to the originating bank, each bank will only include its *pro rata* share of the assets supported, in whole or in part, by the direct credit substitute in its risk-based capital calculation.<sup>52</sup>

2. *Items with a 50 percent conversion factor.* a. Transaction-related contingencies are converted at 50 percent. Such contingencies include bid bonds, performance bonds, warranties, standby letters of credit related to particular transactions, and performance standby letters of credit, as well as acquisitions of risk participations in performance standby letters of credit. Performance standby letters of credit represent obligations backing the performance of nonfinancial or commercial contracts or undertakings. To the extent permitted by law or regulation, performance standby letters of credit include arrangements backing, among other things, subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

b. The unused portion of commitments with an *original* maturity exceeding one year, including underwriting commitments, and commercial and consumer credit commitments also are converted at 50 percent. Original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which: (1) The bank can, at its option, unconditionally (without cause) cancel the commitment,<sup>53</sup> and (2) the bank is scheduled to (and

<sup>52</sup>For example, if a bank has a 10 percent share of a \$10 syndicated direct credit substitute that provides credit support to a \$100 loan, then the bank's \$1 *pro rata* share in the enhancement means that a \$10 *pro rata* share of the loan is included in risk weighted assets.

<sup>53</sup>In the case of consumer home equity or mortgage lines of credit secured by liens on 1-4 family residential properties, the bank is deemed able to unconditionally cancel the commitment for the purpose of this criterion if, at its option, it can prohibit additional

*Continued*

as a normal practice actually does) review the facility to determine whether or not it should be extended. Such reviews must continue to be conducted at least annually for such a facility to qualify as a short-term commitment.

c.i. Commitments are defined as any legally binding arrangements that obligate a bank to extend credit in the form of loans or leases; to purchase loans, securities, or other assets; or to participate in loans and leases. They also include overdraft facilities, revolving credit, home equity and mortgage lines of credit, eligible ABCP liquidity facilities, and similar transactions. Normally, commitments involve a written contract or agreement and a commitment fee, or some other form of consideration. Commitments are included in weighted-risk assets regardless of whether they contain “material adverse change” clauses or other provisions that are intended to relieve the issuer of its funding obligation under certain conditions. In the case of commitments structured as syndications, where the bank is obligated solely for its *pro rata* share, only the bank’s proportional share of the syndicated commitment is taken into account in calculating the risk-based capital ratio.

ii Banks that are subject to the market risk rules are required to convert the notional amount of eligible ABCP liquidity facilities, in form or in substance, with an original maturity of over one year that are carried in the trading account at 50 percent to determine the appropriate credit equivalent amount even though those facilities are structured or characterized as derivatives or other trading book assets. Liquidity facilities that support ABCP, in form or in substance, (including those positions to which the market risk rules may not be applied as set forth in section 2(a) of appendix E to part 208) that are not eligible ABCP liquidity facilities are to be considered recourse obligations or direct credit substitutes, and assessed the appropriate risk-based capital treatment in accordance with section III.B.3. of this appendix.

d. Once a commitment has been converted at 50 percent, any portion that has been conveyed to other U.S. depository institutions or OECD banks as participations in which the originating bank retains the full obligation to the borrower if the participating bank fails to pay when the instrument is drawn, is assigned to the 20 percent risk category. This treatment is analogous to that accorded to conveyances of risk participations in standby letters of credit. The acquisition of a participation in a commitment by a bank is converted at 50 percent and as-

signed to the risk category appropriate to the account party obligor or, if relevant, the nature of the collateral or guarantees.

e. Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and other similar arrangements also are converted at 50 percent regardless of maturity. These are facilities under which a borrower can issue on a revolving basis short-term paper in its own name, but for which the underwriting banks have a legally binding commitment either to purchase any notes the borrower is unable to sell by the roll-over date or to advance funds to the borrower.

3. *Items with a 20 percent conversion factor.* Short-term, self-liquidating trade-related contingencies which arise from the movement of goods are converted at 20 percent. Such contingencies generally include commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

4. *Items with a 10 percent conversion factor.* a. Unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less are converted at 10 percent.

b. Banks that are subject to the market risk rules are required to convert the notional amount of eligible ABCP liquidity facilities, in form or in substance, with an original maturity of one year or less that are carried in the trading account at 10 percent to determine the appropriate credit equivalent amount even though those facilities are structured or characterized as derivatives or other trading book assets. Liquidity facilities that support ABCP, in form or in substance, (including those positions to which the market risk rules may not be applied as set forth in section 2(a) of appendix E of this part) that are not eligible ABCP liquidity facilities are to be considered recourse obligations or direct credit substitutes and assessed the appropriate risk-based capital requirement in accordance with section III.B.3. of this appendix.

5. *Items with a zero percent conversion factor.* These include unused portions of commitments (with the exception of eligible ABCP liquidity facilities) with an original maturity of one year or less,<sup>54</sup> or which are unconditionally cancelable at any time, provided a separate credit decision is made before each drawing under the facility. Unused portions of lines of credit on retail credit cards and related plans are deemed to be short-term commitments if the bank has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

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

extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by relevant Federal law.

<sup>54</sup> [Reserved]

## Federal Reserve System

## Pt. 208, App. A

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

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

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

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

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

e. *Exceptions.* Exchange rate contracts with an original maturity of fourteen or fewer calendar days and derivative contracts traded on exchanges that require daily receipt and payment of cash variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the

same treatment as exchange rate contracts except that gold contracts with an original maturity of fourteen or fewer calendar days are included in the risk-based ratio calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

2. *Calculation of credit equivalent amounts.* a. The credit equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with section III.E.3. of this appendix A is equal to the sum of (i) the current exposure (sometimes referred to as the replacement cost) of the contract; and (ii) an estimate of the potential future credit exposure of the contract.

b. The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is equal to that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in underlying rates, prices, and indices, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit conversion factor. Banks should use, subject to examiner review, the effective rather than the apparent or stated notional amount in this calculation. The credit conversion factors are:

### CONVERSION FACTORS

[In percent]

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

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

e. For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest rate, ex-

change rate, equity, or commodity contracts as set forth in section III.E.1. of this appendix A, is subject to the same conversion factors as a commodity, excluding precious metals.

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

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

3. *Netting.* a. For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values when determining a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit equivalent amount provided that:

i. The netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the bank would have a claim to receive, or obligation to pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to any of the following events: default, insolvency, liquidation, or similar circumstances.

ii. The bank obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the bank's exposure to be the net amount under:

1. The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

2. The law that governs the individual contracts covered by the netting contract; and

3. The law that governs the netting contract.

iii. The bank establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law.

iv. The bank maintains in its files documentation adequate to support the netting of derivative contracts, including a copy of the bilateral netting contract and necessary legal opinions.

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.<sup>55</sup>

<sup>55</sup> A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the con-

c. A bank netting individual contracts for the purpose of calculating credit equivalent amounts of derivative contracts, represents that it has met the requirements of this appendix A and all the appropriate documents are in the bank's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a bank's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable under any one of the bodies of law described in section III.E.3.a.ii. of this appendix A. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

d. The credit equivalent amount of contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract (net current exposure) and (ii) the sum of the estimates of potential future credit exposures on all individual contracts subject to the netting contract (gross potential future exposure) adjusted to reflect the effects of the netting contract.<sup>56</sup>

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

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

g. The effects of the bilateral netting contract on the gross potential future exposure

tract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

<sup>56</sup> For purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.

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

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

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

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

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

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

i. In the event a netting contract covers contracts that are normally excluded from the risk-based ratio calculation—for example, exchange rate contracts with an original maturity of fourteen or fewer calendar days or instruments traded on exchanges that require daily payment and receipt of cash variation margin—a bank may elect to either include or exclude all mark-to-market values of such contracts when determining net current exposure, provided the method chosen is applied consistently.

4. *Risk Weights.* Once the credit equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor

or the nature of any collateral.<sup>57</sup> However, the maximum risk weight applicable to the credit equivalent amount of such contracts is 50 percent.

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

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

#### IV. Minimum Supervisory Ratios and Standards

The interim and final supervisory standards set forth below specify *minimum* supervisory ratios based primarily on broad credit risk considerations. As noted above, the risk-based ratio does not take explicit account of the quality of individual asset portfolios or the range of other types of risks to which banks may be exposed, such as interest rate, liquidity, market or operational risks. For this reason, banks are generally expected to operate with capital positions above the minimum ratios.

Institutions with high or inordinate levels of risk are expected to operate well above minimum capital standards. Banks experiencing or anticipating significant growth are also expected to maintain capital, including tangible capital positions, well above the minimum levels. For example, most such institutions generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banks. In all cases, banks should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

Upon adoption of the risk-based framework, any bank that does not meet the interim or final supervisory ratios, or whose capital is otherwise considered inadequate, is expected to develop and implement a plan

<sup>57</sup> For derivative contracts, sufficiency of collateral or guarantees is generally determined by the market value of the collateral or the amount of the guarantee in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B. of this appendix A.

acceptable to the Federal Reserve for achieving an adequate level of capital consistent with the provisions of these guidelines or with the special circumstances affecting the individual institution. In addition, such banks should avoid any actions, including increased risk-taking or unwarranted expansion, that would lower or further erode their capital positions.

#### A. Minimum Risk-Based Ratio After Transition Period

As reflected in Attachment VI, by year-end 1992, all state member banks should meet a minimum ratio of qualifying total capital to weighted risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of Tier 1 capital. For purposes of section IV.A., Tier 1 capital is defined as the sum of core capital elements less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix. The maximum amount of supplementary capital elements that qualifies as Tier 2 capital is limited to 100 percent of Tier 1 capital. In addition, the combined maximum amount of subordinated debt and intermediate-term preferred stock that qualifies as Tier 2 capital is limited to 50 percent of Tier 1 capital. The maximum amount of the allowance for loan and lease losses that qualifies as Tier 2 capital is limited to 1.25 percent of gross weighted risk assets. Allowances for loan and lease losses in excess of this limit may, of course, be maintained, but would not be included in a bank's total capital. The Federal Reserve will continue to require banks to maintain reserves at levels fully sufficient to cover losses inherent in their loan portfolios.

Qualifying total capital is calculated by adding Tier 1 capital and Tier 2 capital (limited to 100 percent of Tier 1 capital) and then deducting from this sum certain investments

in banking or finance subsidiaries that are not consolidated for accounting or supervisory purposes, reciprocal holdings of banking organization capital securities, or other items at the direction of the Federal Reserve. These deductions are discussed above in section II(B).

#### B. Transition Arrangements

The transition period for implementing the risk-based capital standard ends on December 31, 1992. Initially, the risk-based capital guidelines do not establish a minimum level of capital. However, by year-end 1990, banks are expected to meet a minimum interim target ratio for qualifying total capital to weighted risk assets of 7.25 percent, at least one-half of which should be in the form of Tier 1 capital. For purposes of meeting the 1990 interim target, the amount of loan loss reserves that may be included in capital is limited to 1.5 percent of weighted risk assets and up to 10 percent of a bank's Tier 1 capital may consist of supplementary capital elements. Thus, the 7.25 percent interim target ratio implies a minimum ratio of Tier 1 capital to weighted risk assets of 3.6 percent (one-half of 7.25) and a minimum ratio of core capital elements to weighted risk assets ratio of 3.25 percent (nine-tenths of the Tier 1 capital ratio).

Through year-end 1990, banks have the option of complying with the minimum 7.25 percent year-end 1990 risk-based capital standard, in lieu of the minimum 5.5 percent primary and 6 percent total capital to total assets capital ratios set forth in appendix B to part 225 of the Federal Reserve's Regulation Y. In addition, as more fully set forth in appendix B to this part, banks are expected to maintain a minimum ratio of Tier 1 capital total assets during this transition period.

### ATTACHMENT I—SAMPLE CALCULATION OF RISK-BASED CAPITAL RATIO FOR STATE MEMBER BANKS

Example of a bank with \$6,000 in total capital and the following assets and off-balance sheet items:

<b>Balance Sheet Assets:</b>	
Cash .....	\$5,000
U.S. Treasuries .....	20,000
Balances at domestic banks .....	5,000
Loans secured by first liens on 1–4 family residential properties .....	5,000
Loans to private corporations .....	65,000
<b>Total Balance Sheet Assets .....</b>	<b>\$100,000</b>
<b>Off-Balance Sheet Items:</b>	
Standby letters of credit ("SLCs") backing general obligation debt issues of U.S. municipalities ("GOs") .....	\$10,000
Long-term legally binding commitments to private corporations .....	20,000
<b>Total Off-Balance Sheet Items .....</b>	<b>30,000</b>

This bank's total capital to *total* assets (leverage) ratio would be:  $(\$6,000/\$100,000)=6.00\%$

To compute the bank's weighted risk assets:

1. Compute the credit equivalent amount of each off-balance sheet ("OBS") item

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OBS item	Face value		Conversion factor		Credit equivalent amount
SLCS backing municipal GOs .....	\$10,000	×	1.00	=	\$10,000
Long-term commitments to private corporations .....	20,000	×	0.50	=	10,000
2. Multiply each balance sheet asset and the credit equivalent amount of each OBS item by the appropriate risk weight.					
0% Category:					
Cash .....	\$ 5,000				
U.S. Treasuries .....	20,000				
	25,000	×	0	=	0
20% Category:					
Balances at domestic banks .....	5,000				
Credit equivalent amounts of SLCS backing GOs of U.S. municipalities .....	10,000				
	15,000	×	.20	=	\$3,000
50% Category:					
Loans secured by first liens on 1–4 family residential properties .....	5,000	×	.50	=	2,500
100% Category:					
Loans to private corporations .....	65,000				
Credit equivalent amounts of long-term commitments to private corporations .....	10,000				
	75,000	×	1.00	=	75,000
Total risk-weighted assets .....					80,500
This bank's ratio of total capital to weighted risk assets (risk-based capital ratio) would be: (\$6,000/\$80,500)=7.45%					

### C. Optional Transition Provisions Related to the Implementation of Consolidation Requirements Under FAS 167

This section IV.C. provides optional transition provisions for a bank that is required for financial and regulatory reporting purposes, as a result of its implementation of Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167), to consolidate certain variable interest entities (VIEs) as defined under United States generally accepted accounting principles (GAAP). These transition provisions apply through the end of the fourth quarter following the date of a bank's implementation of FAS 167 (implementation date).

#### 1. Exclusion Period

a. *Exclusion of risk-weighted assets for the first and second quarters.* For the first two quarters after the implementation date (exclusion period), including for the two calendar quarter-end regulatory report dates within those quarters, a bank may exclude from risk-weighted assets:

i. Subject to the limitations in section IV.C.3, assets held by a VIE, provided that the following conditions are met:

(1) The VIE existed prior to the implementation date,

(2) The bank did not consolidate the VIE on its balance sheet for calendar quarter-end regulatory report dates prior to the implementation date,

(3) The bank must consolidate the VIE on its balance sheet beginning as of the imple-

mentation date as a result of its implementation of FAS 167, and

(4) The bank excludes all assets held by VIEs described in paragraphs C.1.a.i.(1) through (3) of this section IV.C.1.a.i; and

ii. Subject to the limitations in section IV.C.3, assets held by a VIE that is a consolidated ABCP program, provided that the following conditions are met:

(1) The bank is the sponsor of the ABCP program,

(2) Prior to the implementation date, the bank consolidated the VIE onto its balance sheet under GAAP and excluded the VIE's assets from the bank's risk-weighted assets, and

(3) The bank chooses to exclude all assets held by ABCP program VIEs described in paragraphs (1) and (2) of this section IV.C.1.a.ii.

b. *Risk-weighted assets during exclusion period.* During the exclusion period, including for the two-calendar quarter-end regulatory report dates within the exclusion period, a bank adopting the optional provisions in section IV.C.1.a must calculate risk-weighted assets for its contractual exposures to the VIEs referenced in section IV.C.1.a on the implementation date and include this calculated amount in its risk-weighted assets. Such contractual exposures may include direct-credit substitutes, recourse obligations, residual interests, liquidity facilities, and loans.

c. *Inclusion of allowance for loan and lease losses in tier 2 capital for the first and second*



*quarters.* During the exclusion period, including for the two calendar quarter-end regulatory report dates within the exclusion period, a bank that excludes VIE assets from risk-weighted assets pursuant to section IV.C.1.a may include in tier 2 capital the full amount of the allowance for loan and lease losses (ALLL) calculated as of the implementation date that is attributable to the assets it excludes pursuant to section IV.C.1.a (inclusion amount). The amount of ALLL includable in tier 2 capital in accordance with this paragraph shall not be subject to the limitations set forth in section II.A.2.a. of this Appendix.

#### 2. Phase-In Period

a. *Exclusion amount.* For purposes of this section IV.C., *exclusion amount* is defined as the amount of risk-weighted assets excluded in section IV.C.1.a. as of the implementation date.

b. *Risk-weighted assets for the third and fourth quarters.* A bank that excludes assets of consolidated VIEs from risk-weighted assets pursuant to section IV.C.1.a. may, for the third and fourth quarters after the implementation date (phase-in period), including for the two calendar quarter-end regulatory report dates within those quarters, exclude from risk-weighted assets 50 percent of the exclusion amount, provided that the bank may not include in risk-weighted assets pursuant to this paragraph an amount less than the aggregate risk-weighted assets calculated pursuant to section IV.C.1.b.

c. *Inclusion of ALLL in tier 2 capital for the third and fourth quarters.* A bank that excludes assets of consolidated VIEs from risk-weighted assets pursuant to section IV.C.2.b. may, for the phase-in period, include in tier 2 capital 50 percent of the inclusion amount it included in tier 2 capital during the exclusion period, notwithstanding the limit on including ALLL in tier 2 capital in section II.A.2.a. of this Appendix.

3. *Implicit recourse limitation.* Notwithstanding any other provision in this section IV.C., assets held by a VIE to which the bank has provided recourse through credit enhancement beyond any contractual obligation to support assets it has sold may not be excluded from risk-weighted assets.

[54 FR 4198, Jan. 27, 1989]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting appendix A to part 208, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at [www.fdsys.gov](http://www.fdsys.gov).

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### APPENDIX B TO PART 208—CAPITAL ADEQUACY GUIDELINES FOR STATE MEMBER BANKS: TIER 1 LEVERAGE MEASURE

LISHED AT 78 FR 62284, OCT. 11, 2013.

#### I. OVERVIEW

a. The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of state member banks.<sup>1</sup> The principal objective of this measure is to place a constraint on the maximum degree to which a state member bank can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

b. The guidelines apply to all state member banks on a consolidated basis and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

#### II. THE TIER 1 LEVERAGE RATIO

a. The minimum ratio of Tier 1 capital to total assets for strong banking institutions (rated composite “1” under the UFIRS rating system of banks) is 3.0 percent. For all other institutions, the minimum ratio of Tier 1 capital to total assets is 4.0 percent. Banking institutions with supervisory, financial, operational, or managerial weaknesses, as well as institutions that are anticipating or experiencing significant growth, are expected to maintain capital ratios well above the minimum levels. Moreover, higher capital ratios may be required for any banking institution if warranted by its particular circumstances or risk profile. In all cases, institutions should hold capital commensurate with the level and nature of the risks, including the volume and severity of problem loans, to which they are exposed.

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

<sup>1</sup>Supervisory risk-based capital ratios that related capital to weighted-risk assets for state member banks are outlined in Appendix A to this part.

will be used.<sup>2</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 bank's Reports of Condition and Income (Call Reports), less goodwill; amounts of mortgage servicing assets, non-mortgage servicing assets, and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, are in excess of 25 percent of Tier 1 capital; amounts of credit-enhancing interest-only strips that 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 Tier 1 capital; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitations set forth in section II.B.4 of appendix A of this part; and the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from Tier 1 capital.<sup>3</sup>

c. Notwithstanding other provisions of this appendix B, a qualifying bank that has transferred small business loans and leases on personal property (small business obligations) with recourse shall, for purposes of calculating its tier 1 leverage ratio, exclude from its average total consolidated assets the outstanding principal amount of the small business loans and leases transferred with recourse, provided two conditions are

met. First, the transaction must be treated as a sale under generally accepted accounting principles (GAAP) and, second, the bank must establish pursuant to GAAP a non-capital reserve sufficient to meet the bank's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act are eligible for this capital treatment.

d. For purposes of this appendix B, a bank is qualifying if it meets the criteria set forth in the Board's prompt corrective action regulation (12 CFR 208.40) for well capitalized or, by order of the Board, adequately capitalized. For purposes of determining whether a bank meets these criteria, its capital ratios must be calculated without regard to the preferential capital treatment for transfers of small business obligations with recourse specified in section II.c. of this appendix B. The total outstanding amount of recourse retained by a qualifying bank on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the bank's total risk-based capital. By order, the Board may approve a higher limit.

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

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

(i) Determining whether a bank is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under prompt corrective action (12 CFR 208.43(b)(1)); and

(ii) Reclassifying a well capitalized bank to adequately capitalized and requiring an adequately capitalized bank to comply with certain mandatory or discretionary supervisory actions as if the bank were in the next lower prompt corrective action capital category (12 CFR 208.43(c)).

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

<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 assets, non-mortgage servicing assets, and purchased credit card relationships that, in the aggregate, exceed 100 percent of Tier 1 capital; nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 25 percent of Tier 1 capital; amounts of credit enhancing interest-only strips in excess of 25 percent of Tier 1 capital; other identifiable intangible assets; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations; and a percentage of the bank's nonfinancial equity investments. The Federal Reserve may exclude certain other investments in subsidiaries or associated companies as appropriate.

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

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

h. Notwithstanding anything in this appendix to the contrary, a bank may deduct from its average total consolidated assets the amount of any asset-backed commercial paper (i) purchased by the bank on or after September 19, 2008, from an SEC-registered open-end investment company that holds itself out as a money market mutual fund under SEC Rule 2a–7 (17 CFR 270.2a–7) and (ii) pledged by the bank to a Federal Reserve Bank to secure financing from the ABCP lending facility (AMLF) established by the Board on September 19, 2008.

[Reg. H, 59 FR 65925, Dec. 22, 1994, as amended at 60 FR 39230, Aug. 1, 1995; 60 FR 45615, Aug. 31, 1995; 63 FR 42675, Aug. 10, 1998; 63 FR 58621, Nov. 2, 1998; 64 FR 10200, Mar. 2, 1999; 66 FR 59643, Nov. 29, 2001; 67 FR 3800, Jan. 25, 2002; 73 FR 55707, Sept. 26, 2008; 74 FR 6224, Feb. 6, 2009]

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#### APPENDIX C TO PART 208—INTERAGENCY GUIDELINES FOR REAL ESTATE LENDING POLICIES

The agencies' regulations require that each insured depository institution adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate or made for the purpose of financing the construction of a building or other improvements.<sup>1</sup> These guidelines are intended to assist institutions in the formulation and maintenance of a real estate lending policy that is appropriate to the size of the institution and the nature and scope of its individual operations, as well as satisfies the requirements of the regulation.

Each institution's policies must be comprehensive, and consistent with safe and sound lending practices, and must ensure that the institution operates within limits and according to standards that are reviewed and approved at least annually by the board of directors. Real estate lending is an integral part of many institutions' business plans and, when undertaken in a prudent manner, will not be subject to examiner criticism.

<sup>1</sup>The agencies have adopted a uniform rule on real estate lending. See 12 CFR part 365 (FDIC); 12 CFR part 208, subpart E (FRB); 12 CFR part 34, subpart D (OCC); and 12 CFR 563.100–101 (OTS).

#### LOAN PORTFOLIO MANAGEMENT CONSIDERATIONS

The lending policy should contain a general outline of the scope and distribution of the institution's credit facilities and the manner in which real estate loans are made, serviced, and collected. In particular, the institution's policies on real estate lending should:

- Identify the geographic areas in which the institution will consider lending.
- Establish a loan portfolio diversification policy and set limits for real estate loans by type and geographic market (e.g., limits on higher risk loans).
- Identify appropriate terms and conditions by type of real estate loan.
- Establish loan origination and approval procedures, both generally and by size and type of loan.
- Establish prudent underwriting standards that are clear and measurable, including loan-to-value limits, that are consistent with these supervisory guidelines.
- Establish review and approval procedures for exception loans, including loans with loan-to-value percentages in excess of supervisory limits.
- Establish loan administration procedures, including documentation, disbursement, collateral inspection, collection, and loan review.
- Establish real estate appraisal and evaluation programs.
- Require that management monitor the loan portfolio and provide timely and adequate reports to the board of directors.

The institution should consider both internal and external factors in the formulation of its loan policies and strategic plan. Factors that should be considered include:

- The size and financial condition of the institution.
- The expertise and size of the lending staff.
- The need to avoid undue concentrations of risk.
- Compliance with all real estate related laws and regulations, including the Community Reinvestment Act, anti-discrimination laws, and for savings associations, the Qualified Thrift Lender test.
- Market conditions.

The institution should monitor conditions in the real estate markets in its lending area so that it can react quickly to changes in market conditions that are relevant to its lending decisions. Market supply and demand factors that should be considered include:

- Demographic indicators, including population and employment trends.
- Zoning requirements.

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- Current and projected vacancy, construction, and absorption rates.
- Current and projected lease terms, rental rates, and sales prices, including concessions.
- Current and projected operating expenses for different types of projects.
- Economic indicators, including trends and diversification of the lending area.
- Valuation trends, including discount and direct capitalization rates.

### UNDERWRITING STANDARDS

Prudently underwritten real estate loans should reflect all relevant credit factors, including:

- The capacity of the borrower, or income from the underlying property, to adequately service the debt.
- The value of the mortgaged property.
- The overall creditworthiness of the borrower.
- The level of equity invested in the property.
- Any secondary sources of repayment.
- Any additional collateral or credit enhancements (such as guarantees, mortgage insurance or takeout commitments).

The lending policies should reflect the level of risk that is acceptable to the board of directors and provide clear and measurable underwriting standards that enable the institution's lending staff to evaluate these credit factors. The underwriting standards should address:

- The maximum loan amount by type of property.
- Maximum loan maturities by type of property.
- Amortization schedules.
- Pricing structure for different types of real estate loans.
- Loan-to-value limits by type of property.

For development and construction projects, and completed commercial properties, the policy should also establish, commensurate with the size and type of the project or property:

- Requirements for feasibility studies and sensitivity and risk analyses (*e.g.*, sensitivity of income projections to changes in economic variables such as interest rates, vacancy rates, or operating expenses).
- Minimum requirements for initial investment and maintenance of hard equity by the borrower (*e.g.*, cash or unencumbered investment in the underlying property).
- Minimum standards for net worth, cash flow, and debt service coverage of the borrower or underlying property.
- Standards for the acceptability of and limits on non-amortizing loans.
- Standards for the acceptability of and limits on the use of interest reserves.

- Pre-leasing and pre-sale requirements for income-producing property.
- Pre-sale and minimum unit release requirements for non-income-producing property loans.
- Limits on partial recourse or non-recourse loans and requirements for guarantor support.
- Requirements for takeout commitments.
- Minimum covenants for loan agreements.

### LOAN ADMINISTRATION

The institution should also establish loan administration procedures for its real estate portfolio that address:

- Documentation, including:
  - Type and frequency of financial statements, including requirements for verification of information provided by the borrower;
  - Type and frequency of collateral evaluations (appraisals and other estimates of value).
- Loan closing and disbursement.
- Payment processing.
- Escrow administration.
- Collateral administration.
- Loan payoffs.
- Collections and foreclosure, including:
  - Delinquency follow-up procedures;
  - Foreclosure timing;
  - Extensions and other forms of forbearance;
  - Acceptance of deeds in lieu of foreclosure.
- Claims processing (*e.g.*, seeking recovery on a defaulted loan covered by a government guaranty or insurance program).
- Servicing and participation agreements.

### SUPERVISORY LOAN-TO-VALUE LIMITS

Institutions should establish their own internal loan-to-value limits for real estate loans. These internal limits should not exceed the following supervisory limits:

Loan category	Loan-to-value limit (percent)
Raw land .....	65
Land development .....	75
Construction:	
Commercial, multifamily, <sup>1</sup> and other nonresidential .....	80
1- to 4-family residential .....	85
Improved property .....	85
Owner-occupied 1- to 4-family and home equity .....	( <sup>2</sup> )

<sup>1</sup>Multifamily construction includes condominiums and co-operatives.

<sup>2</sup>A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied, 1- to 4-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

The supervisory loan-to-value limits should be applied to the underlying property

that collateralizes the loan. For loans that fund multiple phases of the same real estate project (e.g., a loan for both land development and construction of an office building), the appropriate loan-to-value limit is the limit applicable to the final phase of the project funded by the loan; however, loan disbursements should not exceed actual development or construction outlays. In situations where a loan is fully cross-collateralized by two or more properties or is secured by a collateral pool of two or more properties, the appropriate maximum loan amount under supervisory loan-to-value limits is the sum of the value of each property, less senior liens, multiplied by the appropriate loan-to-value limit for each property. To ensure that collateral margins remain within the supervisory limits, lenders should redetermine conformity whenever collateral substitutions are made to the collateral pool.

In establishing internal loan-to-value limits, each lender is expected to carefully consider the institution-specific and market factors listed under “Loan Portfolio Management Considerations,” as well as any other relevant factors, such as the particular subcategory or type of loan. For any subcategory of loans that exhibits greater credit risk than the overall category, a lender should consider the establishment of an internal loan-to-value limit for that subcategory that is lower than the limit for the overall category.

The loan-to-value ratio is only one of several pertinent credit factors to be considered when underwriting a real estate loan. Other credit factors to be taken into account are highlighted in the “Underwriting Standards” section above. Because of these other factors, the establishment of these supervisory limits should not be interpreted to mean that loans at these levels will automatically be considered sound.

#### LOANS IN EXCESS OF THE SUPERVISORY LOAN-TO-VALUE LIMITS

The agencies recognize that appropriate loan-to-value limits vary not only among categories of real estate loans but also among individual loans. Therefore, it may be appropriate in individual cases to originate or purchase loans with loan-to-value ratios in excess of the supervisory loan-to-value limits, based on the support provided by other credit factors. Such loans should be identified in the institutions’s records, and their aggregate amount reported at least quarterly to the institution’s board of directors. (See additional reporting requirements described under “Exceptions to the General Policy.”)

The aggregate amount of all loans in excess of the supervisory loan-to-value limits should not exceed 100 percent of total cap-

ital.<sup>2</sup> Moreover, within the aggregate limit, total loans for all commercial, agricultural, multifamily or other non-1-to-4 family residential properties should not exceed 30 percent of total capital. An institution will come under increased supervisory scrutiny as the total of such loans approaches these levels.

In determining the aggregate amount of such loans, institutions should: (a) Include all loans secured by the same property if any one of those loans exceeds the supervisory loan-to-value limits; and (b) include the recourse obligation of any such loan sold with recourse. Conversely, a loan should no longer be reported to the directors as part of aggregate totals when reduction in principal or senior liens, or additional contribution of collateral or equity (e.g., improvements to the real property securing the loan), bring the loan-to-value ratio into compliance with supervisory limits.

#### EXCLUDED TRANSACTIONS

The agencies also recognize that there are a number of lending situations in which other factors significantly outweigh the need to apply the supervisory loan-to-value limits. These include:

- Loans guaranteed or insured by the U.S. government or its agencies, provided that the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory loan-to-value limit.
- Loans backed by the full faith and credit of a state government, provided that the amount of the assurance is at least equal to the portion of the loan that exceeds the supervisory loan-to-value limit.
- Loans guaranteed or insured by a state, municipal or local government, or an agency thereof, provided that the amount of the

<sup>2</sup>For advanced approaches banks (as defined in 12 CFR 208.41) and, after January 1, 2015, for all state member banks, the term “total capital” refers to that term as defined in subpart A of 12 CFR part 217. For insured state nonmember banks and state savings associations, “total capital” refers to that term defined in subpart A of 12 CFR part 324. For national banks and Federal savings associations, the term “total capital” refers to that term as defined in subpart A of 12 CFR part 3. Prior to January 1, 2015, for state member banks that are not advanced approaches banks (as defined in 12 CFR 208.41), the term “total capital” means “total risk-based capital” as defined in appendix A to 12 CFR part 208. For insured state non-member banks, “total capital” refers to that term described in table I of appendix A to 12 CFR part 325. For national banks, the term “total capital” is defined at 12 CFR 3.2(e). For savings associations, the term “total capital” is defined at 12 CFR 567.5(c).

guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory loan-to-value limit, and provided that the lender has determined that the guarantor or insurer has the financial capacity and willingness to perform under the terms of the guaranty or insurance agreement.

- Loans that are to be sold promptly after origination, without recourse, to a financially responsible third party.

- Loans that are renewed, refinanced, or restructured without the advancement of new funds or an increase in the line of credit (except for reasonable closing costs), or loans that are renewed, refinanced, or restructured in connection with a workout situation, either with or without the advancement of new funds, where consistent with safe and sound banking practices and part of a clearly defined and well-documented program to achieve orderly liquidation of the debt, reduce risk of loss, or maximize recovery on the loan.

- Loans that facilitate the sale of real estate acquired by the lender in the ordinary course of collecting a debt previously contracted in good faith.

- Loans for which a lien on or interest in real property is taken as additional collateral through an abundance of caution by the lender (e.g., the institution takes a blanket lien on all or substantially all of the assets of the borrower, and the value of the real property is low relative to the aggregate value of all other collateral).

- Loans, such as working capital loans, where the lender does not rely principally on real estate as security and the extension of credit is not used to acquire, develop, or construct permanent improvements on real property.

- Loans for the purpose of financing permanent improvements to real property, but not secured by the property, if such security interest is not required by prudent underwriting practice.

#### EXCEPTIONS TO THE GENERAL LENDING POLICY

Some provision should be made for the consideration of loan requests from credit-worthy borrowers whose credit needs do not fit within the institution's general lending policy. An institution may provide for prudently underwritten exceptions to its lending policies, including loan-to-value limits, on a loan-by-loan basis. However, any exceptions from the supervisory loan-to-value limits should conform to the aggregate limits on such loans discussed above.

The board of directors is responsible for establishing standards for the review and approval of exception loans. Each institution should establish an appropriate internal process for the review and approval of loans that do not conform to its own internal policy standards. The approval of any such loan

should be supported by a written justification that clearly sets forth all of the relevant credit factors that support the underwriting decision. The justification and approval documents for such loans should be maintained as a part of the permanent loan file. Each institution should monitor compliance with its real estate lending policy and individually report exception loans of a significant size to its board of directors.

#### SUPERVISORY REVIEW OF REAL ESTATE LENDING POLICIES AND PRACTICES

The real estate lending policies of institutions will be evaluated by examiners during the course of their examinations to determine if the policies are consistent with safe and sound lending practices, these guidelines, and the requirements of the regulation. In evaluating the adequacy of the institution's real estate lending policies and practices, examiners will take into consideration the following factors:

- The nature and scope of the institution's real estate lending activities.

- The size and financial condition of the institution.

- The quality of the institution's management and internal controls.

- The expertise and size of the lending and loan administration staff.

- Market conditions.

Lending policy exception reports will also be reviewed by examiners during the course of their examinations to determine whether the institutions' exceptions are adequately documented and appropriate in light of all of the relevant credit considerations. An excessive volume of exceptions to an institution's real estate lending policy may signal a weakening of its underwriting practices, or may suggest a need to revise the loan policy.

#### DEFINITIONS

For the purposes of these Guidelines:

*Construction loan* means an extension of credit for the purpose of erecting or rehabilitating buildings or other structures, including any infrastructure necessary for development.

*Extension of credit or loan* means:

- (1) The total amount of any loan, line of credit, or other legally binding lending commitment with respect to real property; and

- (2) The total amount, based on the amount of consideration paid, of any loan, line of credit, or other legally binding lending commitment acquired by a lender by purchase, assignment, or otherwise.

*Improved property loan* means an extension of credit secured by one of the following types of real property:

- (1) Farmland, ranchland or timberland committed to ongoing management and agricultural production;

(2) 1- to 4-family residential property that is not owner-occupied;

(3) Residential property containing five or more individual dwelling units;

(4) Completed commercial property; or

(5) Other income-producing property that has been completed and is available for occupancy and use, except income-producing owner-occupied 1- to 4-family residential property.

*Land development loan* means an extension of credit for the purpose of improving unimproved real property prior to the erection of structures. The improvement of unimproved real property may include the laying or placement of sewers, water pipes, utility cables, streets, and other infrastructure necessary for future development.

*Loan origination* means the time of inception of the obligation to extend credit (i.e., when the last event or prerequisite, controllable by the lender, occurs causing the lender to become legally bound to fund an extension of credit).

*Loan-to-value* or *loan-to-value ratio* means the percentage or ratio that is derived at the time of loan origination by dividing an extension of credit by the total value of the property(ies) securing or being improved by the extension of credit plus the amount of any readily marketable collateral and other acceptable collateral that secures the extension of credit. The total amount of all senior liens on or interests in such property(ies) should be included in determining the loan-to-value ratio. When mortgage insurance or collateral is used in the calculation of the loan-to-value ratio, and such credit enhancement is later released or replaced, the loan-to-value ratio should be recalculated.

*Other acceptable collateral* means any collateral in which the lender has a perfected security interest, that has a quantifiable value, and is accepted by the lender in accordance with safe and sound lending practices. Other acceptable collateral should be appropriately discounted by the lender consistent with the lender's usual practices for making loans secured by such collateral. Other acceptable collateral includes, among other items, unconditional irrevocable standby letters of credit for the benefit of the lender.

*Owner-occupied*, when used in conjunction with the term *1- to 4-family residential property* means that the owner of the underlying real property occupies at least one unit of the real property as a principal residence of the owner.

*Readily marketable collateral* means insured deposits, financial instruments, and bullion in which the lender has a perfected interest. Financial instruments and bullion must be salable under ordinary circumstances with reasonable promptness at a fair market value determined by quotations based on actual transactions, on an auction or similarly

available daily bid and ask price market. Readily marketable collateral should be appropriately discounted by the lender consistent with the lender's usual practices for making loans secured by such collateral.

*Value* means an opinion or estimate, set forth in an appraisal or evaluation, whichever may be appropriate, of the market value of real property, prepared in accordance with the agency's appraisal regulations and guidance. For loans to purchase an existing property, the term "value" means the lesser of the actual acquisition cost or the estimate of value.

*1- to 4-family residential property* means property containing fewer than five individual dwelling units, including manufactured homes permanently affixed to the underlying property (when deemed to be real property under state law).

[57 FR 62896, 62900, Dec. 31, 1992; 58 FR 4460, Jan. 14, 1993; 63 FR 58621, Nov. 2, 1998; 78 FR 62284, Oct. 11, 2013]

#### APPENDIX D-1 TO PART 208—INTER-AGENCY GUIDELINES ESTABLISHING STANDARDS FOR SAFETY AND SOUNDNESS

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##### I. INTRODUCTION

- i. Section 39 of the Federal Deposit Insurance Act<sup>1</sup> (FDI Act) requires each Federal

<sup>1</sup>Section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p-1) was added by section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Pub. L. 102-242, 105 Stat. 2236 (1991), and amended by section 956 of the Housing and Community Development Act of 1992, Pub. L. 102-550, 106 Stat. 3895 (1992) and

banking agency (collectively, the agencies) to establish certain safety and soundness standards by regulation or by guideline for all insured depository institutions. Under section 39, the agencies must establish three types of standards: (1) Operational and managerial standards; (2) compensation standards; and (3) such standards relating to asset quality, earnings, and stock valuation as they determine to be appropriate.

ii. Section 39(a) requires the agencies to establish operational and managerial standards relating to: (1) Internal controls, information systems and internal audit systems, in accordance with section 36 of the FDI Act (12 U.S.C. 1831m); (2) loan documentation; (3) credit underwriting; (4) interest rate exposure; (5) asset growth; and (6) compensation, fees, and benefits, in accordance with subsection (c) of section 39. Section 39(b) requires the agencies to establish standards relating to asset quality, earnings, and stock valuation that the agencies determine to be appropriate.

iii. Section 39(c) requires the agencies to establish standards prohibiting as an unsafe and unsound practice any compensatory arrangement that would provide any executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits and any compensatory arrangement that could lead to material financial loss to an institution. Section 39(c) also requires that the agencies establish standards that specify when compensation is excessive.

iv. If an agency determines that an institution fails to meet any standard established by guideline under subsection (a) or (b) of section 39, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. In the event that an institution fails to submit an acceptable plan within the time allowed by the agency or fails in any material respect to implement an accepted plan, the agency must, by order, require the institution to correct the deficiency. The agency may, and in some cases must, take other supervisory actions until the deficiency has been corrected.

v. The agencies have adopted amendments to their rules and regulations to establish deadlines for submission and review of compliance plans.<sup>2</sup>

section 318 of the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325, 108 Stat. 2160 (1994).

<sup>2</sup>For the Office of the Comptroller of the Currency, these regulations appear at 12 CFR Part 30; for the Board of Governors of the Federal Reserve System, these regulations appear at 12 CFR Part 263; for the Federal Deposit Insurance Corporation, these regulations appear at 12 CFR Part 308, subpart R,

vi. The following Guidelines set out the safety and soundness standards that the agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The agencies believe that the standards adopted in these Guidelines serve this end without dictating how institutions must be managed and operated. These standards are designed to identify potential safety and soundness concerns and ensure that action is taken to address those concerns before they pose a risk to the deposit insurance funds.

#### A. Preservation of Existing Authority

Neither section 39 nor these Guidelines in any way limits the authority of the agencies to address unsafe or unsound practices, violations of law, unsafe or unsound conditions, or other practices. Action under section 39 and these Guidelines may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the agencies. Nothing in these Guidelines limits the authority of the FDIC pursuant to section 38(i)(2)(F) of the FDI Act (12 U.S.C. 1831(o)) and Part 325 of title 12 of the Code of Federal Regulations.

#### B. Definitions

1. *In general.* For purposes of these Guidelines, except as modified in the Guidelines or unless the context otherwise requires, the terms used have the same meanings as set forth in sections 3 and 39 of the FDI Act (12 U.S.C. 1813 and 1831p-1).

2. *Board of directors*, in the case of a state-licensed insured branch of a foreign bank and in the case of a federal branch of a foreign bank, means the managing official in charge of the insured foreign branch.

3. *Compensation* means all direct and indirect payments or benefits, both cash and non-cash, granted to or for the benefit of any executive officer, employee, director, or principal shareholder, including but not limited to payments or benefits derived from an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

4. *Director* shall have the meaning described in 12 CFR 215.2(c).<sup>3</sup>

and for the Office of Thrift Supervision, these regulations appear at 12 CFR Part 570.

<sup>3</sup>In applying these definitions for savings associations, pursuant to 12 U.S.C. 1464, savings associations shall use the terms "savings association" and "insured savings association" in place of the terms "member bank" and "insured bank".



5. *Executive officer* shall have the meaning described in 12 CFR 215.2(d).<sup>4</sup>

6. *Principal shareholder* shall have the meaning described in 12 CFR 215.2(i).<sup>5</sup>

## II. OPERATIONAL AND MANAGERIAL STANDARDS

A. *Internal controls and information systems.* An institution should have internal controls and information systems that are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for:

1. An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established policies;
2. Effective risk assessment;
3. Timely and accurate financial, operational and regulatory reports;
4. Adequate procedures to safeguard and manage assets; and
5. Compliance with applicable laws and regulations.

B. *Internal audit system.* An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities and that provides for:

1. Adequate monitoring of the system of internal controls through an internal audit function. For an institution whose size, complexity or scope of operations does not warrant a full scale internal audit function, a system of independent reviews of key internal controls may be used;
2. Independence and objectivity;
3. Qualified persons;
4. Adequate testing and review of information systems;
5. Adequate documentation of tests and findings and any corrective actions;
6. Verification and review of management actions to address material weaknesses; and
7. Review by the institution's audit committee or board of directors of the effectiveness of the internal audit systems.

C. *Loan documentation.* An institution should establish and maintain loan documentation practices that:

1. Enable the institution to make an informed lending decision and to assess risk, as necessary, on an ongoing basis;
2. Identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner;
3. Ensure that any claim against a borrower is legally enforceable;
4. Demonstrate appropriate administration and monitoring of a loan; and

5. Take account of the size and complexity of a loan.

D. *Credit underwriting.* An institution should establish and maintain prudent credit underwriting practices that:

1. Are commensurate with the types of loans the institution will make and consider the terms and conditions under which they will be made;
2. Consider the nature of the markets in which loans will be made;
3. Provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;
4. Establish a system of independent, ongoing credit review and appropriate communication to management and to the board of directors;
5. Take adequate account of concentration of credit risk; and
6. Are appropriate to the size of the institution and the nature and scope of its activities.

E. *Interest rate exposure.* An institution should:

1. Manage interest rate risk in a manner that is appropriate to the size of the institution and the complexity of its assets and liabilities; and
2. Provide for periodic reporting to management and the board of directors regarding interest rate risk with adequate information for management and the board of directors to assess the level of risk.

F. *Asset growth.* An institution's asset growth should be prudent and consider:

1. The source, volatility and use of the funds that support asset growth;
2. Any increase in credit risk or interest rate risk as a result of growth; and
3. The effect of growth on the institution's capital.

G. *Asset quality.* An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should:

1. Conduct periodic asset quality reviews to identify problem assets;
2. Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;
3. Compare problem asset totals to capital;
4. Take appropriate corrective action to resolve problem assets;
5. Consider the size and potential risks of material asset concentrations; and
6. Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

<sup>4</sup>See footnote 3 in section I.B.4. of this appendix.

<sup>5</sup>See footnote 3 in section I.B.4. of this appendix.

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H. *Earnings*. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves. The institution should:

1. Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;
2. Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;
3. Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expense;
4. Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering the institution's asset quality and growth rate; and
5. Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

I. *Compensation, fees and benefits*. An institution should maintain safeguards to prevent the payment of compensation, fees, and benefits that are excessive or that could lead to material financial loss to the institution.

### III. PROHIBITION ON COMPENSATION THAT CONSTITUTES AN UNSAFE AND UNSOUND PRACTICE

#### A. Excessive Compensation

Excessive compensation is prohibited as an unsafe and unsound practice. Compensation shall be considered excessive when amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder, considering the following:

1. The combined value of all cash and non-cash benefits provided to the individual;
2. The compensation history of the individual and other individuals with comparable expertise at the institution;
3. The financial condition of the institution;
4. Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the loan portfolio or other assets;
5. For postemployment benefits, the projected total cost and benefit to the institution;
6. Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and
7. Any other factors the agencies determines to be relevant.

#### B. Compensation Leading to Material Financial Loss

Compensation that could lead to material financial loss to an institution is prohibited as an unsafe and unsound practice.

[60 FR 35678, 35682, July 10, 1995, as amended by Reg. H, 61 FR 43951, Aug. 27, 1996]

### APPENDIX D-2 TO PART 208—INTER-AGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

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#### I. INTRODUCTION

These Interagency Guidelines Establishing Standards for Safeguarding Customer Information (Guidelines) set forth standards pursuant to sections 501 and 505 of the Gramm-Leach-Bliley Act (15 U.S.C. 6801 and 6805), in the same manner, to the extent practicable, as standards prescribed pursuant to section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p-1). These Guidelines address standards for developing and implementing administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of customer information. These Guidelines also address standards with respect to the proper disposal of consumer information, pursuant to sections 621 and 628 of the Fair Credit Reporting Act (15 U.S.C. 1681s and 1681w).

A. *Scope*. The Guidelines apply to customer information maintained by or on behalf of state member banks (banks) and their nonbank subsidiaries, except for brokers, dealers, persons providing insurance, investment companies, and investment advisors. Pursuant to §§ 211.9 and 211.24 of this chapter, these guidelines also apply to customer information maintained by or on behalf of Edge corporations, agreement corporations, and uninsured state-licensed branches or agencies of a foreign bank. These Guidelines also apply to the proper disposal of consumer information by or on behalf of such entities.

B. *Preservation of Existing Authority.* Neither section 39 nor these Guidelines in any way limit the authority of the Board to address unsafe or unsound practices, violations of law, unsafe or unsound conditions, or other practices. The Board may take action under section 39 and these Guidelines independently of, in conjunction with, or in addition to, any other enforcement action available to the Board.

C. *Definitions.*

1. Except as modified in the Guidelines, or unless the context otherwise requires, the terms used in these Guidelines have the same meanings as set forth in sections 3 and 39 of the Federal Deposit Insurance Act (12 U.S.C. 1813 and 1831p-1).

2. For purposes of the Guidelines, the following definitions apply:

a. *Board of directors*, in the case of a branch or agency of a foreign bank, means the managing official in charge of the branch or agency.

b. *Consumer information* means any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report and that is maintained or otherwise possessed by or on behalf of the bank for a business purpose. Consumer information also means a compilation of such records. The term does not include any record that does not identify an individual.

i. *Examples.* (1) *Consumer information* includes:

(A) A consumer report that a bank obtains;

(B) Information from a consumer report that the bank obtains from its affiliate after the consumer has been given a notice and has elected not to opt out of that sharing;

(C) Information from a consumer report that the bank obtains about an individual who applies for but does not receive a loan, including any loan sought by an individual for a business purpose;

(D) Information from a consumer report that the bank obtains about an individual who guarantees a loan (including a loan to a business entity); or

(E) Information from a consumer report that the bank obtains about an employee or prospective employee.

(2) *Consumer information does not include:*

(A) Aggregate information, such as the mean credit score, derived from a group of consumer reports; or

(B) Blind data, such as payment history on accounts that are not personally identifiable, that may be used for developing credit scoring models or for other purposes.

c. *Consumer report* has the same meaning as set forth in the Fair Credit Reporting Act, 15 U.S.C. 1681a(d).

d. *Customer* means any customer of the bank as defined in §216.3(h) of this chapter.

e. *Customer information* means any record containing nonpublic personal information,

as defined in §216.3(n) of this chapter, about a customer, whether in paper, electronic, or other form, that is maintained by or on behalf of the bank.

f. *Customer information systems* means any methods used to access, collect, store, use, transmit, protect, or dispose of customer information.

g. *Service provider* means any person or entity that maintains, processes, or otherwise is permitted access to customer information or consumer information through its provision of services directly to the bank.

h. *Subsidiary* means any company controlled by a bank, except a broker, dealer, person providing insurance, investment company, investment advisor, insured depository institution, or subsidiary of an insured depository institution.

## II. STANDARDS FOR INFORMATION SECURITY

A. *Information Security Program.* Each bank shall implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the size and complexity of the bank and the nature and scope of its activities. While all parts of the bank are not required to implement a uniform set of policies, all elements of the information security program must be coordinated. A bank also shall ensure that each of its subsidiaries is subject to a comprehensive information security program. The bank may fulfill this requirement either by including a subsidiary within the scope of the bank's comprehensive information security program or by causing the subsidiary to implement a separate comprehensive information security program in accordance with the standards and procedures in sections II and III of this appendix that apply to banks.

B. *Objectives.* A bank's information security program shall be designed to:

1. Ensure the security and confidentiality of customer information;

2. Protect against any anticipated threats or hazards to the security or integrity of such information;

3. Protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer; and

4. Ensure the proper disposal of customer information and consumer information.

## III. DEVELOPMENT AND IMPLEMENTATION OF INFORMATION SECURITY PROGRAM

A. *Involve the Board of Directors.* The board of directors or an appropriate committee of the board of each bank shall:

1. Approve the bank's written information security program; and

2. Oversee the development, implementation, and maintenance of the bank's information security program, including assigning

specific responsibility for its implementation and reviewing reports from management.

**B. Assess Risk.** Each bank shall:

1. Identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems.

2. Assess the likelihood and potential damage of these threats, taking into consideration the sensitivity of customer information.

3. Assess the sufficiency of policies, procedures, customer information systems, and other arrangements in place to control risks.

**C. Manage and Control Risk.** Each bank shall:

1. Design its information security program to control the identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of the bank's activities. Each bank must consider whether the following security measures are appropriate for the bank and, if so, adopt those measures the bank concludes are appropriate:

a. Access controls on customer information systems, including controls to authenticate and permit access only to authorized individuals and controls to prevent employees from providing customer information to unauthorized individuals who may seek to obtain this information through fraudulent means.

b. Access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records storage facilities to permit access only to authorized individuals;

c. Encryption of electronic customer information, including while in transit or in storage on networks or systems to which unauthorized individuals may have access;

d. Procedures designed to ensure that customer information system modifications are consistent with the bank's information security program;

e. Dual control procedures, segregation of duties, and employee background checks for employees with responsibilities for or access to customer information;

f. Monitoring systems and procedures to detect actual and attempted attacks on or intrusions into customer information systems;

g. Response programs that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies; and

h. Measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures.

2. Train staff to implement the bank's information security program.

3. Regularly test the key controls, systems and procedures of the information security program. The frequency and nature of such tests should be determined by the bank's risk assessment. Tests should be conducted or reviewed by independent third parties or staff independent of those that develop or maintain the security programs.

4. Develop, implement, and maintain, as part of its information security program, appropriate measures to properly dispose of customer information and consumer information in accordance with each of the requirements in this paragraph III.

**D. Oversee Service Provider Arrangements.** Each bank shall:

1. Exercise appropriate due diligence in selecting its service providers;

2. Require its service providers by contract to implement appropriate measures designed to meet the objectives of these Guidelines; and

3. Where indicated by the bank's risk assessment, monitor its service providers to confirm that they have satisfied their obligations as required by paragraph D.2. As part of this monitoring, a bank should review audits, summaries of test results, or other equivalent evaluations of its service providers.

**E. Adjust the Program.** Each bank shall monitor, evaluate, and adjust, as appropriate, the information security program in light of any relevant changes in technology, the sensitivity of its customer information, internal or external threats to information, and the bank's own changing business arrangements, such as mergers and acquisitions, alliances and joint ventures, outsourcing arrangements, and changes to customer information systems.

**F. Report to the Board.** Each bank shall report to its board or an appropriate committee of the board at least annually. This report should describe the overall status of the information security program and the bank's compliance with these Guidelines. The reports should discuss material matters related to its program, addressing issues such as: risk assessment; risk management and control decisions; service provider arrangements; results of testing; security breaches or violations and management's responses; and recommendations for changes in the information security program.

**G. Implement the Standards.**

1. **Effective date.** Each bank must implement an information security program pursuant to these Guidelines by July 1, 2001.

2. **Two-year grandfathering of agreements with service providers.** Until July 1, 2003, a contract that a bank has entered into with a service provider to perform services for it or functions on its behalf satisfies the provisions of section III.D., even if the contract

does not include a requirement that the servicer maintain the security and confidentiality of customer information, as long as the bank entered into the contract on or before March 5, 2001.

3. *Effective date for measures relating to the disposal of consumer information.* Each bank must satisfy these Guidelines with respect to the proper disposal of consumer information by July 1, 2005.

4. *Exception for existing agreements with service providers relating to the disposal of consumer information.* Notwithstanding the requirement in paragraph III.G.3., a bank's contracts with its service providers that have access to consumer information and that may dispose of consumer information, entered into before July 1, 2005, must comply with the provisions of the Guidelines relating to the proper disposal of consumer information by July 1, 2006.

SUPPLEMENT A TO APPENDIX D-2 TO PART 208—INTERAGENCY GUIDANCE ON RESPONSE PROGRAMS FOR UNAUTHORIZED ACCESS TO CUSTOMER INFORMATION AND CUSTOMER NOTICE

I. BACKGROUND

This Guidance<sup>1</sup> interprets section 501(b) of the Gramm-Leach-Bliley Act ("GLBA") and the Interagency Guidelines Establishing Information Security Standards (the "Security Guidelines")<sup>2</sup> and describes response programs, including customer notification procedures, that a financial institution should develop and implement to address unauthorized access to or use of customer information that could result in substantial harm or inconvenience to a customer. The scope of, and definitions of terms used in, this Guidance are identical to those of the Security Guidelines. For example, the term "customer information" is the same term used in the Security Guidelines, and means any record containing nonpublic personal information about a customer, whether in paper, electronic, or other form, maintained by or on behalf of the institution.

<sup>1</sup>This Guidance is being jointly issued by the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

<sup>2</sup>12 CFR part 30, app. B (OCC); 12 CFR part 208, app. D-2 and part 225, app. F (Board); 12 CFR part 364, app. B (FDIC); and 12 CFR part 570, app. B (OTS). The "Interagency Guidelines Establishing Information Security Standards" were formerly known as "The Interagency Guidelines Establishing Standards for Safeguarding Customer Information."

A. Interagency Security Guidelines

Section 501(b) of the GLBA required the Agencies to establish appropriate standards for financial institutions subject to their jurisdiction that include administrative, technical, and physical safeguards, to protect the security and confidentiality of customer information. Accordingly, the Agencies issued Security Guidelines requiring every financial institution to have an information security program designed to:

1. Ensure the security and confidentiality of customer information;
2. Protect against any anticipated threats or hazards to the security or integrity of such information; and
3. Protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer.

B. Risk Assessment and Controls

1. The Security Guidelines direct every financial institution to assess the following risks, among others, when developing its information security program:

- a. Reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems;
- b. The likelihood and potential damage of threats, taking into consideration the sensitivity of customer information; and
- c. The sufficiency of policies, procedures, customer information systems, and other arrangements in place to control risks.<sup>3</sup>

2. Following the assessment of these risks, the Security Guidelines require a financial institution to design a program to address the identified risks. The particular security measures an institution should adopt will depend upon the risks presented by the complexity and scope of its business. At a minimum, the financial institution is required to consider the specific security measures enumerated in the Security Guidelines,<sup>4</sup> and adopt those that are appropriate for the institution, including:

- a. Access controls on customer information systems, including controls to authenticate and permit access only to authorized individuals and controls to prevent employees from providing customer information to unauthorized individuals who may seek to obtain this information through fraudulent means;
- b. Background checks for employees with responsibilities for access to customer information; and
- c. Response programs that specify actions to be taken when the financial institution

<sup>3</sup>See Security Guidelines, III.B.

<sup>4</sup>See Security Guidelines, III.C.

suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies.<sup>5</sup>

#### C. Service Providers

The Security Guidelines direct every financial institution to require its service providers by contract to implement appropriate measures designed to protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customer.<sup>6</sup>

### II. RESPONSE PROGRAM

Millions of Americans, throughout the country, have been victims of identity theft.<sup>7</sup> Identity thieves misuse personal information they obtain from a number of sources, including financial institutions, to perpetrate identity theft. Therefore, financial institutions should take preventative measures to safeguard customer information against attempts to gain unauthorized access to the information. For example, financial institutions should place access controls on customer information systems and conduct background checks for employees who are authorized to access customer information.<sup>8</sup> However, every financial institution should also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems<sup>9</sup> that

occur nonetheless. A response program should be a key part of an institution's information security program.<sup>10</sup> The program should be appropriate to the size and complexity of the institution and the nature and scope of its activities.

In addition, each institution should be able to address incidents of unauthorized access to customer information in customer information systems maintained by its domestic and foreign service providers. Therefore, consistent with the obligations in the Guidelines that relate to these arrangements, and with existing guidance on this topic issued by the Agencies,<sup>11</sup> an institution's contract with its service provider should require the service provider to take appropriate actions to address incidents of unauthorized access to the financial institution's customer information, including notification to the institution as soon as possible of any such incident, to enable the institution to expeditiously implement its response program.

#### A. Components of a Response Program

1. At a minimum, an institution's response program should contain procedures for the following:

- a. Assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused;
- b. Notifying its primary Federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of sensitive customer information, as defined below;
- c. Consistent with the Agencies' Suspicious Activity Report ("SAR") regulations,<sup>12</sup> notifying appropriate law enforcement authorities, in addition to filing a timely SAR in

<sup>5</sup>See Security Guidelines, III.C.

<sup>6</sup>See Security Guidelines, II.B. and III.D. Further, the Agencies note that, in addition to contractual obligations to a financial institution, a service provider may be required to implement its own comprehensive information security program in accordance with the Safeguards Rule promulgated by the Federal Trade Commission ("FTC"), 16 CFR part 314.

<sup>7</sup>The FTC estimates that nearly 10 million Americans discovered they were victims of some form of identity theft in 2002. See The Federal Trade Commission, *Identity Theft Survey Report*, (September 2003), available at <http://www.ftc.gov/os/2003/09/synovatereport.pdf>.

<sup>8</sup>Institutions should also conduct background checks of employees to ensure that the institution does not violate 12 U.S.C. 1829, which prohibits an institution from hiring an individual convicted of certain criminal offenses or who is subject to a prohibition order under 12 U.S.C. 1818(e)(6).

<sup>9</sup>Under the Guidelines, an institution's customer information systems consist of all of the methods used to access, collect, store, use, transmit, protect, or dispose of customer information, including the systems maintained by its service providers. See Security Guidelines, I.C.2.d (I.C.2.c for OTS).

<sup>10</sup>See FFIEC Information Technology Examination Handbook, Information Security Booklet, Dec. 2002 available at [http://www.ffiec.gov/ffiecinfobase/html\\_pages/infosec\\_book\\_frame.htm](http://www.ffiec.gov/ffiecinfobase/html_pages/infosec_book_frame.htm). Federal Reserve SR 97-32, Sound Practice Guidance for Information Security for Networks, Dec. 4, 1997; OCC Bulletin 2000-14, "Infrastructure Threats—Intrusion Risks" (May 15, 2000), for additional guidance on preventing, detecting, and responding to intrusions into financial institution computer systems.

<sup>11</sup>See Federal Reserve SR Ltr. 00-04, Outsourcing of Information and Transaction Processing, Feb. 9, 2000; OCC Bulletin 2001-47, "Third-Party Relationships Risk Management Principles," Nov. 1, 2001; FDIC FIL 68-99, Risk Assessment Tools and Practices for Information System Security, July 7, 1999; OTS Thrift Bulletin 82a, Third Party Arrangements, Sept. 1, 2004.

<sup>12</sup>An institution's obligation to file a SAR is set out in the Agencies' SAR regulations

*Continued*

situations involving Federal criminal violations requiring immediate attention, such as when a reportable violation is ongoing;

d. Taking appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information, for example, by monitoring, freezing, or closing affected accounts, while preserving records and other evidence;<sup>13</sup> and

e. Notifying customers when warranted.

2. Where an incident of unauthorized access to customer information involves customer information systems maintained by an institution's service providers, it is the responsibility of the financial institution to notify the institution's customers and regulator. However, an institution may authorize or contract with its service provider to notify the institution's customers or regulator on its behalf.

### III. CUSTOMER NOTICE

Financial institutions have an affirmative duty to protect their customers' information against unauthorized access or use. Notifying customers of a security incident involving the unauthorized access or use of the customer's information in accordance with the standard set forth below is a key part of

and Agency guidance. See 12 CFR 21.11 (national banks, Federal branches and agencies); 12 CFR 208.62 (State member banks); 12 CFR 211.5(k) (Edge and agreement corporations); 12 CFR 211.24(f) (uninsured State branches and agencies of foreign banks); 12 CFR 225.4(f) (bank holding companies and their nonbank subsidiaries); 12 CFR part 353 (State non-member banks); and 12 CFR 563.180 (savings associations). National banks must file SARs in connection with computer intrusions and other computer crimes. See OCC Bulletin 2000-14, "Infrastructure Threats—Intrusion Risks" (May 15, 2000); Advisory Letter 97-9, "Reporting Computer Related Crimes" (November 19, 1997) (general guidance still applicable though instructions for new SAR form published in 65 FR 1229, 1230 (January 7, 2000)). See also Federal Reserve SR 01-11, Identity Theft and Pretext Calling, Apr. 26, 2001; SR 97-28, Guidance Concerning Reporting of Computer Related Crimes by Financial Institutions, Nov. 6, 1997; FDIC FIL 48-2000, Suspicious Activity Reports, July 14, 2000; FIL 47-97, Preparation of Suspicious Activity Reports, May 6, 1997; OTS CEO Memorandum 139, Identity Theft and Pretext Calling, May 4, 2001; CEO Memorandum 126, New Suspicious Activity Report Form, July 5, 2000; <http://www.ots.treas.gov/BSA> (for the latest SAR form and filing instructions required by OTS as of July 1, 2003).

<sup>13</sup>See FFIEC Information Technology Examination Handbook, Information Security Booklet, Dec. 2002, pp. 68-74.

that duty. Timely notification of customers is important to manage an institution's reputation risk. Effective notice also may reduce an institution's legal risk, assist in maintaining good customer relations, and enable the institution's customers to take steps to protect themselves against the consequences of identity theft. When customer notification is warranted, an institution may not forgo notifying its customers of an incident because the institution believes that it may be potentially embarrassed or inconvenienced by doing so.

#### A. Standard for Providing Notice

When a financial institution becomes aware of an incident of unauthorized access to sensitive customer information, the institution should conduct a reasonable investigation to promptly determine the likelihood that the information has been or will be misused. If the institution determines that misuse of its information about a customer has occurred or is reasonably possible, it should notify the affected customer as soon as possible. Customer notice may be delayed if an appropriate law enforcement agency determines that notification will interfere with a criminal investigation and provides the institution with a written request for the delay. However, the institution should notify its customers as soon as notification will no longer interfere with the investigation.

#### 1. Sensitive Customer Information

Under the Guidelines, an institution must protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customer. Substantial harm or inconvenience is most likely to result from improper access to *sensitive customer information* because this type of information is most likely to be misused, as in the commission of identity theft. For purposes of this Guidance, *sensitive customer information* means a customer's name, address, or telephone number, in conjunction with the customer's social security number, driver's license number, account number, credit or debit card number, or a personal identification number or password that would permit access to the customer's account. *Sensitive customer information* also includes any combination of components of customer information that would allow someone to log onto or access the customer's account, such as user name and password or password and account number.

#### 2. Affected Customers

If a financial institution, based upon its investigation, can determine from its logs or other data precisely which customers' information has been improperly accessed, it may limit notification to those customers with

regard to whom the institution determines that misuse of their information has occurred or is reasonably possible. However, there may be situations where the institution determines that a group of files has been accessed improperly, but is unable to identify which specific customers' information has been accessed. If the circumstances of the unauthorized access lead the institution to determine that misuse of the information is reasonably possible, it should notify all customers in the group.

#### *B. Content of Customer Notice*

1. Customer notice should be given in a clear and conspicuous manner. The notice should describe the incident in general terms and the type of customer information that was the subject of unauthorized access or use. It also should generally describe what the institution has done to protect the customers' information from further unauthorized access. In addition, it should include a telephone number that customers can call for further information and assistance.<sup>14</sup> The notice also should remind customers of the need to remain vigilant over the next twelve to twenty-four months, and to promptly report incidents of suspected identity theft to the institution. The notice should include the following additional items, when appropriate:

- a. A recommendation that the customer review account statements and immediately report any suspicious activity to the institution;
- b. A description of fraud alerts and an explanation of how the customer may place a fraud alert in the customer's consumer reports to put the customer's creditors on notice that the customer may be a victim of fraud;
- c. A recommendation that the customer periodically obtain credit reports from each nationwide credit reporting agency and have information relating to fraudulent transactions deleted;
- d. An explanation of how the customer may obtain a credit report free of charge; and
- e. Information about the availability of the FTC's online guidance regarding steps a consumer can take to protect against identity theft. The notice should encourage the customer to report any incidents of identity theft to the FTC, and should provide the FTC's Web site address and toll-free telephone number that customers may use to ob-

tain the identity theft guidance and report suspected incidents of identity theft.<sup>15</sup>

2. The Agencies encourage financial institutions to notify the nationwide consumer reporting agencies prior to sending notices to a large number of customers that include contact information for the reporting agencies.

#### *C. Delivery of Customer Notice*

Customer notice should be delivered in any manner designed to ensure that a customer can reasonably be expected to receive it. For example, the institution may choose to contact all customers affected by telephone or by mail, or by electronic mail for those customers for whom it has a valid e-mail address and who have agreed to receive communications electronically.

[Reg. H, 66 FR 8634, Feb. 1, 2001, as amended at 69 FR 77617, Dec. 28, 2004; 70 FR 15753, Mar. 29, 2005; 71 FR 5780, Feb. 3, 2006]

### APPENDIX E TO PART 208—RISK-BASED CAPITAL GUIDELINES; MARKET RISK

- Section 1 Purpose, Applicability, and Reservation of Authority
- Section 2 Definitions
- Section 3 Requirements for Application of the Market Risk Capital Rule
- Section 4 Adjustments to the Risk-Based Capital Ratio Calculations
- Section 5 VaR-based Measure
- Section 6 Stressed VaR-based Measure
- Section 7 Specific Risk
- Section 8 Incremental Risk
- Section 9 Comprehensive Risk
- Section 10 Standardized Measurement Method for Specific Risk
- Section 11 Simplified Supervisory Formula Approach
- Section 12 Market Risk Disclosures

#### *Section 1. Purpose, Applicability, and Reservation of Authority*

(a) *Purpose.* This appendix establishes risk-based capital requirements for banks with significant exposure to market risk and provides methods for these banks to calculate their risk-based capital requirements for market risk. This appendix supplements and adjusts the risk-based capital calculations under appendix A to this part and appendix F to this part and establishes public disclosure requirements.

<sup>15</sup> Currently, the FTC Web site for the ID Theft brochure and the FTC Hotline phone number are <http://www.consumer.gov/idtheft> and 1-877-IDTHEFT. The institution may also refer customers to any materials developed pursuant to section 151(b) of the FACT Act (educational materials developed by the FTC to teach the public how to prevent identity theft).

<sup>14</sup> The institution should, therefore, ensure that it has reasonable policies and procedures in place, including trained personnel, to respond appropriately to customer inquiries and requests for assistance.



(b) *Applicability.* (1) This appendix applies to any bank with aggregate trading assets and trading liabilities (as reported in the bank's most recent quarterly Consolidated Reports of Condition and Income (Call Report)), equal to:

(i) 10 percent or more of quarter-end total assets as reported on the most recent quarterly Call Report; or

(ii) \$1 billion or more.

(2) The Board may apply this appendix to any bank if the Board deems it necessary or appropriate because of the level of market risk of the bank or to ensure safe and sound banking practices.

(3) The Board may exclude a bank that meets the criteria of paragraph (b)(1) of this section from application of this appendix if the Board determines that the exclusion is appropriate based on the level of market risk of the bank and is consistent with safe and sound banking practices.

(c) *Reservation of authority.* (1) The Board may require a bank to hold an amount of capital greater than otherwise required under this appendix if the Board determines that the bank's capital requirement for market risk as calculated under this appendix is not commensurate with the market risk of the bank's covered positions. In making determinations under paragraphs (c)(1) through (c)(3) of this section, the Board will apply notice and response procedures generally in the same manner as the notice and response procedures set forth in [12 CFR 3.12, 12 CFR 263.202, 12 CFR 325.6(c), 12 CFR 567.3(d)].

(2) If the Board determines that the risk-based capital requirement calculated under this appendix by the bank for one or more covered positions or portfolios of covered positions is not commensurate with the risks associated with those positions or portfolios, the Board may require the bank to assign a different risk-based capital requirement to the positions or portfolios that more accurately reflects the risk of the positions or portfolios.

(3) The Board may also require a bank to calculate risk-based capital requirements for specific positions or portfolios under this appendix, or under appendix F to this part or appendix A to this part, as appropriate, to more accurately reflect the risks of the positions.

(4) Nothing in this appendix limits the authority of the Board under any other provision of law or regulation to take supervisory or enforcement action, including action to address unsafe or unsound practices or conditions, deficient capital levels, or violations of law.

#### Section 2. Definitions

For purposes of this appendix, the following definitions apply:

*Affiliate* with respect to a company means any company that controls, is controlled by,

or is under common control with, the company.

*Backtesting* means the comparison of a bank's internal estimates with actual outcomes during a sample period not used in model development. For purposes of this appendix, backtesting is one form of out-of-sample testing.

*Bank holding company* is defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)).

*Commodity position* means a position for which price risk arises from changes in the price of a commodity.

*Company* means a corporation, partnership, limited liability company, depository institution, business trust, special purpose entity, association, or similar organization.

*Control* A person or company controls a company if it:

(1) Owns, controls, or holds with power to vote 25 percent or more of a class of voting securities of the company; or

(2) Consolidates the company for financial reporting purposes.

*Corporate debt position* means a debt position that is an exposure to a company that is not a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, a multilateral development bank, a depository institution, a foreign bank, a credit union, a public sector entity, a government-sponsored entity, or a securitization.

*Correlation trading position* means:

(1) A securitization position for which all or substantially all of the value of the underlying exposures is based on the credit quality of a single company for which a two-way market exists, or on commonly traded indices based on such exposures for which a two-way market exists on the indices; or

(2) A position that is not a securitization position and that hedges a position described in paragraph (1) of this definition; and

(3) A correlation trading position does not include:

(i) A resecuritization position;

(ii) A derivative of a securitization position that does not provide a pro rata share in the proceeds of a securitization tranche; or

(iii) A securitization position for which the underlying assets or reference exposures are retail exposures, residential mortgage exposures, or commercial mortgage exposures.

*Country risk classification (CRC)* for a sovereign entity means the consensus CRC published from time to time by the Organization for Economic Cooperation and Development that provides a view of the likelihood that the sovereign entity will service its external debt.

*Covered position* means the following positions:

(1) A trading asset or trading liability (whether on- or off-balance sheet),<sup>43</sup> as reported on Schedule RC-D of the Call Report or Schedule HC-D of the FR Y-9C, that meets the following conditions:

(i) The position is a trading position or hedges another covered position;<sup>44</sup> and

(ii) The position is free of any restrictive covenants on its tradability or the bank is able to hedge the material risk elements of the position in a two-way market;

(2) A foreign exchange or commodity position, regardless of whether the position is a trading asset or trading liability (excluding any structural foreign currency positions that the bank chooses to exclude with prior supervisory approval); and

(3) Notwithstanding paragraphs (1) and (2) of this definition, a covered position does not include:

(i) An intangible asset, including any servicing asset;

(ii) Any hedge of a trading position that the Board or the appropriate Reserve Bank, with concurrence of the Board, determines to be outside the scope of the bank's hedging strategy required in paragraph (a)(2) of section 3 of this appendix;

(iii) Any position that, in form or substance, acts as a liquidity facility that provides support to asset-backed commercial paper;

(iv) A credit derivative the bank recognizes as a guarantee for risk-weighted asset amount calculation purposes under appendix F to this part or appendix A to this part;

(v) Any equity position that is not publicly traded, other than a derivative that references a publicly traded equity;

(vi) Any position a bank holds with the intent to securitize; or

(vii) Any direct real estate holding.

*Credit derivative* means a financial contract executed under standard industry documentation that allows one party (the protection purchaser) to transfer the credit risk of one or more exposures (reference exposure(s)) to another party (the protection provider).

*Credit union* means an insured credit union as defined under the Federal Credit Union Act (12 U.S.C. 1752).

*Default by a sovereign entity* means non-compliance by the sovereign entity with its external debt service obligations or the inability or unwillingness of a sovereign entity to service an existing obligation according to its original contractual terms, as evi-

denced by failure to pay principal and interest timely and fully, arrearages, or restructuring.

*Debt position* means a covered position that is not a securitization position or a correlation trading position and that has a value that reacts primarily to changes in interest rates or credit spreads.

*Depository institution* is defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

*Equity position* means a covered position that is not a securitization position or a correlation trading position and that has a value that reacts primarily to changes in equity prices.

*Event risk* means the risk of loss on equity or hybrid equity positions as a result of a financial event, such as the announcement or occurrence of a company merger, acquisition, spin-off, or dissolution.

*Foreign bank* means a foreign bank as defined in §211.2 of the Federal Reserve Board's Regulation K (12 CFR 211.2), other than a depository institution.

*Foreign exchange position* means a position for which price risk arises from changes in foreign exchange rates.

*General market risk* means the risk of loss that could result from broad market movements, such as changes in the general level of interest rates, credit spreads, equity prices, foreign exchange rates, or commodity prices.

*General obligation* means a bond or similar obligation that is guaranteed by the full faith and credit of states or other political subdivisions of a sovereign entity.

*Government-sponsored entity (GSE)* means an entity established or chartered by the U.S. government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. government.

*Hedge* means a position or positions that offset all, or substantially all, of one or more material risk factors of another position.

*Idiosyncratic risk* means the risk of loss in the value of a position that arises from changes in risk factors unique to that position.

*Incremental risk* means the default risk and credit migration risk of a position. Default risk means the risk of loss on a position that could result from the failure of an obligor to make timely payments of principal or interest on its debt obligation, and the risk of loss that could result from bankruptcy, insolvency, or similar proceeding. Credit migration risk means the price risk that arises from significant changes in the underlying credit quality of the position.

*Investment grade* means that the entity to which the bank is exposed through a loan or security, or the reference entity with respect to a credit derivative, has adequate capacity

<sup>43</sup> Securities subject to repurchase and lending agreements are included as if they are still owned by the lender.

<sup>44</sup> A position that hedges a trading position must be within the scope of the bank's hedging strategy as described in paragraph (a)(2) of section 3 of this appendix.

to meet financial commitments for the projected life of the asset or exposure. Such an entity or reference entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected.

*Market risk* means the risk of loss on a position that could result from movements in market prices.

*Multilateral development bank* means the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, and any other multilateral lending institution or regional development bank in which the U.S. government is a shareholder or contributing member or which the Board determines poses comparable credit risk.

*Nth-to-default credit derivative* means a credit derivative that provides credit protection only for the nth-defaulting reference exposure in a group of reference exposures.

*Over-the-counter (OTC) derivative* means a derivative contract that is not traded on an exchange that requires the daily receipt and payment of cash-variation margin.

*Public sector entity (PSE)* means a state, local authority, or other governmental subdivision below the sovereign entity level.

*Publicly traded* means traded on:

(1) Any exchange registered with the SEC as a national securities exchange under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(2) Any non-U.S.-based securities exchange that:

(i) Is registered with, or approved by, a national securities regulatory authority; and

(ii) Provides a liquid, two-way market for the instrument in question.

*Qualifying securities borrowing transaction* means a cash-collateralized securities borrowing transaction that meets the following conditions:

(1) The transaction is based on liquid and readily marketable securities;

(2) The transaction is marked-to-market daily;

(3) The transaction is subject to daily margin maintenance requirements; and

(4)(i) The transaction is a securities contract for the purposes of section 555 of the Bankruptcy Code (11 U.S.C. 555), a qualified financial contract for the purposes of section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions for

the purposes of sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407) or the Board’s Regulation EE (12 CFR part 231); or

(ii) If the transaction does not meet the criteria in paragraph (4)(i) of this definition, either:

(A) The bank has conducted sufficient legal review to reach a well-founded conclusion that:

(1) The securities borrowing agreement executed in connection with the transaction provides the bank the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of counterparty default, including in a bankruptcy, insolvency, or other similar proceeding of the counterparty; and

(2) Under applicable law of the relevant jurisdiction, its rights under the agreement are legal, valid, binding, and enforceable and any exercise of rights under the agreement will not be stayed or avoided; or

(B) The transaction is either overnight or unconditionally cancelable at any time by the bank, and the bank has conducted sufficient legal review to reach a well-founded conclusion that:

(1) The securities borrowing agreement executed in connection with the transaction provides the bank the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of counterparty default; and

(2) Under the law governing the agreement, its rights under the agreement are legal, valid, binding, and enforceable.

*Resecuritization* means a securitization in which one or more of the underlying exposures is a securitization position.

*Resecuritization position* means a covered position that is:

(1) An on- or off-balance sheet exposure to a resecuritization; or

(2) An exposure that directly or indirectly references a resecuritization exposure in paragraph (1) of this definition.

*Revenue obligation* means a bond or similar obligation, including loans and leases, that is an obligation of a state or other political subdivision of a sovereign entity, but for which the government entity is committed to repay with revenues from the specific project financed rather than with general tax funds.

*SEC* means the U.S. Securities and Exchange Commission.

*Securitization* means a transaction in which:

(1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties;

(2) The credit risk associated with the underlying exposures has been separated into

at least two tranches that reflect different levels of seniority;

(3) Performance of the securitization exposures depends upon the performance of the underlying exposures;

(4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities);

(5) For non-synthetic securitizations, the underlying exposures are not owned by an operating company;

(6) The underlying exposures are not owned by a small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682); and

(7) The underlying exposures are not owned by a firm an investment in which qualifies as a community development investment under 12 U.S.C. 24 (Eleventh).

(8) The Board may determine that a transaction in which the underlying exposures are owned by an investment firm that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures is not a securitization based on the transaction's leverage, risk profile, or economic substance.

(9) The Board may deem an exposure to a transaction that meets the definition of a securitization, notwithstanding paragraph (5), (6), or (7) of this definition, to be a securitization based on the transaction's leverage, risk profile, or economic substance.

*Securitization position* means a covered position that is:

(1) An on-balance sheet or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a securitization (including a res securitization); or

(2) An exposure that directly or indirectly references a securitization exposure described in paragraph (1) of this definition.

*Sovereign debt position* means a direct exposure to a sovereign entity.

*Sovereign entity* means a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government.

*Sovereign of incorporation* means the country where an entity is incorporated, chartered, or similarly established.

*Specific risk* means the risk of loss on a position that could result from factors other than broad market movements and includes event risk, default risk, and idiosyncratic risk.

*Structural position in a foreign currency* means a position that is not a trading position and that is:

(1) Subordinated debt, equity, or minority interest in a consolidated subsidiary that is denominated in a foreign currency;

(2) Capital assigned to foreign branches that is denominated in a foreign currency;

(3) A position related to an unconsolidated subsidiary or another item that is denominated in a foreign currency and that is deducted from the bank's tier 1 and tier 2 capital; or

(4) A position designed to hedge a bank's capital ratios or earnings against the effect on paragraphs (1), (2), or (3) of this definition of adverse exchange rate movements.

*Term repo-style transaction* means a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction, including a transaction in which the bank acts as agent for a customer and indemnifies the customer against loss, that has an original maturity in excess of one business day, provided that:

(1) The transaction is based solely on liquid and readily marketable securities or cash;

(2) The transaction is marked-to-market daily and subject to daily margin maintenance requirements;

(3) The transaction is executed under an agreement that provides the bank the right to accelerate, terminate, and close-out the transaction on a net basis and to liquidate or set off collateral promptly upon an event of default (including bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;<sup>45</sup> and

(4) The bank has conducted and documented sufficient legal review to conclude with a well-founded basis that the agreement meets the requirements of paragraph (3) of this definition and is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions.

*Tier 1 capital* is defined in appendix A to this part or appendix F to this part, as applicable.

*Tier 2 capital* is defined in appendix A to this part or appendix F to this part, as applicable.

*Trading position* means a position that is held by the bank for the purpose of short-

<sup>45</sup> This requirement is met where all transactions under the agreement are (i) executed under U.S. law and (ii) constitute "securities contracts" or "repurchase agreements" under section 555 or 559, respectively, of the Bankruptcy Code (11 U.S.C. 555 or 559), qualified financial contracts under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or netting contracts between or among financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4407), or the Federal Reserve Board's Regulation EE (12 CFR part 231).

term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits.

*Two-way market* means a market where there are independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined within one day and settled at that price within a relatively short time frame conforming to trade custom.

*Underlying exposure* means one or more exposures that have been securitized in a securitization transaction.

*Value-at-Risk (VaR)* means the estimate of the maximum amount that the value of one or more positions could decline due to market price or rate movements during a fixed holding period within a stated confidence interval.

### *Section 3. Requirements for Application of the Market Risk Capital Rule*

(a) *Trading positions.* (1) *Identification of trading positions.* A bank must have clearly defined policies and procedures for determining which of its trading assets and trading liabilities are trading positions and which of its trading positions are correlation trading positions. These policies and procedures must take into account:

(i) The extent to which a position, or a hedge of its material risks, can be marked-to-market daily by reference to a two-way market; and

(ii) Possible impairments to the liquidity of a position or its hedge.

(2) *Trading and hedging strategies.* A bank must have clearly defined trading and hedging strategies for its trading positions that are approved by senior management of the bank.

(i) The trading strategy must articulate the expected holding period of, and the market risk associated with, each portfolio of trading positions.

(ii) The hedging strategy must articulate for each portfolio of trading positions the level of market risk the bank is willing to accept and must detail the instruments, techniques, and strategies the bank will use to hedge the risk of the portfolio.

(b) *Management of covered positions.* (1) *Active management.* A bank must have clearly defined policies and procedures for actively managing all covered positions. At a minimum, these policies and procedures must require:

(i) Marking positions to market or to model on a daily basis;

(ii) Daily assessment of the bank's ability to hedge position and portfolio risks, and of the extent of market liquidity;

(iii) Establishment and daily monitoring of limits on positions by a risk control unit independent of the trading business unit;

(iv) Daily monitoring by senior management of information described in paragraphs (b)(1)(i) through (b)(1)(iii) of this section;

(v) At least annual reassessment of established limits on positions by senior management; and

(vi) At least annual assessments by qualified personnel of the quality of market inputs to the valuation process, the soundness of key assumptions, the reliability of parameter estimation in pricing models, and the stability and accuracy of model calibration under alternative market scenarios.

(2) *Valuation of covered positions.* The bank must have a process for prudent valuation of its covered positions that includes policies and procedures on the valuation of positions, marking positions to market or to model, independent price verification, and valuation adjustments or reserves. The valuation process must consider, as appropriate, unearned credit spreads, close-out costs, early termination costs, investing and funding costs, liquidity, and model risk.

(c) *Requirements for internal models.* (1) A bank must obtain the prior written approval of the Board or the appropriate Reserve Bank, with concurrence of the Board, before using any internal model to calculate its risk-based capital requirement under this appendix.

(2) A bank must meet all of the requirements of this section on an ongoing basis. The bank must promptly notify the Board and the appropriate Reserve Bank when:

(i) The bank plans to extend the use of a model that the Board or the appropriate Reserve Bank, with concurrence of the Board, has approved under this appendix to an additional business line or product type;

(ii) The bank makes any change to an internal model approved by the Board or the appropriate Reserve Bank, with concurrence of the Board, under this appendix that would result in a material change in the bank's risk-weighted asset amount for a portfolio of covered positions; or

(iii) The bank makes any material change to its modeling assumptions.

(3) The Board or the appropriate Reserve Bank, with concurrence of the Board, may rescind its approval of the use of any internal model (in whole or in part) or of the determination of the approach under section 9(a)(2)(ii) of this appendix for a bank's modeled correlation trading positions and determine an appropriate capital requirement for the covered positions to which the model would apply, if the Board or the appropriate Reserve Bank, with concurrence of the Board, determines that the model no longer complies with this appendix or fails to reflect accurately the risks of the bank's covered positions.

(d) *Control, oversight, and validation mechanisms.* (1) The bank must have a risk control

unit that reports directly to senior management and is independent from the business trading units.

(2) The bank must validate its internal models initially and on an ongoing basis. The bank's validation process must be independent of the internal models' development, implementation, and operation, or the validation process must be subjected to an independent review of its adequacy and effectiveness. Validation must include:

(i) An evaluation of the conceptual soundness of (including developmental evidence supporting) the internal models;

(ii) An ongoing monitoring process that includes verification of processes and the comparison of the bank's model outputs with relevant internal and external data sources or estimation techniques; and

(iii) An outcomes analysis process that includes backtesting. For internal models used to calculate the VaR-based measure, this process must include a comparison of the changes in the bank's portfolio value that would have occurred were end-of-day positions to remain unchanged (therefore, excluding fees, commissions, reserves, net interest income, and intraday trading) with VaR-based measures during a sample period not used in model development.

(3) The bank must stress test the market risk of its covered positions at a frequency appropriate to each portfolio, and in no case less frequently than quarterly. The stress tests must take into account concentration risk (including but not limited to concentrations in single issuers, industries, sectors, or markets), illiquidity under stressed market conditions, and risks arising from the bank's trading activities that may not be adequately captured in its internal models.

(4) The bank must have an internal audit function independent of business-line management that at least annually assesses the effectiveness of the controls supporting the bank's market risk measurement systems, including the activities of the business trading units and independent risk control unit, compliance with policies and procedures, and calculation of the bank's measures for market risk under this appendix. At least annually, the internal audit function must report its findings to the bank's board of directors (or a committee thereof).

(e) *Internal assessment of capital adequacy.* The bank must have a rigorous process for assessing its overall capital adequacy in relation to its market risk. The assessment must take into account risks that may not be captured fully in the VaR-based measure, including concentration and liquidity risk under stressed market conditions.

(f) *Documentation.* The bank must adequately document all material aspects of its internal models, management and valuation of covered positions, control, oversight, vali-

dation and review processes and results, and internal assessment of capital adequacy.

#### *Section 4. Adjustments to the Risk-Based Capital Ratio Calculations*

(a) *Risk-based capital ratio denominators.* A bank must calculate its general risk-based capital ratio denominator by following the steps described in paragraphs (a)(1) through (a)(4) of this section. A bank subject to appendix F to this part must use its general risk-based capital ratio denominator for purposes of determining its total risk-based capital ratio and its tier 1 risk-based capital ratio under section 3(a)(2)(ii) and section 3(a)(3)(ii), respectively, of appendix F to this part, provided that the bank may not use the supervisory formula approach (SFA) in section 10(b)(2)(vii)(B) of this appendix for purposes of this calculation. A bank subject to appendix F to this part also must calculate an advanced risk-based capital ratio denominator by following the steps in paragraphs (a)(1) through (a)(4) of this section for purposes of determining its total risk-based capital ratio and its tier 1 risk-based capital ratio under sections 3(a)(2)(i) and section 3(a)(3)(i), respectively, of appendix F to this part.

(1) *Adjusted risk-weighted assets.* (i) The bank must calculate:

(A) General adjusted risk-weighted assets, which equals risk-weighted assets as determined in accordance with appendix A to this part with the adjustments in paragraphs (a)(1)(ii) and, if applicable, (a)(1)(iii) of this section; and

(B) For a bank subject to appendix F to this part, advanced adjusted risk-weighted assets, which equal risk-weighted assets as determined in accordance with appendix F to this part with the adjustments in paragraph (a)(1)(ii) of this section.

(ii) For purposes of calculating its general and advanced adjusted risk-weighted assets under paragraphs (a)(1)(i)(A) and (a)(1)(i)(B) of this section, respectively, the bank must exclude the risk-weighted asset amounts of all covered positions (except foreign exchange positions that are not trading positions and over-the-counter derivative positions).

(iii) For purposes of calculating its general adjusted risk-weighted assets under paragraph (a)(1)(i)(A) of this section, a bank may exclude receivables that arise from the posting of cash collateral and are associated with qualifying securities borrowing transactions to the extent the receivable is collateralized by the market value of the borrowed securities.

(2) *Measure for market risk.* The bank must calculate the general measure for market risk (except, as provided in paragraph (a) of this section, that the bank may not use the SFA in section 10(b)(2)(vii)(B) of this appendix for purposes of this calculation), which

equals the sum of the VaR-based capital requirement, stressed VaR-based capital requirement, specific risk add-ons, incremental risk capital requirement, comprehensive risk capital requirement, and capital requirement for *de minimis* exposures all as defined under this paragraph (a)(2). A bank subject to appendix F to this part also must calculate the advanced measure for market risk, which equals the sum of the VaR-based capital requirement, stressed VaR-based capital requirement, specific risk add-ons, incremental risk capital requirement, comprehensive risk capital requirement, and capital requirement for *de minimis* exposures as defined under this paragraph (a)(2).

(i) *VaR-based capital requirement.* A bank's VaR-based capital requirement equals the greater of:

(A) The previous day's VaR-based measure as calculated under section 5 of this appendix; or

(B) The average of the daily VaR-based measures as calculated under section 5 of this appendix for each of the preceding 60 business days multiplied by three, except as provided in paragraph (b) of this section.

(ii) *Stressed VaR-based capital requirement.* A bank's stressed VaR-based capital requirement equals the greater of:

(A) The most recent stressed VaR-based measure as calculated under section 6 of this appendix; or

(B) The average of the stressed VaR-based measures as calculated under section 6 of this appendix for each of the preceding 12 weeks multiplied by three, except as provided in paragraph (b) of this section.

(iii) *Specific risk add-ons.* A bank's specific risk add-ons equal any specific risk add-ons that are required under section 7 of this appendix and are calculated in accordance with section 10 of this appendix.

(iv) *Incremental risk capital requirement.* A bank's incremental risk capital requirement equals any incremental risk capital requirement as calculated under section 8 of this appendix.

(v) *Comprehensive risk capital requirement.* A bank's comprehensive risk capital requirement equals any comprehensive risk capital requirement as calculated under section 9 of this appendix.

(vi) *Capital requirement for de minimis exposures.* A bank's capital requirement for *de minimis* exposures equals:

(A) The absolute value of the market value of those *de minimis* exposures that are not captured in the bank's VaR-based measure or under paragraph (a)(2)(vi)(B) of this section; and

(B) With the prior written approval of the Board or the appropriate Reserve Bank, with concurrence of the Board, the capital requirement for any *de minimis* exposures using alternative techniques that appropriately

measure the market risk associated with those exposures.

(3) *Market risk equivalent assets.* The bank must calculate general market risk equivalent assets as the general measure for market risk (as calculated in paragraph (a)(2) of this section) multiplied by 12.5. A bank subject to appendix F to this part also must calculate advanced market risk equivalent assets as the advanced measure for market risk (as calculated in paragraph (a)(2) of this section) multiplied by 12.5.

(4) *Denominator calculation.* (i) The bank must add general market risk equivalent assets (as calculated in paragraph (a)(3) of this section) to general adjusted risk-weighted assets (as calculated in paragraph (a)(1)(i) of this section). The resulting sum is the bank's general risk-based capital ratio denominator.

(ii) A bank subject to appendix F to this part must add advanced market risk equivalent assets (as calculated in paragraph (a)(3) of this section) to advanced adjusted risk-weighted assets (as calculated in paragraph (a)(1)(i) of this section). The resulting sum is the bank's advanced risk-based capital ratio denominator.

(b) *Backtesting.* A bank must compare each of its most recent 250 business days' trading losses (excluding fees, commissions, reserves, net interest income, and intraday trading) with the corresponding daily VaR-based measures calibrated to a one-day holding period and at a one-tail, 99.0 percent confidence level. A bank must begin backtesting as required by this paragraph no later than one year after the later of January 1, 2013 and the date on which the bank becomes subject to this appendix. In the interim, consistent with safety and soundness principles, a bank subject to this appendix as of its effective date should continue to follow backtesting procedures in accordance with the supervisory expectations of the Board or the appropriate Reserve Bank.

#### Section 5. VaR-Based Measure

(a) *General requirement.* A bank must use one or more internal models to calculate daily a VaR-based measure of the general market risk of all covered positions. The daily VaR-based measure also may reflect the bank's specific risk for one or more portfolios of debt and equity positions, if the internal models meet the requirements of paragraph (b)(1) of section 7 of this appendix. The daily VaR-based measure must also reflect the bank's specific risk for any portfolio of correlation trading positions that is modeled under section 9 of this appendix. A bank may elect to include term repo-style transactions in its VaR-based measure, provided that the bank includes all such term repo-style transactions consistently over time.

(1) The bank's internal models for calculating its VaR-based measure must use risk factors sufficient to measure the market risk inherent in all covered positions. The market risk categories must include, as appropriate, interest rate risk, credit spread risk, equity price risk, foreign exchange risk, and commodity price risk. For material positions in the major currencies and markets, modeling techniques must incorporate enough segments of the yield curve—in no case less than six—to capture differences in volatility and less than perfect correlation of rates along the yield curve.

(2) The VaR-based measure may incorporate empirical correlations within and across risk categories, provided the bank validates and demonstrates the reasonableness of its process for measuring correlations. If the VaR-based measure does not incorporate empirical correlations across risk categories, the bank must add the separate measures from its internal models used to calculate the VaR-based measure for the appropriate market risk categories (interest rate risk, credit spread risk, equity price risk, foreign exchange rate risk, and/or commodity price risk) to determine its aggregate VaR-based measure.

(3) The VaR-based measure must include the risks arising from the nonlinear price characteristics of options positions or positions with embedded optionality and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates, prices, or other material risk factors. A bank with a large or complex options portfolio must measure the volatility of options positions or positions with embedded optionality by different maturities and/or strike prices, where material.

(4) The bank must be able to justify to the satisfaction of the Board or the appropriate Reserve Bank, with the concurrence of the Board, the omission of any risk factors from the calculation of its VaR-based measure that the bank uses in its pricing models.

(5) The bank must demonstrate to the satisfaction of the Board or the appropriate Reserve Bank, with the concurrence of the Board, the appropriateness of any proxies used to capture the risks of the bank's actual positions for which such proxies are used.

(b) *Quantitative requirements for VaR-based measure.* (1) The VaR-based measure must be calculated on a daily basis using a one-tail, 99.0 percent confidence level, and a holding period equivalent to a 10-business-day movement in underlying risk factors, such as rates, spreads, and prices. To calculate VaR-based measures using a 10-business-day holding period, the bank may calculate 10-business-day measures directly or may convert VaR-based measures using holding periods other than 10 business days to the equivalent of a 10-business-day holding period. A bank

that converts its VaR-based measure in such a manner must be able to justify the reasonableness of its approach to the satisfaction of the Board or the appropriate Reserve Bank, with the concurrence of the Board.

(2) The VaR-based measure must be based on a historical observation period of at least one year. Data used to determine the VaR-based measure must be relevant to the bank's actual exposures and of sufficient quality to support the calculation of risk-based capital requirements. The bank must update data sets at least monthly or more frequently as changes in market conditions or portfolio composition warrant. For a bank that uses a weighting scheme or other method for the historical observation period, the bank must either:

(i) Use an effective observation period of at least one year in which the average time lag of the observations is at least six months; or

(ii) Demonstrate to the Board or the appropriate Reserve Bank, with the concurrence of the Board, that its weighting scheme is more effective than a weighting scheme with an average time lag of at least six months representing the volatility of the bank's trading portfolio over a full business cycle. A bank using this option must update its data more frequently than monthly and in a manner appropriate for the type of weighting scheme.

(c) A bank must divide its portfolio into a number of significant subportfolios approved by the Board or the appropriate Reserve Bank, with concurrence of the Board, for subportfolio backtesting purposes. These subportfolios must be sufficient to allow the bank and the Board or the appropriate Reserve Bank, with concurrence of the Board, to assess the adequacy of the VaR model at the risk factor level; the Board or the appropriate Reserve Bank, with concurrence of the Board, will evaluate the appropriateness of these subportfolios relative to the value and composition of the bank's covered positions. The bank must retain and make available to the Board and the appropriate Reserve Bank the following information for each subportfolio for each business day over the previous two years (500 business days), with no more than a 60-day lag:

#### *Section 6. Stressed VaR-Based Measure*

(a) *General requirement.* At least weekly, a bank must use the same internal model(s) used to calculate its VaR-based measure to calculate a stressed VaR-based measure.

(b) *Quantitative requirements for stressed VaR-based measure.* (1) A bank must calculate a stressed VaR-based measure for its covered positions using the same model(s) used to calculate the VaR-based measure, subject to the same confidence level and holding period applicable to the VaR-based measure under



section 5 of this appendix, but with model inputs calibrated to historical data from a continuous 12-month period that reflects a period of significant financial stress appropriate to the bank's current portfolio.

(2) The stressed VaR-based measure must be calculated at least weekly and be no less than the bank's VaR-based measure.

(3) A bank must have policies and procedures that describe how it determines the period of significant financial stress used to calculate the bank's stressed VaR-based measure under this section and must be able to provide empirical support for the period used. The bank must obtain the prior approval of the Board or the appropriate Reserve Bank, with concurrence of the Board, for, and notify the Board and the appropriate Reserve Bank if the bank makes any material changes to, these policies and procedures. The policies and procedures must address:

(4) Nothing in this section prevents the Board or the appropriate Reserve Bank, with the concurrence of the Board, from requiring a bank to use a different period of significant financial stress in the calculation of the stressed VaR-based measure.

#### *Section 7. Specific Risk*

(a) *General requirement.* A bank must use one of the methods in this section to measure the specific risk for each of its debt, equity, and securitization positions with specific risk.

(b) *Modeled specific risk.* A bank may use models to measure the specific risk of covered positions as provided in paragraph (a) of section 5 of this appendix (therefore, excluding securitization positions that are not modeled under section 9 of this appendix). A bank must use models to measure the specific risk of correlation trading positions that are modeled under section 9 of this appendix.

(1) *Requirements for specific risk modeling.* (i) If a bank uses internal models to measure the specific risk of a portfolio, the internal models must:

(A) Explain the historical price variation in the portfolio;

(B) Be responsive to changes in market conditions;

(C) Be robust to an adverse environment, including signaling rising risk in an adverse environment; and

(D) Capture all material components of specific risk for the debt and equity positions in the portfolio. Specifically, the internal models must:

(1) Capture event risk and idiosyncratic risk;

(2) Capture and demonstrate sensitivity to material differences between positions that are similar but not identical and to changes in portfolio composition and concentrations.

(ii) If a bank calculates an incremental risk measure for a portfolio of debt or equity positions under section 8 of this appendix, the bank is not required to capture default and credit migration risks in its internal models used to measure the specific risk of those portfolios.

(2) *Specific risk fully modeled for one or more portfolios.* If the bank's VaR-based measure captures all material aspects of specific risk for one or more of its portfolios of debt, equity, or correlation trading positions, the bank has no specific risk add-on for those portfolios for purposes of paragraph (a)(2)(iii) of section 4 of this appendix.

(c) *Specific risk not modeled.*

(1) If the bank's VaR-based measure does not capture all material aspects of specific risk for a portfolio of debt, equity, or correlation trading positions, the bank must calculate a specific-risk add-on for the portfolio under the standardized measurement method as described in section 10 of this appendix.

(2) A bank must calculate a specific risk add-on under the standardized measurement method as described in section 10 of this appendix for all of its securitization positions that are not modeled under section 9 of this appendix.

#### *Section 8. Incremental Risk*

(a) *General requirement.* A bank that measures the specific risk of a portfolio of debt positions under section 7(b) of this appendix using internal models must calculate at least weekly an incremental risk measure for that portfolio according to the requirements in this section. The incremental risk measure is the bank's measure of potential losses due to incremental risk over a one-year time horizon at a one-tail, 99.9 percent confidence level, either under the assumption of a constant level of risk, or under the assumption of constant positions. With the prior approval of the Board or the appropriate Reserve Bank, with the concurrence of the Board, a bank may choose to include portfolios of equity positions in its incremental risk model, provided that it consistently includes such equity positions in a manner that is consistent with how the bank internally measures and manages the incremental risk of such positions at the portfolio level. If equity positions are included in the model, for modeling purposes default is considered to have occurred upon the default of any debt of the issuer of the equity position. A bank may not include correlation trading positions or securitization positions in its incremental risk measure.

(b) *Requirements for incremental risk modeling.* For purposes of calculating the incremental risk measure, the incremental risk model must:

(1) Measure incremental risk over a one-year time horizon and at a one-tail, 99.9 percent confidence level, either under the assumption of a constant level of risk, or under the assumption of constant positions.

(i) A constant level of risk assumption means that the bank rebalances, or rolls over, its trading positions at the beginning of each liquidity horizon over the one-year horizon in a manner that maintains the bank's initial risk level. The bank must determine the frequency of rebalancing in a manner consistent with the liquidity horizons of the positions in the portfolio. The liquidity horizon of a position or set of positions is the time required for a bank to reduce its exposure to, or hedge all of its material risks of, the position(s) in a stressed market. The liquidity horizon for a position or set of positions may not be less than the shorter of three months or the contractual maturity of the position.

(ii) A constant position assumption means that the bank maintains the same set of positions throughout the one-year horizon. If a bank uses this assumption, it must do so consistently across all portfolios.

(iii) A bank's selection of a constant position or a constant risk assumption must be consistent between the bank's incremental risk model and its comprehensive risk model described in section 9 of this appendix, if applicable.

(iv) A bank's treatment of liquidity horizons must be consistent between the bank's incremental risk model and its comprehensive risk model described in section 9 of this appendix, if applicable.

(2) Recognize the impact of correlations between default and migration events among obligors.

(3) Reflect the effect of issuer and market concentrations, as well as concentrations that can arise within and across product classes during stressed conditions.

(4) Reflect netting only of long and short positions that reference the same financial instrument.

(5) Reflect any material mismatch between a position and its hedge.

(6) Recognize the effect that liquidity horizons have on dynamic hedging strategies. In such cases, a bank must:

(i) Choose to model the rebalancing of the hedge consistently over the relevant set of trading positions;

(ii) Demonstrate that the inclusion of rebalancing results in a more appropriate risk measurement;

(iii) Demonstrate that the market for the hedge is sufficiently liquid to permit rebalancing during periods of stress; and

(iv) Capture in the incremental risk model any residual risks arising from such hedging strategies.

(7) Reflect the nonlinear impact of options and other positions with material nonlinear

behavior with respect to default and migration changes.

(8) Maintain consistency with the bank's internal risk management methodologies for identifying, measuring, and managing risk.

(c) *Calculation of incremental risk capital requirement.* The incremental risk capital requirement is the greater of:

(1) The average of the incremental risk measures over the previous 12 weeks; or

(2) The most recent incremental risk measure.

#### *Section 9. Comprehensive Risk*

(a) *General requirement.* (1) Subject to the prior approval of the Board or the appropriate Reserve Bank, with the concurrence of the Board, a bank may use the method in this section to measure comprehensive risk, that is, all price risk, for one or more portfolios of correlation trading positions.

(2) A bank that measures the price risk of a portfolio of correlation trading positions using internal models must calculate at least weekly a comprehensive risk measure that captures all price risk according to the requirements of this section. The comprehensive risk measure is either:

(i) The sum of:

(A) The bank's modeled measure of all price risk determined according to the requirements in paragraph (b) of this section; and

(B) A surcharge for the bank's modeled correlation trading positions equal to the total specific risk add-on for such positions as calculated under section 10 of this appendix multiplied by 8.0 percent; or

(ii) With approval of the Board or the appropriate Reserve Bank, with the concurrence of the Board, and provided the bank has met the requirements of this section for a period of at least one year and can demonstrate the effectiveness of the model through the results of ongoing model validation efforts including robust benchmarking, the greater of:

(A) The bank's modeled measure of all price risk determined according to the requirements in paragraph (b) of this section; or

(B) The total specific risk add-on that would apply to the bank's modeled correlation trading positions as calculated under section 10 of this appendix multiplied by 8.0 percent.

(b) *Requirements for modeling all price risk.* If a bank uses an internal model to measure the price risk of a portfolio of correlation trading positions:

(1) The internal model must measure comprehensive risk over a one-year time horizon at a one-tail, 99.9 percent confidence level, either under the assumption of a constant level of risk, or under the assumption of constant positions.

(2) The model must capture all material price risk, including but not limited to the following:

(i) The risks associated with the contractual structure of cash flows of the position, its issuer, and its underlying exposures;

(ii) Credit spread risk, including nonlinear price risks;

(iii) The volatility of implied correlations, including nonlinear price risks such as the cross-effect between spreads and correlations;

(iv) Basis risk;

(v) Recovery rate volatility as it relates to the propensity for recovery rates to affect tranche prices; and

(vi) To the extent the comprehensive risk measure incorporates the benefits of dynamic hedging, the static nature of the hedge over the liquidity horizon must be recognized. In such cases, a bank must:

(A) Choose to model the rebalancing of the hedge consistently over the relevant set of trading positions;

(B) Demonstrate that the inclusion of rebalancing results in a more appropriate risk measurement;

(C) Demonstrate that the market for the hedge is sufficiently liquid to permit rebalancing during periods of stress; and

(D) Capture in the comprehensive risk model any residual risks arising from such hedging strategies;

(3) The bank must use market data that are relevant in representing the risk profile of the bank's correlation trading positions in order to ensure that the bank fully captures the material risks of the correlation trading positions in its comprehensive risk measure in accordance with this section; and

(4) The bank must be able to demonstrate that its model is an appropriate representation of comprehensive risk in light of the historical price variation of its correlation trading positions.

(c) *Requirements for stress testing.*

(1) A bank must at least weekly apply specific, supervisory stress scenarios to its portfolio of correlation trading positions that capture changes in:

(i) Default rates;

(ii) Recovery rates;

(iii) Credit spreads;

(iv) Correlations of underlying exposures; and

(v) Correlations of a correlation trading position and its hedge.

(2) Other requirements. (i) A bank must retain and make available to the Board and the appropriate Reserve Bank the results of the supervisory stress testing, including comparisons with the capital requirements generated by the bank's comprehensive risk model.

(ii) A bank must report to the Board and the appropriate Reserve Bank promptly any instances where the stress tests indicate any

material deficiencies in the comprehensive risk model.

(d) *Calculation of comprehensive risk capital requirement.* The comprehensive risk capital requirement is the greater of:

(1) The average of the comprehensive risk measures over the previous 12 weeks; or

(2) The most recent comprehensive risk measure.

#### *Section 10. Standardized Measurement Method for Specific Risk*

(a) *General requirement.* A bank must calculate a total specific risk add-on for each portfolio of debt and equity positions for which the bank's VaR-based measure does not capture all material aspects of specific risk and for all securitization positions that are not modeled under section 9 of this appendix. A bank must calculate each specific risk add-on in accordance with the requirements of this section. Notwithstanding any other definition or requirement in this appendix, a position that would have qualified as a debt position or an equity position but for the fact that it qualifies as a correlation trading position under paragraph (2) of the definition of correlation trading position, shall be considered a debt position or an equity position, respectively, for purposes of this section 10.

(1) The specific risk add-on for an individual debt or securitization position that represents sold credit protection is capped at the notional amount of the credit derivative contract. The specific risk add-on for an individual debt or securitization position that represents purchased credit protection is capped at the current market value of the transaction plus the absolute value of the present value of all remaining payments to the protection seller under the transaction. This sum is equal to the value of the protection leg of the transaction.

(2) For debt, equity, or securitization positions that are derivatives with linear payoffs, a bank must assign a specific risk-weighting factor to the market value of the effective notional amount of the underlying instrument or index portfolio, except for a securitization position for which the bank directly calculates a specific risk add-on using the SFA in paragraph (b)(2)(vii)(B) of this section. A swap must be included as an effective notional position in the underlying instrument or portfolio, with the receiving side treated as a long position and the paying side treated as a short position. For debt, equity, or securitization positions that are derivatives with nonlinear payoffs, a bank must risk weight the market value of the effective notional amount of the underlying instrument or portfolio multiplied by the derivative's delta.

(3) For debt, equity, or securitization positions, a bank may net long and short positions (including derivatives) in identical

issues or identical indices. A bank may also net positions in depositary receipts against an opposite position in an identical equity in different markets, provided that the bank includes the costs of conversion.

(4) A set of transactions consisting of either a debt position and its credit derivative hedge or a securitization position and its credit derivative hedge has a specific risk add-on of zero if:

(i) The debt or securitization position is fully hedged by a total return swap (or similar instrument where there is a matching of swap payments and changes in market value of the debt or securitization position);

(ii) There is an exact match between the reference obligation of the swap and the debt or securitization position;

(iii) There is an exact match between the currency of the swap and the debt or securitization position; and

(iv) There is either an exact match between the maturity date of the swap and the maturity date of the debt or securitization position; or, in cases where a total return swap references a portfolio of positions with different maturity dates, the total return swap maturity date must match the maturity date of the underlying asset in that portfolio that has the latest maturity date.

(5) The specific risk add-on for a set of transactions consisting of either a debt position and its credit derivative hedge or a securitization position and its credit derivative hedge that does not meet the criteria of paragraph (a)(4) of this section is equal to 20.0 percent of the capital requirement for the side of the transaction with the higher specific risk add-on when:

(i) The credit risk of the position is fully hedged by a credit default swap or similar instrument;

(ii) There is an exact match between the reference obligation of the credit derivative hedge and the debt or securitization position;

(iii) There is an exact match between the currency of the credit derivative hedge and the debt or securitization position; and

(iv) There is either an exact match between the maturity date of the credit derivative hedge and the maturity date of the debt or securitization position; or, in the case where the credit derivative hedge has a standard maturity date:

(A) The maturity date of the credit derivative hedge is within 30 business days of the maturity date of the debt or securitization position; or

(B) For purchased credit protection, the maturity date of the credit derivative hedge is later than the maturity date of the debt or securitization position, but is no later than the standard maturity date for that instrument that immediately follows the maturity date of the debt or securitization position. The maturity date of the credit derivative hedge may not exceed the maturity date of the debt or securitization position by more than 90 calendar days.

(6) The specific risk add-on for a set of transactions consisting of either a debt position and its credit derivative hedge or a securitization position and its credit derivative hedge that does not meet the criteria of either paragraph (a)(4) or (a)(5) of this section, but in which all or substantially all of the price risk has been hedged, is equal to the specific risk add-on for the side of the transaction with the higher specific risk add-on.

(b) *Debt and securitization positions.* (1) The total specific risk add-on for a portfolio of debt or securitization positions is the sum of the specific risk add-ons for individual debt or securitization positions, as computed under this section. To determine the specific risk add-on for individual debt or securitization positions, a bank must multiply the absolute value of the current market value of each net long or net short debt or securitization position in the portfolio by the appropriate specific risk-weighting factor as set forth in paragraphs (b)(2)(i) through (b)(2)(vii) of this section.

(2) For the purpose of this section, the appropriate specific risk-weighting factors include:

(i) *Sovereign debt positions.* (A) *In general.* A bank must assign a specific risk-weighting factor to a sovereign debt position based on the CRC applicable to the sovereign entity and, as applicable, the remaining contractual maturity of the position, in accordance with table 2. Sovereign debt positions that are backed by the full faith and credit of the United States are treated as having a CRC of 0.

TABLE 2—SPECIFIC RISK-WEIGHTING FACTORS FOR SOVEREIGN DEBT POSITIONS

		Specific risk-weighting factor	Percent
CRC of Sovereign .....	0-1		0.0
	2-3	Remaining contractual maturity of 6 months or less .....	0.25
		Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
		Remaining contractual maturity exceeds 24 months .....	1.6

TABLE 2—SPECIFIC RISK-WEIGHTING FACTORS FOR SOVEREIGN DEBT POSITIONS—Continued

	4–6	8.0
	7	12.0
No CRC .....		8.0
Default by the Sovereign Entity .....		12.0

(B) Notwithstanding paragraph (b)(2)(i)(A) of this section, a bank may assign to a sovereign debt position a specific risk-weighting factor that is lower than the applicable specific risk-weighting factor in table 2 if:

(1) The position is denominated in the sovereign entity's currency;

(2) The bank has at least an equivalent amount of liabilities in that currency; and

(3) The sovereign entity allows banks under its jurisdiction to assign the lower specific risk-weighting factor to the same exposures to the sovereign entity.

(C) A bank must assign a 12.0 percent specific risk-weighting factor to a sovereign debt position immediately upon determination that a default has occurred; or if a default has occurred within the previous five years.

(D) A bank must assign an 8.0 percent specific risk-weighting factor to a sovereign debt position if the sovereign entity does not have a CRC assigned to it, unless the sovereign debt position must be assigned a higher specific risk-weighting factor under paragraph (b)(2)(i)(C) of this section.

(ii) *Certain supranational entity and multilateral development bank debt positions.* A bank may assign a 0.0 percent specific risk-weighting factor to a debt position that is an exposure to the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, or an MDB.

(iii) *GSE debt positions.* A bank must assign a 1.6 percent specific risk-weighting factor to a debt position that is an exposure to a GSE. Notwithstanding the foregoing, a bank must assign an 8.0 percent specific risk-weighting factor to preferred stock issued by a GSE.

(iv) *Depository institution, foreign bank, and credit union debt positions.* (A) Except as provided in paragraph (b)(2)(iv)(B) of this section, a bank must assign a specific risk-weighting factor to a debt position that is an exposure to a depository institution, a foreign bank, or a credit union using the specific risk-weighting factor that corresponds to that entity's sovereign of incorporation and, as applicable, the remaining contractual maturity of the position, in accordance with table 3.

TABLE 3—SPECIFIC RISK-WEIGHTING FACTORS FOR DEPOSITORY INSTITUTION, FOREIGN BANK, AND CREDIT UNION DEBT POSITIONS

		Specific risk-weighting factor	Percent
CRC of Sovereign .....	0–2	Remaining contractual maturity of 6 months or less .....	0.25
		Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
		Remaining contractual maturity exceeds 24 months .....	1.6
	3		8.0
	4–7		12.0
No CRC .....			8.0
Default by the Sovereign Entity .....			12.0

(B) A bank must assign a specific risk-weighting factor of 8.0 percent to a debt position that is an exposure to a depository institution or a foreign bank that is includable in the depository institution's or foreign bank's regulatory capital and that is not subject to deduction as a reciprocal holding under appendix A to this part.

(C) A bank must assign a 12.0 percent specific risk-weighting factor to a debt position that is an exposure to a foreign bank immediately upon determination that a default by the foreign bank's sovereign of incorporation has occurred or if a default by the foreign bank's sovereign of incorporation has occurred within the previous five years.

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(v) *PSE debt positions.* (A) Except as provided in paragraph (b)(2)(v)(B) of this section, a bank must assign a specific risk-weighting factor to a debt position that is an exposure to a PSE based on the specific risk-weighting factor that corresponds to the PSE's sovereign of incorporation and to the position's categorization as a general obligation or revenue obligation and, as applicable, the remaining contractual maturity of the position, as set forth in tables 4 and 5.

(B) A bank may assign a lower specific risk-weighting factor than would otherwise apply under tables 4 and 5 to a debt position that is an exposure to a foreign PSE if:

(1) The PSE's sovereign of incorporation allows banks under its jurisdiction to assign a lower specific risk-weighting factor to such position; and

(2) The specific risk-weighting factor is not lower than the risk weight that corresponds to the PSE's sovereign of incorporation in accordance with tables 4 and 5.

(C) A bank must assign a 12.0 percent specific risk-weighting factor to a PSE debt position immediately upon determination that a default by the PSE's sovereign of incorporation has occurred or if a default by the PSE's sovereign of incorporation has occurred within the previous five years.

**TABLE 4—SPECIFIC RISK-WEIGHTING FACTORS FOR PSE GENERAL OBLIGATION DEBT POSITIONS**

		General obligation specific risk-weighting factor (in percent)	Percent
CRC of Sovereign .....	0–2	Remaining contractual maturity of 6 months or less .....	0.25
		Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
		Remaining contractual maturity exceeds 24 months .....	1.6
	3		8.0
	4–7		12.0
No CRC .....			8.0
Default by the Sovereign Entity .....			12.0

**TABLE 5—SPECIFIC RISK-WEIGHTING FACTORS FOR PSE REVENUE OBLIGATION DEBT POSITIONS**

		Revenue obligation specific risk-weighting factor	Percent
CRC of Sovereign .....	0–1	Remaining contractual maturity of 6 months or less .....	0.25
		Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
		Remaining contractual maturity exceeds 24 months .....	1.6
	2–3		8.0
	4–7		12.0
No CRC .....			8.0
Default by the Sovereign Entity .....			12.0

(vi) *Corporate debt positions.* Except as otherwise provided in paragraph (b)(2)(vi)(B), a bank must assign a specific risk-weighting factor to a corporate debt position in accordance with the investment grade methodology in paragraph (b)(2)(vi)(A) of this section.

(A) *Investment grade methodology.* (1) For corporate debt positions that are exposures to entities that have issued and outstanding

publicly traded instruments, a bank must assign a specific risk-weighting factor based on the category and remaining contractual maturity of the position, in accordance with table 6. For purposes of this paragraph (A), the bank must determine whether the position is in the investment grade or not investment grade category.

TABLE 6—SPECIFIC RISK-WEIGHTING FACTORS FOR CORPORATE DEBT POSITIONS UNDER THE INVESTMENT GRADE METHODOLOGY

Category	Remaining contractual maturity	Specific risk-weighting factor (in percent)
Investment Grade .....	6 months or less .....	0.50
	Greater than 6 and up to and including 24 months .....	2.00
	Greater than 24 months .....	4.00
Not-investment Grade .....	.....	12.00

(2) A bank must assign an 8.0 percent specific risk-weighting factor for corporate debt positions that are exposures to entities that do not have publicly traded instruments outstanding.

(B) *Limitations.* (1) A bank must assign a specific risk-weighting factor of at least 8.0 percent to an interest-only mortgage-backed security that is not a securitization position.

(2) A bank shall not assign a corporate debt position a specific risk-weighting factor that is lower than the specific risk-weighting factor that corresponds to the CRC of the issuer's sovereign of incorporation in table 1.

(vii) *Securitization positions.* (A) *General requirements.* (1) A bank that does not use appendix F to this part must assign a specific risk-weighting factor to a securitization position using either the simplified supervisory formula approach (SSFA) in accordance with section 11 of this appendix or assign a specific risk-weighting factor of 100 percent to the position.

(2) A bank that uses appendix F to this part must calculate a specific risk add-on for a securitization position using the SFA in section 45 of appendix F to this part and in accordance with paragraph (b)(2)(vii)(B) of this section if the bank and the securitization position each qualifies to use the SFA under appendix F to this part. A bank that uses appendix F to this part and that has a securitization position that does not qualify for the SFA may assign a specific risk-weighting factor to the securitization position using the SSFA in accordance with section 11 of this appendix or assign a specific risk-weighting factor of 100 percent to the position.

(3) A bank must treat a short securitization position as if it is a long securitization position solely for calculation purposes when using the SFA in paragraph (b)(2)(vii)(B) or the SSFA in section 11 of this appendix.

(B) *SFA.* To calculate the specific risk add-on for a securitization position using the SFA, a bank that is subject to appendix F to this part must set the specific risk add-on for the position equal to the risk-based capital requirement, calculated under section 45 of appendix F to this part.

(C) *SSFA.* To use the SSFA to determine the specific risk-weighting factor for a securitization position, a bank must calculate the specific risk-weighting factor in accordance with section 11 of this appendix.

(D) *Nth-to-default credit derivatives.* A bank must determine a specific risk add-on using the SFA in paragraph (b)(2)(vii)(B), or assign a specific risk-weighting factor using the SSFA in section 11 of this appendix to an nth-to-default credit derivative in accordance with this paragraph (D), irrespective of whether the bank is a net protection buyer or net protection seller. A bank must determine its position in the nth-to-default credit derivative as the largest notional dollar amount of all the underlying exposures.

(1) For purposes of determining the specific risk add-on using the SFA in paragraph (b)(2)(vii)(B) or the specific risk-weighting factor for an nth-to-default credit derivative using the SSFA in section 11 of this appendix, the bank must calculate the attachment point and detachment point of its position as follows:

(i) The attachment point (parameter A) is the ratio of the sum of the notional amounts of all underlying exposures that are subordinated to the bank's position to the total notional amount of all underlying exposures. For purposes of using the SFA to calculate the specific add-on for its position in an nth-to-default credit derivative, parameter A must be set equal to the *credit enhancement level* (L) input to the SFA formula. In the case of a first-to-default credit derivative, there are no underlying exposures that are subordinated to the bank's position. In the case of a second-or-subsequent-to-default credit derivative, the smallest (n-1) notional amounts of the underlying exposure(s) are subordinated to the bank's position.

(ii) The detachment point (parameter D) equals the sum of parameter A plus the ratio of the notional amount of the bank's position in the nth-to-default credit derivative to the total notional amount of all underlying exposures. For purposes of using the SFA to calculate the specific risk add-on for its position in an nth-to-default credit derivative, parameter D must be set to equal L plus the *thickness of tranche* (T) input to the SFA formula.

(2) A bank that does not use the SFA to determine a specific risk-add on, or the SSFA to determine a specific risk-weighting factor for its position in an nth-to-default credit derivative must assign a specific risk-weighting factor of 100 percent to the position.

(c) *Modeled correlation trading positions.* For purposes of calculating the comprehensive risk measure for modeled correlation trading positions under either paragraph (a)(2)(i) or (a)(2)(ii) of section 9 of this appendix, the total specific risk add-on is the greater of:

(1) The sum of the bank's specific risk add-ons for each net long correlation trading position calculated under this section; or

(2) The sum of the bank's specific risk add-ons for each net short correlation trading position calculated under this section.

(d) *Non-modeled securitization positions.* For securitization positions that are not correlation trading positions and for securitizations that are correlation trading positions not modeled under section 9 of this appendix, the total specific risk add-on is the greater of:

(1) The sum of the bank's specific risk add-ons for each net long securitization position calculated under this section; or

(2) The sum of the bank's specific risk add-ons for each net short securitization position calculated under this section.

(e) *Equity positions.* The total specific risk add-on for a portfolio of equity positions is the sum of the specific risk add-ons of the individual equity positions, as computed under this section. To determine the specific risk add-on of individual equity positions, a bank must multiply the absolute value of the current market value of each net long or net short equity position by the appropriate specific risk-weighting factor as determined under this paragraph:

(1) The bank must multiply the absolute value of the current market value of each net long or net short equity position by a specific risk-weighting factor of 8.0 percent. For equity positions that are index contracts comprising a well-diversified portfolio of equity instruments, the absolute value of the current market value of each net long or net short position is multiplied by a specific risk-weighting factor of 2.0 percent.<sup>46</sup>

(2) For equity positions arising from the following futures-related arbitrage strategies, a bank may apply a 2.0 percent specific risk-weighting factor to one side (long or short) of each position with the opposite side exempt from an additional capital requirement:

(i) Long and short positions in exactly the same index at different dates or in different market centers; or

(ii) Long and short positions in index contracts at the same date in different, but similar indices.

(3) For futures contracts on main indices that are matched by offsetting positions in a basket of stocks comprising the index, a bank may apply a 2.0 percent specific risk-weighting factor to the futures and stock basket positions (long and short), provided that such trades are deliberately entered into and separately controlled, and that the basket of stocks is comprised of stocks representing at least 90.0 percent of the capitalization of the index. A main index refers to the Standard & Poor's 500 Index, the FTSE All-World Index, and any other index for which the bank can demonstrate to the satisfaction of the Board or the appropriate Reserve Bank, with the concurrence of the Board, that the equities represented in the index have liquidity, depth of market, and size of bid-ask spreads comparable to equities in the Standard & Poor's 500 Index and FTSE All-World Index.

(f) *Due diligence requirements.* (1) A bank must demonstrate to the satisfaction of the Board or the appropriate Reserve Bank, with the concurrence of the Board, a comprehensive understanding of the features of a securitization position that would materially affect the performance of the position by conducting and documenting the analysis set forth in paragraph (f)(2) of this section. The bank's analysis must be commensurate with the complexity of the securitization position and the materiality of the position in relation to capital.

(2) To support the demonstration of its comprehensive understanding, for each securitization position a bank must:

(i) Conduct an analysis of the risk characteristics of a securitization position prior to acquiring the position and document such analysis within three business days after acquiring the position, considering:

(A) Structural features of the securitization that would materially impact the performance of the position, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

(B) Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification data on the underlying exposure(s);

<sup>46</sup> A portfolio is well-diversified if it contains a large number of individual equity positions, with no single position representing a substantial portion of the portfolio's total market value.



(C) Relevant market data of the securitization, for example, bid-ask spreads, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the securitization; and

(D) For resecuritization positions, performance information on the underlying securitization exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the securitization exposures; and

(ii) On an on-going basis (no less frequently than quarterly), evaluate, review, and update as appropriate the analysis required under paragraph (f)(1) of this section for each securitization position.

*Section 11. Simplified Supervisory Formula Approach*

(a) *General requirements.* To use the SSFA to determine the specific risk-weighting factor for a securitization position, a bank must have data that enables it to assign accurately the parameters described in paragraph (b) of this section. Data used to assign the parameters described in paragraph (b) of this section must be the most currently available data and no more than 91 calendar days old. A bank that does not have the appropriate data to assign the parameters described and defined, for purposes of this section, in paragraph (b) of this section must assign a specific risk-weighting factor of 100 percent to the position.

(b) *SSFA parameters.* To calculate the specific risk-weighting factor for a securitization position using the SSFA, a bank must have accurate information on the five inputs to the SSFA calculation described in paragraphs (b)(1) through (b)(5) of this section:

(1)  $K_G$  is the weighted-average (with unpaid principal used as the weight for each exposure) total capital requirement of the underlying exposures calculated using appendix A to this part.  $K_G$  is expressed as a decimal value between zero and 1 (that is, an average risk weight of 100 percent represents a value of  $K_G$  equal to .08).

(2) Parameter  $W$  is expressed as a decimal value between zero and one. Parameter  $W$  is the ratio of the sum of the dollar amounts of any underlying exposures within the securitized pool that meet any of the criteria as set forth in paragraphs (i) through (vi) of this paragraph (b)(2) to the ending balance, measured in dollars, of underlying exposures:

- (i) Ninety days or more past due;
- (ii) Subject to a bankruptcy or insolvency proceeding;
- (iii) In the process of foreclosure;
- (iv) Held as real estate owned;
- (v) Has contractually deferred interest payments for 90 days or more; or

(vi) Is in default.

(3) Parameter  $A$  is the attachment point for the position, which represents the threshold at which credit losses will first be allocated to the position. Parameter  $A$  equals the ratio of the current dollar amount of underlying exposures that are subordinated to the position of the bank to the current dollar amount of underlying exposures. Any reserve account funded by the accumulated cash flows from the underlying exposures that is subordinated to the position that contains the bank's securitization exposure may be included in the calculation of parameter  $A$  to the extent that cash is present in the account. Parameter  $A$  is expressed as a decimal value between zero and one.

(4) Parameter  $D$  is the detachment point for the position, which represents the threshold at which credit losses of principal allocated to the position would result in a total loss of principal. Parameter  $D$  equals parameter  $A$  plus the ratio of the current dollar amount of the securitization positions that are *pari passu* with the position (that is, have equal seniority with respect to credit risk) to the current dollar amount of the underlying exposures. Parameter  $D$  is expressed as a decimal value between zero and one.

(5) A supervisory calibration parameter,  $p$ , is equal to 0.5 for securitization positions that are not resecuritization positions and equal to 1.5 for resecuritization positions.

(c) *Mechanics of the SSFA.*  $K_A$  and  $W$  are used to calculate  $K_A$ , the augmented value of  $K_G$ , which reflects the observed credit quality of the underlying pool of exposures.  $K_A$  is defined in paragraph (d) of this section. The values of parameters  $A$  and  $D$ , relative to  $K_A$  determine the specific risk-weighting factor assigned to a position as described in this paragraph and paragraph (d) of this section. The specific risk-weighting factor assigned to a securitization position, or portion of a position, as appropriate, is the larger of the specific risk-weighting factor determined in accordance with this paragraph and paragraph (d) of this section and a specific risk-weighting factor of 1.6 percent.

(1) When the detachment point, parameter  $D$ , for a securitization position is less than or equal to  $K_A$ , the position must be assigned a specific risk-weighting factor of 100 percent.

(2) When the attachment point, parameter  $A$ , for a securitization position is greater than or equal to  $K_A$ , the bank must calculate the specific risk-weighting factor in accordance with paragraph (d) of this section.

(3) When  $A$  is less than  $K_A$  and  $D$  is greater than  $K_A$ , the specific risk-weighting factor is a weighted-average of 1.00 and  $K_{SSFA}$  calculated in accordance with paragraph (d) of this section, but with the parameter  $A$  revised to be set equal to  $K_A$ . For the purpose of this weighted-average calculation:

(i) The weight assigned to 1.00 equals  $\frac{K_A - A}{D - A}$ .

(ii) The weight assigned to  $K_{SSFA}$  equals  $\frac{D - K_A}{D - A}$ . The specific risk-weighting

factor will be set equal to:

$$SRWF = 100 \times \left[ \left( \frac{K_A - A}{D - A} \right) \times 1.00 \right] + \left[ \left( \frac{D - K_A}{D - A} \right) \times K_{SSFA} \right]$$

(d) SSFA equation. (1) The [bank] must define the following parameters:

$$K_A = (1 - W) \cdot K_G + (0.5 \cdot W)$$

$$\alpha = -\frac{1}{p \cdot K_A}$$

$$u = D - K_A$$

$$l = A - K_A$$

$e = 2.71828$ , the base of the natural logarithms.

(2) Then the [bank] must calculate  $K_{SSFA}$  according to the following equation:

$$K_{SSFA} = \frac{e^{\alpha u} - e^{\alpha l}}{\alpha (u - l)}$$

(3) The specific risk-weighting factor for the position (expressed as a percent) is

equal to  $K_{SSFA} \times 100$ .

#### Section 12. Market Risk Disclosures

(a) *Scope*. A bank must comply with this section unless it is a consolidated subsidiary of a bank holding company or a depository institution that is subject to these requirements or of a non-U.S. banking organization that is subject to comparable public disclosure requirements in its home jurisdiction. A bank must make quantitative disclosures publicly each calendar quarter. If a significant change occurs, such that the most recent reporting amounts are no longer reflective of the bank's capital adequacy and risk profile, then a brief discussion of this change and its likely impact must be provided as soon as practicable thereafter. Qualitative disclosures that typically do not change each

quarter may be disclosed annually, provided any significant changes are disclosed in the interim. If a bank believes that disclosure of specific commercial or financial information would prejudice seriously its position by making public certain information that is either proprietary or confidential in nature, the bank is not required to disclose these specific items, but must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed.

(b) *Disclosure policy*. The bank must have a formal disclosure policy approved by the board of directors that addresses the bank's approach for determining its market risk

disclosures. The policy must address the associated internal controls and disclosure controls and procedures. The board of directors and senior management must ensure that appropriate verification of the disclosures takes place and that effective internal controls and disclosure controls and procedures are maintained. One or more senior officers of the bank must attest that the disclosures meet the requirements of this appendix, and the board of directors and senior management are responsible for establishing and maintaining an effective internal control structure over financial reporting, including the disclosures required by this section.

(c) *Quantitative disclosures.*

(1) For each material portfolio of covered positions, the bank must disclose publicly the following information at least quarterly:

(i) The high, low, and mean VaR-based measures over the reporting period and the VaR-based measure at period-end;

(ii) The high, low, and mean stressed VaR-based measures over the reporting period and the stressed VaR-based measure at period-end;

(iii) The high, low, and mean incremental risk capital requirements over the reporting period and the incremental risk capital requirement at period-end;

(iv) The high, low, and mean comprehensive risk capital requirements over the reporting period and the comprehensive risk capital requirement at period-end, with the period-end requirement broken down into appropriate risk classifications (for example, default risk, migration risk, correlation risk);

(v) Separate measures for interest rate risk, credit spread risk, equity price risk, foreign exchange risk, and commodity price risk used to calculate the VaR-based measure; and

(vi) A comparison of VaR-based estimates with actual gains or losses experienced by the bank, with an analysis of important outliers.

(2) In addition, the bank must disclose publicly the following information at least quarterly:

(i) The aggregate amount of on-balance sheet and off-balance sheet securitization positions by exposure type; and

(ii) The aggregate amount of correlation trading positions.

(d) *Qualitative disclosures.* For each material portfolio of covered positions, the bank must disclose publicly the following information at least annually, or more frequently in the event of material changes for each portfolio:

(1) The composition of material portfolios of covered positions;

(2) The bank's valuation policies, procedures, and methodologies for covered positions including, for securitization positions,

the methods and key assumptions used for valuing such positions, any significant changes since the last reporting period, and the impact of such change;

(3) The characteristics of the internal models used for purposes of this appendix. For the incremental risk capital requirement and the comprehensive risk capital requirement, this must include:

(i) The approach used by the bank to determine liquidity horizons;

(ii) The methodologies used to achieve a capital assessment that is consistent with the required soundness standard; and

(iii) The specific approaches used in the validation of these models;

(4) A description of the approaches used for validating and evaluating the accuracy of internal models and modeling processes for purposes of this appendix;

(5) For each market risk category (that is, interest rate risk, credit spread risk, equity price risk, foreign exchange risk, and commodity price risk), a description of the stress tests applied to the positions subject to the factor;

(6) The results of the comparison of the bank's internal estimates for purposes of this appendix with actual outcomes during a sample period not used in model development;

(7) The soundness standard on which the bank's internal capital adequacy assessment under this appendix is based, including a description of the methodologies used to achieve a capital adequacy assessment that is consistent with the soundness standard;

(8) A description of the bank's processes for monitoring changes in the credit and market risk of securitization positions, including how those processes differ for resecuritization positions; and

(8) A description of the bank's policy governing the use of credit risk mitigation to mitigate the risks of securitization and resecuritization positions.

[Reg. H, 77 FR 53112, Aug. 30, 2012]

EDITORIAL NOTE: At 77 FR 53113, Aug. 30, 2012, section 3(e)(4) of appendix E to part 208 was amended; however, the amendment could not be incorporated because section 3(e)(4) does not exist in appendix E to part 208.

EFFECTIVE DATE NOTES: 1. At 78 FR 62284, Oct. 11, 2013, appendix E to part 208 was removed and reserved, effective Jan. 1, 2015.

2. At 78 FR 76524 and 76526, Dec. 18, 2013, appendix E to part 208 was amended as follows, effective Apr. 1, 2014.

In section 2, by revising paragraphs (3)(v) through (vii) and adding paragraph (3)(viii) in the definition of "Covered position"

In section 10, by revising paragraph (b)(2)(i)(A), Table 2, and paragraphs

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(b)(2)(i)(B), (C), and (D), and adding paragraph (b)(2)(i)(E); revising paragraph (b)(2)(iv)(A) and Table 3; and revising paragraph (b)(2)(v), Table 4 and Table 5;

In section 11, by revising paragraph (b)(2); and

In section 12, by revising paragraph (a); revising paragraph (c)(1) introductory text; and revising paragraph (d) introductory text.

For the convenience of the user, the added and revised text is set forth as follows:

### APPENDIX E TO PART 208—RISK-BASED CAPITAL GUIDELINES; MARKET RISK

\* \* \* \* \*

#### Section 2. Definitions

\* \* \* \* \*

#### Covered position \* \* \*

(3) \* \* \*

(v) Any equity position that is not publicly traded, other than a derivative that references a publicly traded equity and other than a position in an investment company as defined in and registered with the SEC under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*), provided that all the underlying equities held by the investment company are publicly traded;

(vi) Any equity position that is not publicly traded, other than a derivative that references a publicly traded equity and other than a position in an entity not domiciled in the United States (or a political subdivision thereof) that is supervised and regulated in a manner similar to entities described in paragraph (3)(v) of this definition;

(vii) Any position a bank holds with the intent to securitize; or

(viii) Any direct real estate holding.

\* \* \* \* \*

#### Section 10. Standardized Measurement Method for Specific Risk

\* \* \* \* \*

#### (b) Debt and securitization positions. \* \* \*

(2) \* \* \*

(i) *Sovereign Debt Positions.* (A) In accordance with table 2, a bank must assign a specific risk-weighting factor to a sovereign debt position based on the CRC applicable to the sovereign entity and, as applicable, the remaining contractual maturity of the position, or, if there is no CRC applicable to the sovereign entity, based on whether the sovereign entity is a member of the OECD. Notwithstanding any other provision in this Appendix E, sovereign debt positions that are backed by the full faith and credit of the

United States are treated as having a CRC of 0.

TABLE 2—SPECIFIC RISK-WEIGHTING FACTORS FOR SOVEREIGN DEBT POSITIONS

	Specific risk-weighting factor (in percent)	
	0–1	0.0
CRC .....	2–3	Remaining contractual maturity of 6 months or less. 0.25
		Remaining contractual maturity of greater than 6 and up to and including 24 months. 1.0
		Remaining contractual maturity exceeds 24 months. 1.6
	4–6	8.0
	7	12.0
OECD Member with No CRC.		0.0
Non-OECD Member with No CRC.		8.0
Default by the Sovereign Entity.		12.0

(B) Notwithstanding paragraph (b)(2)(i)(A) of this section, a bank may assign to a sovereign debt position a specific risk-weighting factor that is lower than the applicable specific risk-weighting factor in table 2 if:

(1) The position is denominated in the sovereign entity's currency;

(2) The bank has at least an equivalent amount of liabilities in that currency; and

(3) The sovereign entity allows banks under its jurisdiction to assign the lower specific risk-weighting factor to the same exposures to the sovereign entity.

(C) A bank must assign a 12.0 percent specific risk-weighting factor to a sovereign debt position immediately upon determination a default has occurred; or if a default has occurred within the previous five years.

(D) A bank must assign a 0.0 percent specific risk-weighting factor to a sovereign debt position if the sovereign entity is a member of the OECD and does not have a CRC assigned to it, except as provided in paragraph (b)(2)(i)(C) of this section.

(E) A bank must assign an 8.0 percent specific risk-weighting factor to a sovereign debt position if the sovereign entity is not a member of the OECD and does not have a CRC assigned to it, except as provided in paragraph (b)(2)(i)(C) of this section.

\* \* \* \* \*

(iv) *Depository institution, foreign bank, and credit union debt positions.* (A) Except as provided in paragraph (b)(2)(iv)(B) of this section, a bank must assign a specific risk-weighting factor to a debt position that is an exposure to a depository institution, a foreign bank, or a credit union in accordance with table 3, based on the CRC that corresponds to that entity's sovereign of incorporation or the OECD membership status of that entity's sovereign of incorporation if there is no CRC applicable to the entity's sovereign of incorporation, and, as applicable, the remaining contractual maturity of the position.

TABLE 3—SPECIFIC RISK-WEIGHTING FACTORS FOR DEPOSITORY INSTITUTION, FOREIGN BANK, AND CREDIT UNION DEBT POSITIONS

	Specific risk-weighting factor (in percent)	
CRC 0–2 or OECD Member with No CRC.	Remaining contractual maturity of 6 months or less.	0.25
	Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
	Remaining contractual maturity exceeds 24 months.	1.6
CRC 3 .....	8.0	
CRC 4–7 .....	12.0	
Non-OECD Member with No CRC.	8.0	
Default by the Sovereign Entity.	12.0	

\* \* \* \* \*

(v) *PSE debt positions.* (A) Except as provided in paragraph (b)(2)(v)(B) of this section, a bank must assign a specific risk-weighting factor to a debt position that is an exposure to a PSE in accordance with table 4 and table 5 depending on the position's categorization as a general obligation or revenue obligation, based on the CRC that corresponds to the PSE's sovereign of incorporation or the OECD membership status of the PSE's sovereign of incorporation if there is no CRC applicable to the PSE's sovereign of incorporation, and, as applicable, the remaining contractual maturity of the position.

(B) A bank may assign a lower specific risk-weighting factor than would otherwise apply under tables 4 and 5 to a debt position that is an exposure to a foreign PSE if:

(1) The PSE's sovereign of incorporation allows banks under its jurisdiction to assign a lower specific risk-weighting factor to such position; and

(2) The specific risk-weighting factor is not lower than the risk weight that corresponds to the PSE's sovereign of incorporation in accordance with tables 4 and 5.

(C) A bank must assign a 12.0 percent specific risk-weighting factor to a PSE debt position immediately upon determination that a default by the PSE's sovereign of incorporation has occurred or if a default by the PSE's sovereign of incorporation has occurred within the previous five years.

TABLE 4—SPECIFIC RISK-WEIGHTING FACTORS FOR PSE GENERAL OBLIGATION DEBT POSITIONS

	General obligation specific risk-weighting factor (in percent)	
CRC 0–2 or OECD Member with No CRC.	Remaining contractual maturity of 6 months or less.	0.25
	Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
	Remaining contractual maturity exceeds 24 months.	1.6
CRC 3 .....	8.0	
CRC 4–7 .....	12.0	
Non-OECD Member with No CRC.	8.0	
Default by the Sovereign Entity.	12.0	

TABLE 5—SPECIFIC RISK-WEIGHTING FACTORS FOR PSE REVENUE OBLIGATION DEBT POSITIONS

	Revenue obligation specific risk-weighting factor (in percent)	
CRC 0–1 or OECD Member with No CRC.	Remaining contractual maturity of 6 months or less.	0.25
	Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
	Remaining contractual maturity exceeds 24 months.	1.6
CRC 2–3 .....	8.0	
CRC 4–7 .....	12.0	
Non-OECD Member with No CRC.	8.0	
Default by the Sovereign Entity.	12.0	

\* \* \* \* \*

## Federal Reserve System

## § 209.1

### Section 11. Simplified Supervisory Formula Approach

\* \* \* \* \*

(b) *SSFA parameters.* \* \* \*

(2) Parameter W is expressed as a decimal value between zero and one. Parameter W is the ratio of the sum of the dollar amounts of any underlying exposures of the securitization that meet any of the criteria as set forth in paragraphs (i) through (vi) of this paragraph (b)(2) to the balance, measured in dollars, of underlying exposures:

- (i) Ninety days or more past due;
- (ii) Subject to a bankruptcy or insolvency proceeding;
- (iii) In the process of foreclosure;
- (iv) Held as real estate owned;
- (v) Has contractually deferred payments for 90 days or more, other than principal or interest payments deferred on:
  - (A) Federally-guaranteed student loans, in accordance with the terms of those guarantee programs; or
  - (B) Consumer loans, including non-federally-guaranteed student loans, provided that such payments are deferred pursuant to provisions included in the contract at the time funds are disbursed that provide for period(s) of deferral that are not initiated based on changes in the creditworthiness of the borrower; or
- (vi) Is in default.

\* \* \* \* \*

### Section 12. Market Risk Disclosures

(a) *Scope.* A bank must comply with this section unless it is a consolidated subsidiary of a bank holding company or a depository institution that is subject to these requirements or of a non-U.S. banking organization that is subject to comparable public disclosure requirements in its home jurisdiction. A bank must make timely disclosures publicly each calendar quarter. If a significant change occurs, such that the most recent reporting amounts are no longer reflective of the bank's capital adequacy and risk profile, then a brief discussion of this change and its likely impact must be provided as soon as practicable thereafter. Qualitative disclosures that typically do not change each quarter may be disclosed annually, provided any significant changes are disclosed in the interim. If a bank believes that disclosure of specific commercial or financial information would prejudice seriously its position by making public certain information that is either proprietary or confidential in nature, the bank is not required to disclose these specific items, but must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of in-

formation have not been disclosed. The bank's management may provide all of the disclosures required by this section in one place on the bank's public Web site or may provide the disclosures in more than one public financial report or other regulatory reports, provided that the bank publicly provides a summary table specifically indicating the location(s) of all such disclosures.

\* \* \* \* \*

(c) \* \* \* (1) For each material portfolio of covered positions, the bank must provide timely public disclosures of the following information at least quarterly:

\* \* \* \* \*

(d) \* \* \* For each material portfolio of covered positions, the bank must provide timely public disclosures of the following information at least annually after the end of the fourth calendar quarter, or more frequently in the event of material changes for each portfolio:

\* \* \* \* \*

### APPENDIX F TO PART 208 RESERVED

## PART 209—ISSUE AND CANCELLATION OF FEDERAL RESERVE BANK CAPITAL STOCK (REGULATION I)

Sec.

- 209.1 Authority, purpose, and scope.
- 209.2 Banks desiring to become member banks.
- 209.3 Cancellation of Reserve Bank stock.
- 209.4 Amounts and payments.
- 209.5 The share register.

AUTHORITY: 12 U.S.C. 222, 248, 282, 286–288, 321, 323, 327–328, 333, 466.

SOURCE: 63 FR 37663, July 13, 1998, unless otherwise noted.

### § 209.1 Authority, purpose, and scope.

(a) *Authority.* This part is issued pursuant to 12 U.S.C. 222, 248, 282, 286–288, 321, 323, 327–328, and 466.

(b) *Purpose.* The purpose of this part is to implement the provisions of the Federal Reserve Act relating to the issuance and cancellation of Federal Reserve Bank stock upon becoming or ceasing to be a member bank, or upon changes in the capital and surplus of a member bank, of the Federal Reserve System.