
(6) Minority interest in consolidated subsidiaries means the portion of equity capital accounts of all consolidated subsidiaries of the bank that is allocated to minority shareholders of such subsidiaries. (7) Mortgage servicing assets means the bank-owned rights to service for a fee mortgage loans that are owned by others. (8) Perpetual preferred stock means preferred stock that does not have a stated maturity date and cannot be redeemed at the option of the holder.

(f) Requirements and restrictions: Limited life preferred stock, mandatory convertible debt, and other subordinated debt—(1) Requirements. Issues of limited life preferred stock and subordinated notes and debentures (except mandatory convertible debt) shall have original weighted average maturities of at least five years to be included in the definition of surplus. In addition, a subordinated note or debenture must also:

(i) Be subordinated to the claims of depositors;

(ii) State on the instrument that it is not a deposit and is not insured by the FDIC;

(iii) Be unsecured;

(iv) Be ineligible as collateral for a loan by the issuing bank;

(v) Provide that once any scheduled payments of principal begin, all scheduled payments shall be made at least annually and the amount repaid in each year shall be no less than in the prior year; and

(vi) Provide that no prepayment (including payment pursuant to an acceleration clause or redemption prior to maturity) shall be made without prior OCC approval unless the bank remains an eligible bank, as defined in 12 CFR 5.3(g), after the prepayment.

(2) Restrictions. The total amount of mandatory convertible debt not included in paragraph (c)(3) of this section, limited life preferred stock, and subordinated notes and debentures considered as surplus is limited to 50 percent of the sum of paragraphs (a) and (c)(1), (2) and (3) of this section.

(g) Transitional rules. (1) Equity commitment notes approved by the OCC as capital and issued prior to April 15, 1985, may continue to be included in paragraph (c)(3) of this section. All other instruments approved by the OCC as capital and issued prior to April 15, 1985, are to be included in paragraph (c)(4) of this section.

(2) Intangible assets (other than mortgage servicing assets) purchased prior to April 15, 1985, and accounted for in accordance with OCC instructions, may continue to be included as surplus up to 25% of the sum of paragraphs (a) and (c)(1) of this section.


APPENDIX A TO PART 3—RISK-BASED CAPITAL GUIDELINES

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

(a) Purpose. (1) An important function of the Office of the Comptroller of the Currency (OCC) is to evaluate the adequacy of capital maintained by each national bank. Such an evaluation involves the consideration of numerous factors, including the riskiness of a bank’s assets and off-balance sheet items. This appendix A implements the OCC’s risk-based capital guidelines. The risk-based capital ratio derived from these guidelines is more systematically sensitive to the credit risk associated with various bank activities than is a capital ratio based strictly on a bank’s total balance sheet assets. A bank’s risk-based capital ratio is obtained by dividing its capital base (as defined in section 2 of this appendix A) by its risk-weighted assets (as calculated pursuant to section 3 of this appendix A). These guidelines were created
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within the framework established by the report issued by the Committee on Banking Regulations and Supervisory Practices in July 1988. The OCC believes that the risk-based capital ratio is a useful tool in evaluating the capital adequacy of all national banks, not just those that are active in the international banking system.

(2) The purpose of this appendix A is to explain precisely (i) how a national bank’s risk-based capital ratio is determined and (ii) how these risk-based capital guidelines are applied to national banks. The OCC will review these guidelines periodically for possible adjustments commensurate with its experience with the risk-based capital ratio and with changes in the economy, financial markets and domestic and international banking practices.

(b) Applicability. (1) The risk-based capital ratio derived from these guidelines is an important factor in the OCC’s evaluation of a bank’s capital adequacy. However, since this measure addresses only credit risk, the 8% minimum ratio should not be viewed as the level to be targeted, but rather as a floor.

The final supervisory judgment on a bank’s capital adequacy is based on an individualized assessment of numerous factors, including those listed in 12 CFR 3.10. With respect to the consideration of these factors, the OCC will give particular attention to any bank with significant exposure to declines in the economic value of its capital due to changes in interest rates. As a result, it may differ from the conclusion drawn from an isolated comparison of a bank’s risk-based capital ratio to the 8% minimum specified in these guidelines. In addition to the standards established by these risk-based capital guidelines, all national banks must maintain a minimum capital-to-total assets ratio in accordance with the provisions of 12 CFR part 3.

(2) Effective December 31, 1990, these risk-based capital guidelines will apply to all national banks. In the interim, banks must maintain minimum capital-to-total assets ratios as required by 12 CFR part 3, and should begin preparing for the implementation of these risk-based capital guidelines. In this regard, each national bank that does not currently meet the final minimum ratio established in section 4b(1) of this appendix A should begin planning for achieving that standard.

(c) Definitions. For purposes of this appendix A, the following definitions apply:

(1) Adjusted carrying value means, for purposes of section 2(c)(3) of this appendix A, the aggregate value that investments are carried on the balance sheet of the bank reduced by any unrealized gains on the investments that are reflected in such carrying value but excluded from the bank’s Tier 1 capital and reduced by any 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 that are not reflected in Tier 1 capital, and less any associated deferred tax liabilities. Unrealized losses on AFS nonfinancial equity investments must be deducted from Tier 1 capital in accordance with section 1(c)(10) of this appendix A. The treatment of small business investment companies that are consolidated for accounting purposes under generally accepted accounting principles is discussed in section 2(c)(5)(ii) of this appendix A. For investments in a nonfinancial company that is consolidated for accounting purposes, 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 Tier 1 capital in accordance with section 2(c)(2) 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) are excluded from the bank’s risk-weighted assets.

(2) Allowances for loan and lease losses means the balance of the valuation reserve on December 31, 1988, plus additions to the reserve charged to operations since that date, less losses charged against the allowance net of recoveries.

(3) Asset-backed commercial paper 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.

(4) Asset-backed commercial paper sponsor means a bank that:

(i) Establishes an asset-backed commercial paper program;

(ii) Approves the sellers permitted to participate in an asset-backed commercial paper program;

(iii) Approves the asset pools to be purchased by an asset-backed commercial paper program; or

(iv) Administers the asset-backed commercial paper 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.

(3) Associated company means any corporation, partnership, business trust, joint venture, association or similar organization in which a national bank directly or indirectly holds a 20 to 50 percent ownership interest.
Banking and finance subsidiary means any subsidiary of a national bank that engages in banking- and finance-related activities.

Cash items in the process of collection means checks or drafts in the process of collection that are drawn on another depository institution, including a central bank, and that are payable immediately upon presentation in the country in which the reporting bank's office that is clearing or collecting the check or draft is located; U.S. Government checks that are drawn on the United States Treasury or any other U.S. Government or Government-sponsored agency and that are payable immediately upon presentation; broker's security drafts and commodity or bill-of-lading drafts payable immediately upon presentation in the United States or the country in which the reporting bank's office that is handling the drafts is located; and unposted debits.

Central government means the national governing authority of a country; it includes the departments, ministries and agencies of the central government and the central bank. The U.S. Central Bank includes the 12 Federal Reserve Banks. The definition of central government does not include the following: State, provincial, or local governments; commercial enterprises owned by the central government, which are entities engaged in activities involving trade, commerce, or profit that are generally conducted or performed in the private sector of the United States economy; and non-central government entities whose obligations are guaranteed by the central government.

Commitment means any arrangement that obligates a national bank to: (i) Purchase loans or securities; or (ii) extend credit in the form of loans or leases, participations in loans or leases, overdraft facilities, revolving credit facilities, home equity lines of credit, liquidity facilities, or similar transactions.

Common stockholders' equity means common stock, common stock surplus, undivided profits, capital reserves, and adjustments for the cumulative effect of foreign currency translation, less any unearned holding losses on available-for-sale equity securities with readily determinable fair values.

Conditional guarantee means a contingent obligation of the United States Government or any agency, or the central government of an OECD country, the validity of which to the beneficiary is dependent upon some affirmative action—e.g., servicing requirements—on the part of the beneficiary of the guarantee or a third party.

Deferred tax assets means the tax consequences attributable to tax carryforwards and deductible temporary differences. Tax carryforwards are deductions or credits that cannot be used for tax purposes during the current period, but can be carried forward to reduce taxable income or taxes payable in a future period or periods. Temporary differences are financial events or transactions that are recognized in one period for financial statement purposes, but are recognized in another period or periods for income tax purposes. Deductible temporary differences are temporary differences that result in a reduction of taxable income in a future period or periods.

Derivative contract means generally a financial contract whose value is derived from the values of one or more underlying assets, reference rates or indexes of asset values. Derivative contracts include interest rate, foreign exchange rate, equity, precious metals and commodity contracts, or any other instrument that poses similar credit risks.

Depository institution means a financial institution that engages in the business of banking; that is recognized as a bank by the bank supervisory or monetary authorities of the country of its incorporation and the country of its principal banking operations; that receives deposits to a substantial extent in the regular course of business; and that has the power to accept demand deposits. In the U.S., this definition encompasses all federally insured offices of commercial banks, mutual and stock savings banks, savings or building and loan associations (stock and mutual), cooperative banks, credit unions, and international banking facilities of domestic depository institution. Bank holding companies are excluded from this definition. For the purposes of assigning risk weights, the differentiation between OECD depository institutions and non-OECD depository institutions is based on the country of incorporation. Claims on branches and agencies of foreign banks located in the United States are to be categorized on the basis of the parent bank's country of incorporation.

Equity investment means, for purposes of section 1(c)(19) and section 2(c)(5) of this appendix A, any equity instrument including 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. An investment in any other instrument, including subordinated debt or other types of debt instruments, may be treated as an equity investment if the OCC determines that the instrument is the functional equivalent of equity or exposes the bank to essentially the same risks as an equity instrument.

Exchange rate contracts include: Cross-currency interest rate swaps; forward foreign exchange rate contracts; currency options purchased; and any similar instrument that, in the opinion of the OCC, gives rise to similar risks.
(17) 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.

(18) Intangible assets include mortgage and non-mortgage servicing assets (but exclude any interest only (IO) strips receivable related to these mortgage and non-mortgage servicing assets), purchased credit card relationships, goodwill, favorable leaseholds, and core deposit value.

(19) Interest rate contracts include: Single currency interest rate swaps; basis swaps; forward rate agreements; interest rate options purchased; forward foreign deposits accepted; and any similar instrument that, in the opinion of the OCC, gives rise to similar risks, including when-issued securities.

(20) Liquidity facility means a legally binding commitment to provide liquidity to various types of transactions, structures or programs. A liquidity facility that supports asset-backed commercial paper, in any amount, by lending to, or purchasing assets from any structure, program, or conduit constitutes an asset-backed commercial paper liquidity facility.

(21) Multifamily residential property means any residential property consisting of five or more dwelling units including apartment buildings, condominiums, cooperatives, and other similar structures primarily for residential use, but not including hospitals, nursing homes, or other similar facilities.

(22) 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 or SEC) as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers.

(23) Nonfinancial equity investment means any equity investment held by a bank in a nonfinancial 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)) or under the portfolio investment provisions of Regulation K (12 CFR 211.8(c)(3)). An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in a SBIC that is not consolidated with the bank is treated as a nonfinancial equity investment in the manner provided in section 2(c)(9)(ii)(C) of this appendix A. A nonfinancial company is an entity that engages in any activity that has not been determined to be permissible for a 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)).

(24) 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. These countries are hereinafter referred to as OECD countries. 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.

(25) Original maturity means, with respect to a commitment, the earliest possible date after a commitment is made on which the commitment is scheduled to expire (i.e., it will reach its stated maturity and cease to be binding on either party), provided that either: (i) The commitment is not subject to extension or renewal and will actually expire on its stated expiration date; or (ii) If the commitment is subject to extension or renewal beyond its stated expiration date, the stated expiration date will be deemed the original maturity only if the extension or renewal must be based upon terms and conditions independently negotiated in good faith with the customer at the time of the extension or renewal and upon a new, bona fide credit analysis utilizing current information on financial condition and trends.

(26) Preferred stock includes the following instruments: (i) Convertible preferred stock, which means preferred stock that is mandatorily convertible into either common or perpetual preferred stock; (ii) Intermediate-term preferred stock, which means preferred stock with an original maturity of at least five years, but less than 20 years; (iii) Long-term preferred stock, which means preferred stock with an original maturity of 20 years or more; and (iv) Perpetual preferred stock, which means preferred stock without a fixed maturity date that cannot be redeemed at the option of the holder, and that has no

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1 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.
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other provisions that will require future redemption of the issue. For purposes of these instruments, preferred stock that can be redeemed at the option of the holder is deemed to have an original maturity of the earliest possible date on which it may be so redeemed.

(27) Public-sector entities include states, local authorities and governmental subdivisions below the central government level in an OECD country. In the United States, this definition encompasses a state, county, city, town, or other municipal corporation, a public authority, and generally any publicly-owned entity that is an instrumentality of a state or municipal corporation. This definition does not include commercial companies owned by the public sector. 1a

(28) Reciprocal holdings of bank capital instruments means cross-holdings or other formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other’s capital instruments. This definition does not include holdings of capital instruments issued by other banking organizations that were taken in satisfaction of debts previously contracted, provided that the reporting national bank has not held such instruments for more than five years or a longer period approved by the OCC.

(29) Replacement cost means, with respect to interest rate and exchange rate contracts, the loss that would be incurred in the event of a counterparty default, as measured by the net cost of replacing the contract at the current market value. If default would result in a theoretical profit, the replacement value is considered to be zero. The mark-to-market process should incorporate changes in both interest rates and counterparty credit quality.

(30) Residential properties means houses, condominiums, cooperative units, and manufactured homes. This definition does not include boats or motor homes, even if used as a primary residence.

(31) Risk-weighted assets means the sum of total risk-weighted balance sheet assets and the total of risk-weighted off-balance sheet credit equivalent amounts. Risk-weighted balance sheet and off-balance sheet assets are calculated in accordance with section 3 of this appendix A.

(32) State means any one of the several states of the United States of America, the District of Columbia, Puerto Rico, and the territories and possessions of the United States.

(33) Subsidiary means any corporation, partnership, business trust, joint venture, association or similar organization in which a national bank directly or indirectly holds more than a 50% ownership interest. This definition does not include ownership interests that were taken in satisfaction of debts previously contracted, provided that the reporting bank has not held the interest for more than five years or a longer period approved by the OCC.

(34) Total capital means the sum of a national bank’s core (Tier 1) and qualifying supplementary (Tier 2) capital elements.

(35) Unconditionally cancelable means, with respect to a commitment-type lending arrangement, that the bank may, at any time, with or without cause, refuse to advance funds or extend credit under the facility. In the case of home equity lines of credit, the bank is deemed able to unconditionally cancel the commitment if it can, at its option, prohibit additional extensions of credit, reduce the line, and terminate the commitment to the full extent permitted by relevant Federal law.

(36) United States Government or its agencies means an instrumentality of the U.S. Government whose debt obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the United States Government.

(37) United States Government-sponsored agency means an agency originally established or chartered to serve public purposes specified by the United States Congress, but whose obligations are not explicitly guaranteed by the full faith and credit of the United States Government.

(38) Walkaway clause means a provision in a bilateral netting contract that permits a nondefaulting counterparty to make a lower payment than it would make otherwise under the bilateral netting contract, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the bilateral netting contract.

Section 2. Components of Capital.

A national bank’s qualifying capital base consists of two types of capital—core (Tier 1) and supplementary (Tier 2).

(a) Tier 1 Capital. The following elements comprise a national bank’s Tier 1 capital:

(1) Common stockholders’ equity;

(2) Noncumulative perpetual preferred stock and related surplus; and 2

See Definition (5), Central government, for further explanation of commercial companies owned by the public sector.

1aSee Definition (5), Central government, for further explanation of commercial companies owned by the public sector.

2Preferred stock issues where the dividend is reset periodically based upon current market conditions and the bank’s current credit rating, including but not limited to, auction rate, money market or remarketable preferred stock, are assigned to Tier 2 capital, regardless of whether the dividends are cumulative or noncumulative.
(3) Minority interests in the equity accounts of consolidated subsidiaries, except that the following are not included in Tier 1 capital or total capital:

(i) Minority interests in a small business investment company or investment fund that holds nonfinancial equity investments and minority interests in a subsidiary that is engaged in a nonfinancial activities and is held under one of the legal authorities listed in section 1(c)(23) of this appendix A.

(ii) Minority interests in consolidated asset-backed commercial paper programs sponsored by a bank if the consolidated assets are excluded from risk-weighted assets pursuant to section 3(a)(5)(i) of this appendix A.

(b) Tier 2 Capital. The following elements comprise a national bank’s Tier 2 capital:

(1) Allowance for loan and lease losses, up to a maximum of 1.25% of risk-weighted assets, subject to the transition rules in section 4(a)(2) of this appendix A;

(2) Cumulative perpetual preferred stock, long-term preferred stock, convertible preferred stock, and any related surplus, without limit, if the issuing national bank has the option to defer payment of dividends on these instruments. For long-term preferred stock, the amount that is eligible to be included as Tier 2 capital is reduced by 20% of the original amount of the instrument (net of redemptions) at the beginning of each of the last five years for the life of the instrument;

(3) Hybrid capital instruments, without limit. Hybrid capital instruments are those instruments that combine certain characteristics of debt and equity, such as perpetual debt. To be included as Tier 2 capital, these instruments must meet the following criteria:

(i) The instrument must be unsecured, subordinated to the claims of depositors and general creditors, and fully paid-up;

(ii) The instrument must not be redeemable at the option of the holder prior to maturity, except with the prior approval of the OCC;

(iii) The instrument must be available to participate in losses while the issuer is operating as a going concern (in this regard, the instrument must automatically convert to common stock or perpetual preferred stock, if the sum of the retained earnings and capital surplus accounts of the issuer shows a negative balance); and

(iv) The instrument must provide the option for the issuer to defer principal and interest payments, if:

(A) The issuer does not report a net profit for the most recent combined four quarters, and

(B) The issuer eliminates cash dividends on its common and preferred stock.

(4) Term subordinated debt instruments, and intermediate-term preferred stock and related surplus are included in Tier 2 capital, but only to a maximum of 50% of Tier 1 capital as calculated after deductions pursuant to section 2(c) of this appendix. To be considered capital, term subordinated debt instruments shall meet the requirements of §3.100(f)(1). However, pursuant to 12 CFR 5.47, the OCC may, in some cases, require that the subordinated debt be approved by the OCC before the subordinated debt may qualify as Tier 2 capital or may require prior approval for any prepayment (including payment pursuant to an acceleration clause or redemption prior to maturity) of the subordinated debt. Also, at the beginning of each of the last five years for the life of either type of instrument, the amount that is eligible to be included as Tier 2 capital is reduced by 20% of the original amount of that instrument (net of redemptions).

(5) Up to 45 percent of the pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities with readily determinable fair values. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in Tier 2 capital, but the OCC may take these unrealized gains (losses) into account as additional factors when assessing a bank’s overall capital adequacy.

\[3\] The amount of the allowance for loan and lease losses that may be included in capital is based on a percentage of risk-weighted assets. The gross sum of risk-weighted assets used in this calculation includes all risk-weighted assets, with the exception of the assets required to be deducted under section 3 in establishing risk-weighted assets (i.e., the assets required to be deducted from capital under section 2(c) of this appendix). A bank or organization may deduct reserves for loan and lease losses in excess of the amount permitted to be included as capital, as well as allocated transfer risk reserves and reserves held against other real estate owned, from the gross sum of risk-weighted assets in computing the denominator of the risk-based capital ratio.

\[4\] Mandatory convertible debt instruments that meet the requirements of 12 CFR 3.100(e)(5), or that have been previously approved as capital by the OCC, are treated as qualifying hybrid capital instruments.

\[5\] The OCC reserves the authority to exclude all or a portion of unrealized gains from Tier 2 capital if the OCC determines that the equity securities are not prudently valued.
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(c) Deductions from Capital. The following items are deducted from the appropriate portion of a national bank’s capital base when calculating its risk-based capital ratio:

(i) Goodwill;

(ii) Other intangible assets, except as provided in section 2(c)(2) of this appendix A;

(iii) Deferred tax assets, except as provided in section 2(c)(1)(ii) of this appendix A, that are dependent upon future taxable income, which exceed the lesser of:

(A) The amount of deferred tax assets that the bank could reasonably expect to realize within one year of the quarter-end Call Report, based on its estimate of future taxable income for that year; or

(B) 10% of Tier 1 capital, net of goodwill and all intangible assets other than purchased credit card relationships, mortgage servicing assets and non-mortgage servicing assets; and

(iv) Credit-enhancing interest-only strips (as defined in section 4(a)(2) of this appendix A), as provided in section 2(c)(4).

(v) Nonfinancial equity investments as provided by section 2(c)(5) of this appendix A.

(2) Qualifying intangible assets. Subject to the following conditions, mortgage servicing assets, nonmortgage servicing assets6 and purchased credit card relationships need not be deducted from Tier 1 capital:

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

(ii) Banks must value each intangible asset included in Tier 1 capital at least quarterly at the lesser of:

(A) 90 percent of the fair value of each intangible asset, determined in accordance with section 2(c)(2)(iii) of this appendix A; or

(B) 100 percent of the remaining unamortized book value.

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

(3) Deferred tax assets—(i) Net unrealized gains and losses on available-for-sale securities. Net unrealized gains and losses on available-for-sale securities before calculating the amount of deferred tax assets subject to the limit in section 2(c)(1)(iii) of this appendix A, a bank may eliminate the deferred tax effects of any net unrealized holding gains and losses on available-for-sale debt securities. Banks report these net unrealized holding gains and losses in their Call Reports as a separate component of equity capital, but exclude them from the definition of common stockholders’ equity for regulatory capital purposes. A bank that adopts a policy to deduct these amounts must apply that approach consistently in all future calculations of the amount of disallowed deferred tax assets under section 2(c)(1)(iii) of this appendix A.

(ii) Consolidated groups. The amount of deferred tax assets that a bank can realize from taxes paid in prior carryback years and from reversals of existing temporary differences generally would not be deducted from capital. However, for a bank that is a member of a consolidated group (for tax purposes), the amount of carryback potential a bank may consider in calculating the limit on deferred tax assets under section 2(c)(1)(iii) of this appendix A, may not exceed the amount that the bank could reasonably expect to have refunded by its parent holding company.

(iii) Estimated future taxable income. Estimated future taxable income does not include net operating loss carryforwards to be used during that year or the amount of existing temporary differences expected to reverse within the year. A bank may use future taxable income projections for their closest fiscal year, provided it adjusts the projections for any significant changes that occur or that it expects to occur. Such projections must include the estimated effect of tax planning strategies that the bank expects to implement to realize net operating losses or tax credit carryforwards that will otherwise expire during the year.

(4) Credit-enhancing interest-only strips. Credit-enhancing interest-only strips, whether purchased or retained, that exceed 25% of Tier 1 capital must be deducted from Tier 1 capital. Purchased and retained credit-enhancing interest-only strips, on a non-tax adjusted basis, are included in the total
amount that is used for purposes of determining whether a bank exceeds its Tier 1 capital.

(i) The 25% limitation on credit-enhancing interest-only strips will be based on Tier 1 capital net of goodwill and all identifiable intangibles, other than purchased credit card relationships, mortgage servicing assets and non-mortgage servicing assets. 

(ii) Banks must value each credit-enhancing interest-only strip included in Tier 1 capital at least quarterly. The quarterly determination of the current fair value of the credit-enhancing interest-only strip must include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates.

(5) Nonfinancial equity investments—(i) General. (A) A bank must deduct from its Tier 1 capital the appropriate percentage, as determined in accordance with Table A, of the adjusted carrying value of all nonfinancial equity investments held by the bank and its subsidiaries.

![Table A — Deduction for Nonfinancial Equity Investments](image)

<table>
<thead>
<tr>
<th>Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by banks (as a percentage of the Tier 1 capital of the bank)</th>
<th>Deduction from Tier 1 Capital (as a percentage of the adjusted carrying value of the investment)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 15 percent</td>
<td>8.0 percent.</td>
</tr>
<tr>
<td>Greater than or equal to 15 percent but less than 25 percent</td>
<td>12.0 percent.</td>
</tr>
<tr>
<td>Greater than or equal to 25 percent</td>
<td>25.0 percent.</td>
</tr>
</tbody>
</table>

1For 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 the Tier 1 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 disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, disallowed credit-enhancing interest-only strips (both purchased and retained), disallowed deferred tax assets, and nonfinancial equity investments.

(B) Deductions for nonfinancial equity investments must be 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 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 bank’s Tier 1 capital, 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 equal to, or in excess of, 15 percent of the bank’s Tier 1 capital.

(C) The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under section 2(c)(5) of this appendix A is excluded from the bank’s weighted risk assets for purposes of computing the denominator of the bank’s risk-based capital ratio. 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 of the risk-based capital ratio.

(D) Banks engaged in equity investment activities, including those banks with a high concentration in nonfinancial equity investments (e.g., in excess of 50 percent of Tier 1 capital), will be monitored and may be subject to heightened supervision, as appropriate, by the OCC to ensure that such banks maintain capital levels that are appropriate in light of their equity investment activities, and the OCC may 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.

(ii) Small business investment company investments. (A) Notwithstanding section 2(c)(5)(i) of this appendix A, no deduction is required for nonfinancial equity investments that are made by a bank or its subsidiary through a SBIC that is consolidated with the bank, or in a SBIC that is not consolidated with the bank, to the extent that such investments, in the aggregate, do not exceed 15 percent of the Tier 1 capital of the bank. Except as provided in paragraph (c)(5)(ii)(B) of this section, any nonfinancial equity investment that is held through or in a SBIC and not deducted from Tier 1 capital will be assigned to the 100 percent risk-weight category and included in the bank’s consolidated risk-weighted assets.

(B) If a bank has an investment in a SBIC that is consolidated for accounting purposes but the SBIC is not wholly owned by the bank, the adjusted carrying value of the bank’s nonfinancial equity investments held through the SBIC is equal to the bank’s proportionate share of the SBIC’s adjusted carrying value of its 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.
(C) If a bank has an investment in a 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 bank’s adjusted carrying value of the SBIC’s assets that are not equity investments in nonfinancial companies. The amount by which the adjusted carrying value of the bank’s investment in the SBIC is reduced under this paragraph will be risk weighted at 100 percent and included in the bank’s risk-weighted assets.

(D) To the extent the adjusted carrying value of all nonfinancial equity investments that the bank holds through a consolidated SBIC or in a nonconsolidated SBIC equals or exceeds, in the aggregate, 15 percent of the Tier 1 capital of the bank, the appropriate percentage of such amounts, as set forth in Table A, must be deducted from the bank’s Tier 1 capital. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held through a consolidated SBIC and in a nonconsolidated SBIC (including any nonfinancial equity investments for which no deduction is required) must be included in determining, for purposes of Table A the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital.

(iii) Nonfinancial equity investments excluded. (A) Notwithstanding section 2(c)(5)(i) and (ii) of this appendix A, no deduction from Tier 1 capital is required for the following:

(1) Nonfinancial equity investments (or portion of such investments) made by the bank prior to March 13, 2000, and continuously held by the bank since March 13, 2000.

(2) Nonfinancial equity investments made on or after March 13, 2000, pursuant to a legally binding written commitment that was entered into by the bank prior to March 13, 2000, and that required the bank to make the investment, if the bank has continuously held the investment since the date the investment was acquired.

(3) Nonfinancial equity investments received by the bank through a stock split or stock dividend on a nonfinancial equity investment made prior to March 13, 2000, provided that 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 nonfinancial company.

(4) Nonfinancial equity investments received by the bank through the exercise of an option, warrant, or other agreement that provides the bank with the right, but not the obligation, to acquire equity or make an investment in a nonfinancial company, if the option, warrant, or other agreement was acquired by the bank prior to March 13, 2000, and the bank provides no consideration for the nonfinancial equity investments.

(B) Any excluded nonfinancial equity investments described in section 2(c)(5)(i)(A) of this appendix A 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 A. In addition, any excluded nonfinancial equity investments will be risk weighted at 100 percent and included in the bank’s risk-weighted assets.

(6) Netting of Deferred Tax Liability. (i) Banks may elect to deduct the following assets from Tier 1 capital on a basis that is not of any associated deferred tax liability:

(A) Goodwill;

(B) Intangible assets acquired due to a nontaxable purchase business combination, except banks may not elect to deduct from Tier 1 capital on a basis that is not of any associated deferred tax liability, regardless of the method by which they were acquired:

(1) Purchased credit card relationships; and

(2) Servicing assets that are includable in Tier 1 capital;

(C) If a bank has an investment in a SBIC and the bank holds through a consolidated SBIC or in a nonconsolidated SBIC equals or exceeds, in the aggregate, 15 percent of the Tier 1 capital of the bank, the appropriate percentage of such amounts, as set forth in Table A, must be deducted from the bank’s Tier 1 capital. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held through a consolidated SBIC and in a nonconsolidated SBIC (including any nonfinancial equity investments for which no deduction is required) must be included in determining, for purposes of Table A the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital.

(ii) 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 as calculated under section 2(c)(3)(i) of this appendix A.

(7) Deductions from total capital. The following assets are deducted from total capital:

(i) Investments, both equity and debt, in unconsolidated banking and finance subsidiaries that are deemed to be capital of the subsidiary; and

(ii) Reciprocal holdings of bank capital instruments.

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

The denominator of the risk-based capital ratio, i.e., a national bank’s risk-weighted assets, is derived by assigning that bank’s assets and off-balance sheet items to one of

7The OCC may require deduction of investments in other subsidiaries and associated companies, on a case-by-case basis.

8The OCC reserves the right to require a bank to compute its risk-based capital ratio on the basis of average, rather than period-end, risk-weighted assets when necessary to carry out the purposes of these guidelines.
the four risk categories detailed in section 3(a) of this appendix A. Each category has a specific risk weight. Before an off-balance sheet item is assigned a risk weight, it is converted to an on-balance sheet credit equivalent amount in accordance with section 3(b) of this appendix A. The risk weight assigned to a particular asset or on-balance sheet credit equivalent amount determines the percentage of that asset/credit equivalent that is included in the denominator of the bank's risk-based capital ratio. Any asset deducted from a bank's capital in computing the numerator of the risk-based capital ratio is not included as part of the bank's risk-weighted assets.

Some of the assets on a bank's balance sheet may represent an indirect holding of a pool of assets, e.g., mutual funds, that encompasses more than one risk weight within the pool. In those situations, the bank may assign the asset to the risk category applicable to the highest risk-weighted asset that pool is permitted to hold pursuant to its stated investment objectives in the fund's prospectus. Alternatively, the bank may assign the asset on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus. In either case, the minimum risk weight that may be assigned to such a pool is 20%. If a bank assigns the asset on a pro rata basis, and the sum of the investment limits in the fund's prospectus exceeds 100%, the bank must assign the highest pro rata amounts of its total investment to the higher risk category. If, in order to maintain a necessary degree of liquidity, the 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 not be taken into account in determining the risk category into which the bank's holding in the overall pool should be assigned. The prudent use of hedging instruments by a fund to reduce the risk of its assets will not increase the risk weighting of the investment in that fund above the 20% category. However, if a fund engages in any activities that are deemed to be speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, the bank's investment in the fund will be assigned to the 100% risk category. More detail on the treatment of mortgage-backed securities is provided in section 3(a)(3)(vi) of this appendix A.

(a) On-Balance Sheet Assets. The following are the risk categories/weights for on-balance sheet assets.

(1) Zero percent risk weight. (i) Cash, including domestic and foreign currency owned and held in all offices of a national bank or in transit. Any foreign currency held by a national bank should be converted into U.S. dollar equivalents.

(ii) Deposit reserves and other balances at Federal Reserve Banks.

(iii) Securities issued by, and other direct claims on, the United States Government or its agencies, or the central government of an OECD country.

(iv) That portion of assets directly and unconditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country, of the following types: a collateralized by cash or securities issued or directly and unconditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country, provided that:

(A) The bank maintains control over the collateral:

(1) If the collateral consists of cash, the cash must be held on deposit by the bank or by a third-party for the account of the bank;

(2) If the collateral consists of OECD government securities, then the OECD government securities must be held by the bank or

9a Securities issued by the United States Government or its agencies, or the central government of an OECD country included in the credit equivalent amount in accordance with section 3(b) of this appendix A. The risk weight assigned to a particular asset or on-balance sheet credit equivalent amount determines the percentage of that asset/credit equivalent that is included in the denominator of the bank's risk-based capital ratio. Any asset deducted from a bank's capital in computing the numerator of the risk-based capital ratio is not included as part of the bank's risk-weighted assets.

9b Any amount of such claims that exceeds the amount of the bank's liabilities in that currency. Any amount of such claims that exceeds the amount of the bank's liabilities in that currency is assigned to the 100% risk category of section 3(a)(4) of this appendix.

(v) That portion of local currency claims on, or unconditionally guaranteed by, central governments of non-OECD countries, to the extent the bank has liabilities in that currency. Any amount of such claims that exceeds the amount of the bank's liabilities in that currency is assigned to the 100% risk category of section 3(a)(4) of this appendix.

(vi) Gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis, to the extent it is backed by gold bullion liabilities.


(viii) That portion of assets and off-balance sheet transactions collateralized by cash or securities issued or directly and unconditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country, provided that:

(A) The bank maintains control over the collateral:

(1) If the collateral consists of cash, the cash must be held on deposit by the bank or by a third-party for the account of the bank;

(2) If the collateral consists of OECD government securities, then the OECD government securities must be held by the bank or

9 For the treatment of privately-issued mortgage-backed securities where the underlying pool is comprised solely of mortgage-related securities issued by GNMA, see infra note 10.

10 See footnote 22 in section 3(b)(5)(iii) of this appendix A (collateral held against derivative contracts).

9a For the treatment of privately-issued mortgage-backed securities where the underlying pool is comprised solely of mortgage-related securities issued by GNMA, see infra note 10.
by a third-party acting on behalf of the bank;

(B) The bank maintains a daily positive margin of collateral fully taking into account any change in the market value of the collateral held as security;

(C) Where the bank is acting as a customer’s agent in a transaction involving the loan or sale of securities that is collateralized by cash or OECD government securities delivered to the bank, any obligation by the bank to indemnify the customer is limited to no more than the difference between the market value of the securities lent and the market value of the collateral received, and any reinvestment risk associated with the collateral is borne by the customer; and

(D) The transaction involves no more than minimal risk.

(ix) Asset-backed commercial paper (ABCP) that is:

(A) Pledged by the bank to a Federal Reserve Bank to secure financing from the ABCP lending facility (AMLF) established by the Federal Reserve Board on September 19, 2008.

(B) Pledged by the bank on or after September 19, 2008, from a Securities and Exchange Commission (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

(x) Claims on, or guaranteed by depository institutions incorporated in an OECD country.

(v) That portion of assets conditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country, that does not qualify for the zero percent risk-weight category.

(vi) Securities issued by, or other direct claims on, United States Government-sponsored agencies.

(vii) That portion of assets collateralized by United States Government-sponsored agencies.

(viii) That portion of assets collateralized by the current market value of securities issued or guaranteed by United States Government-sponsored agencies.

(ix) Claims representing general obligations of any public-sector entity in an OECD country, and that portion of any claims guaranteed by any such public-sector entity. In the U.S., these obligations must meet the requirements of 12 CFR 1.2(b).

(x) Claims on, or guaranteed by, official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member.11

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10 Privately issued mortgage-backed securities, e.g., CMOS and REMICS, where the underlying pool is comprised solely of mortgage-related securities issued by GNMA, FNMA and FHLMC, will be treated as an indirect holding of the underlying assets and assigned to the 20% risk category of this section 3(a)(2). If the underlying pool is comprised of assets which attract different risk weights, e.g., FNMA securities and conventional mortgages, the bank should generally assign the security to the highest risk category appropriate for any asset in the pool. However, on a case-by-case basis, the OCC may allow the bank to assign the security proportionately to the various risk categories based on the proportion in which the risk categories are represented by the composition cash flows of the underlying pool of assets. Before the OCC will consider a request to proportionately risk-weight such a security, the bank must have current information for the reporting date that details the composition and cash flows of the underlying pool of assets. Furthermore, before a mortgage-related security will receive a risk weight lower than 100%, it must meet the criteria set forth in section 3(a)(3)(vi) of this appendix A.

11 These institutions include, but are not limited to, the International Bank for Reconstruction and Development (World Bank), the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the International Monetary Fund and the Bank for International Settlements.
(ix) That portion of assets collateralized by the current market value of securities issued by official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member.

(x) That portion of local currency claims conditionally guaranteed by central governments of non-OECD countries, to the extent the bank has local currency liabilities in that country. Any amount of such claims that exceeds the amount of the bank’s local currency liabilities is assigned to the 100% risk category of section 3(a)(4) of this appendix.

(xii) Collateralized claim. The claim on the securities firm must be collateralized subject to all of the following requirements:

(i) The claim must arise from a reverse repurchase agreement or securities lending/borrowing contract executed using standard industry documentation.

(ii) The collateral must consist of debt or equity securities that are liquid and readily marketable.

(iii) The claim and collateral must be marked-to-market daily.

(iv) The claim must be subject to daily margin maintenance requirements under standard industry documentation.

(v) The contract from which the claim arises can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceedings, and the security or collateral agreement will not be stayed or avoided under the applicable law of the relevant jurisdiction. To be exempt from the automatic stay in bankruptcy in the United States, the claim must arise from a securities contract or a repurchase agreement under section 555 or 559, respectively, of the Bankruptcy Code (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 or among financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (912 U.S.C. 4407), or the Regulation EE (12 CFR part 231).

(x) That portion of assets collateralized by the current market value of securities issued by official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member.

(xii) Collateralized claim. The claim on the securities firm must be collateralized subject to all of the following requirements:

(i) The claim must arise from a reverse repurchase agreement or securities lending/borrowing contract executed using standard industry documentation.

(ii) The collateral must consist of debt or equity securities that are liquid and readily marketable.

(iii) The claim and collateral must be marked-to-market daily.

(iv) The claim must be subject to daily margin maintenance requirements under standard industry documentation.

(v) The contract from which the claim arises can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceedings, and the security or collateral agreement will not be stayed or avoided under the applicable law of the relevant jurisdiction. To be exempt from the automatic stay in bankruptcy in the United States, the claim must arise from a securities contract or a repurchase agreement under section 555 or 559, respectively, of the Bankruptcy Code (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 or among financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (912 U.S.C. 4407), or the Regulation EE (12 CFR part 231).

(3) 50 percent risk weight. (i) Revenue obligations of any public-sector entity in an OECD country for which the underlying obligor is the public-sector entity, but which are repayable solely from the revenues generated by the project financed through the issuance of the obligations.

(ii) The credit equivalent amount of derivative contracts, calculated in accordance with section 3(b)(5) of this appendix A, that do not qualify for inclusion in a lower risk category.

(iii) Loans secured by first mortgages on one-to-four family residential properties, either owner occupied or rented, provided that such loans are not otherwise 90 days or more past due, or on nonaccrual or restructured. It is presumed that such loans will meet the prudent underwriting standards. For the purposes of the risk-based capital guidelines, a loan modified on a permanent or trial basis solely pursuant to the U.S. Department of Treasury’s Home Affordable Mortgage Program will not be considered to have been restructured. If a loan holds a first lien and

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junior lien on a one-to-four family 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 both determining the loan-to-value ratio and assigning a risk weight to the transaction. Furthermore, residential property loans made for the purpose of construction financing are assigned to the 100% risk category of this appendix A; however, these loans may be included in the 50% risk category of this section 3(a)(3) of this appendix A if they are subject to a legally binding sales contract and satisfy the requirements of section 3(a)(3)(iv) of this appendix A.

(iv) Loans to residential real estate builders for one-to-four family residential property construction, if the bank obtains sufficient documentation demonstrating that the buyer of the home intends to purchase the home (i.e., a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (i.e., a firm written commitment for permanent financing of the home upon completion), subject to the following additional criteria:

A. The builder must incur at least the first 10% of the direct costs (i.e., actual costs of the land, labor, and material) before any drawdown is made under the construction loan and the construction loan may not exceed 80% of the sales price of the resold home;

B. The individual purchaser has made a substantial “earnest money deposit” of no less than 3% of the sales price of the home that must be subject to forfeiture by the individual purchaser if the sales contract is terminated by the individual purchaser; however, the earnest money deposit shall not be subject to forfeiture by reason of breach or termination of the sales contract on the part of the builder;

C. The earnest money deposit must be held in escrow by the bank financing the builder or by an independent party in a fiduciary capacity; the escrow agreement must provide that in the event of default the escrow funds must be used to defray any cost incurred relating to any cancellation of the sales contract by the buyer;

D. If the individual purchaser terminates the contract or if the loan fails to satisfy any other criterion under this section, then the bank must immediately recategorize the loan at a 100% risk weight and must accurately report the loan in the bank’s next quarterly Consolidated Reports of Condition and Income (Call Report);

E. The individual purchaser must intend that the home will be owner-occupied;

F. The loan is made by the bank in accordance with prudent underwriting standards;

G. The loan is not more than 90 days past due, or on nonaccrual; and

H. The purchaser is an individual(s) and not a partnership, joint venture, trust, corporation, or any other entity (including an entity acting as a sole proprietorship) that is purchasing one or more of the homes for speculative purposes.

(i) Loans secured by a first mortgage on multifamily residential properties:11b

A. The amortization of principal and interest occurs in not more than 30 years;

B. The minimum original maturity for repayment of principal is not less than 7 years;

C. All principal and interest payments have been made on a timely basis in accordance with the terms of the loan for at least one year immediately preceding the risk weighting of the loan in the 50% risk weight category, and the loan is not otherwise 90 days or more past due, or on nonaccrual status;

D. The loan is made in accordance with all applicable requirements and prudent underwriting standards;

E. If the rate of interest does not change over the term of the loan:

I. The current loan amount outstanding does not exceed 80% of the current value of the property, as measured by either the value of the property at origination of the loan (which is the lower of the purchase price or the value as determined by the initial appraisal, or if appropriate, the initial evaluation) or the most current appraisal, or if appropriate, the most current evaluation;

II. In the most recent fiscal year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 120%.11c

11b The portion of multifamily residential property loans that is sold subject to a pro rata loss sharing arrangement may be treated by the selling bank as sold 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. The portion of multifamily residential property loans sold subject to any loss sharing arrangement other than pro rata sharing of the loss shall be accorded the same treatment as any other asset sold under an agreement to repurchase or sold with recourse under section 4(b) of this appendix A.

11c For the purposes of the debt service requirements in sections 3(a)(3)(v)(E)(II) and 3(a)(3)(v)(F)(II) of this appendix A, other forms of debt service coverage that generate sufficient cash flows to provide comparable protection to the institution may be considered for (a) a loan secured by cooperative housing or (b) a multifamily residential
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(F) If the rate of interest changes over the term of the loan:
   (I) The current loan amount outstanding does not exceed 75% of the current value of
   the property, as measured by either the value of the property at origination of the
   loan (which is the lower of the purchase price or the value as determined by the ini-
   tial appraisal, or if appropriate, the initial evaluation) or the most current appraisal, or if
   appropriate, the most current evaluation; and
   (II) In the most recent fiscal year, the ratio of annual net operating income gener-
   ated by the property (before payment of any debt service on the loan) to annual debt
   service on the loan is not less than 115%; and
   (G) If the loan was refinanced by the bor-
   rower:
   (I) All principal and interest payments on
   the loan being refinanced which were made
   in the preceding year prior to refinancing
   shall apply in determining the one-year
timely payment requirement under para-
graph (a)(3)(v)(C) of this section; and
   (II) The net operating income generated by
   the property in the preceding year prior to
   refinancing shall apply in determining the
   applicable debt service requirements under
paragraphs (a)(3)(v)(E) and (a)(3)(v)(F) of this section.

(vi) Privately-issued mortgage-backed se-
curities, i.e. those that do not carry the
guarantee of a government or government-
sponsored agency, if the privately-issued
mortgage-backed securities are at the time
the mortgage-backed securities are origi-
nated fully secured by or otherwise represen-
t a sufficiently secure interest in mortgages
that qualify for the 50% risk weight under
paragraphs (a)(3)(iii), (iv) and (v) of this sec-
tion, 12 provided that they meet the following
criteria:

The underlying assets must have no liabili-
 ties or the trust that issues
the underlying assets or the trust that issues
an undivided pro rata ownership interest in
the underlying assets fully meet the cash
flows requirements of the security without
undue reliance on any reinvestment income;
and

(C) The trust that issues the security must
be structured such that the cash flows from
the underlying assets fully meet the cash
flows requirements of the security without
undue reliance on any reinvestment income;
and

(D) There must not be any material rein-
vestment risk associated with any funds
awaiting distribution to the holder of the se-
curity.

(4) 100 percent risk weight. All other assets
not specified above, 12a including:

(i) Claims on or guaranteed by depository
institutions incorporated in a non-OECD
country, as well as claims on the central
bank of a non-OECD country, with a residual
maturity exceeding one year.

(ii) Any local currency claims on non-
OECD central governments, as well as local
currency claims on non-OECD central gov-
ernments that are not included in section
3(a)(3)(v) of this appendix A.

(iii) Asset-or mortgage backed securities
that are externally rated are risk weighted
in accordance with section 4(d) of this appen-
dix A.

(iv) All stripped mortgage-backed securi-
ties, including interest only portions (IOs),
principal only portions (POs) and other simi-
lar instruments, regardless of the issuer or
guarantor.

(v) Obligations issued by any state or any
political subdivision thereof for the benefit
of a private party or enterprise where that
party or enterprise, rather than the issuing
state or political subdivision, is responsible
for the timely payment of principal and in-
terest on the obligation, e.g., industrial de-
velopment bonds.

(vi) Claims on commercial enterprises
owned by non-OECD and OECD central gov-
ernments.

12 A bank subject to the market risk cap-
ital requirements pursuant to appendix B of
this part 3 may calculate the capital require-
ment for qualifying securities borrowing
transactions pursuant to section 3(a)(1)(ii) of
appendix B of this part 3.
(vi) Any investment in an unconsolidated subsidiary that is not required to be deducted from total capital pursuant to section 2(c)(3) of this appendix A.

(1) Institutions owned by depository institutions incorporated in OECD and non-OECD countries that qualify as capital of the issuer.

(ix) Investments in fixed assets, premises, and other real estate owned.

(x) Claims representing capital of a securities firm notwithstanding section 3(a)(2)(xii) of this appendix A.

(5) Asset-backed commercial paper programs subject to consolidation. (i) A bank that qualifies as a primary beneficiary and must consolidate an asset-backed commercial paper program as a variable interest entity under generally accepted accounting principles may exclude the consolidated asset-backed commercial paper program assets from risk-weighted assets if the bank is the sponsor of the consolidated asset-backed commercial paper program.

(ii) If a bank excludes such consolidated asset-backed commercial paper program assets from risk-weighted assets, the bank must assess the appropriate risk-based capital charge against any risk exposures of the bank arising in connection with such asset-backed commercial paper program, including direct credit substitutes, recourse obligations, residual interests, asset-backed commercial paper liquidity facilities, and loans, in accordance with section 3 and section 4 of this appendix A.

(iii) If a bank either is not permitted to exclude consolidated asset-backed commercial paper program assets or elects not to exclude consolidated asset-backed commercial paper program assets from its risk-weighted assets, the bank must assess a risk-based capital charge based on the appropriate risk weight of the consolidated asset-backed commercial paper program assets in accordance with sections 3(a) and 4 of this appendix A. Any direct credit substitutes and recourse obligations (including residual interests), and loans that a bank may provide to such a variable interest entity are not subject to any capital charge under section 4 of this appendix A.

(b) Off-Balance Sheet Activities. The risk weight assigned to an off-balance sheet item is determined by a two-step process. First, the face amount of the off-balance sheet item is multiplied by the appropriate credit conversion factor specified in this section. This calculation translates the face amount of an off-balance sheet item into an on-balance sheet credit equivalent amount. Second, the resulting credit equivalent amount is then assigned to the proper risk category using the criteria regarding obligors, guarantors, and collateral listed in section 3(a) of this appendix A, or external credit rating in accordance with section 4(d), if applicable.

Collateral and guarantees are applied to the face amount of an off-balance sheet item under generally accepted accounting principles; however, with respect to derivative contracts under section 3(b)(5) of this appendix A, collateral and guarantees are applied to the credit equivalent amounts of such derivative contracts. The following are the credit conversion factors and the off-balance sheet items to which they apply. However, direct credit substitutes, recourse obligations, and securities issued in connection with asset securitizations are treated as described in section 4 of this appendix A.

(1) 100 percent credit conversion factor. (i) [Reserved] 13

(ii) Risk participations purchased in bankers’ acceptances:

(iii) [Reserved] 14

(iv) Contingent obligations with a certain draw down, e.g., legally binding agreements to purchase assets as a specified future date.

(v) Indemnification of customers whose securities the bank has lent as agent. If the customer is not indemnified against loss by the bank, the transaction is excluded from the risk-based capital calculation. 15
2. 50 percent credit conversion factor. (i) Transaction-related contingencies including, among other things, performance bonds and performance-based standby letters of credit related to a particular transaction. ¹⁶ To the extent permitted by law or regulation, performance-based standby letters of credit include such things as arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids;

   (ii) Unused portion of commitments with an original maturity exceeding one-year; ¹⁷ however, commitments that are asset-backed commercial paper liquidity facilities must satisfy the eligibility requirements under section 3(b)(6)(ii) of this appendix A;

   (iii) Revolving underwriting facilities, note issuance facilities, and similar arrangements pursuant to which the bank's customer can issue short-term debt obligations in its own name, but for which the bank has a legally binding commitment to either:

   (A) Purchase the obligations the customer is unable to sell by a stated date; or

   (B) Advance funds to its customer, if the obligations cannot be sold;

(3) 20 percent credit conversion factor. (i) Trade-related contingencies. These are short-term self-liquidating instruments used to finance the movement of goods and are collateralized by the underlying shipment. A commercial letter of credit is an example of such an instrument.

(4) 10 percent credit conversion factor. Unused portion of asset-backed commercial paper liquidity facilities with an original maturity of one year or less that satisfy the eligibility requirements under section 3(b)(6)(ii) of this appendix A.

(5) Zero percent credit conversion factor. (i) Unused portion of commitments with an original maturity of one year or less, but excluding any asset-backed commercial paper liquidity facilities;

   (ii) Unused portion of commitments with an original maturity of greater than one year, if they are unconditionally cancelable ¹⁸ at any time at the option of the bank and the bank has the contractual right to make, and in fact does make, either—

   (A) A separate credit decision based upon the borrower's current financial condition, before each drawing under the lending facility; or

   (B) An annual (or more frequent) credit review based upon the borrower's current financial condition to determine whether or not the lending facility should be continued; and

   (iii) The unused portion of retail credit card lines or other related plans that are unconditionally cancelable by the bank in accordance with applicable law.

(6) Liquidity facility provided to asset-backed commercial paper. (i) Noneligible asset-backed commercial paper liquidity facilities treated as recourse or direct credit substitute. Unused portion of asset-backed commercial paper liquidity facilities that do not meet the criteria for an eligible liquidity facility provided to asset-backed commercial paper in accordance with section 3(b)(6)(ii) of this appendix A must be treated as recourse or as a direct credit substitute, and assessed the appropriate risk-based capital charge in accordance with section 4 of this appendix A.

   (ii) Eligible asset-backed commercial paper liquidity facility. Except as provided in section 3(b)(6)(iii) of this appendix A, in order for the unused portion of asset-backed commercial paper liquidity facility to be eligible for either the 50 percent or 10 percent credit conversion factors under section 3(b)(2)(ii) or 3(b)(4) of this appendix A, the asset-backed commercial paper liquidity facility must satisfy the following criteria:

   (A) At the time of draw, the asset-backed commercial paper liquidity facility must be subject to a credit quality test that:

      (1) Precludes funding of assets that are 90 days or more past due or in default; and

      (2) If the assets that an asset-backed commercial paper liquidity facility is required to fund are externally rated securities at the time they are transferred into the program, the asset-backed commercial paper liquidity facility must be used to fund only securities that are externally rated investment grade at the time of funding. If the assets are not externally rated at the time they are transferred into the program, they are not subject to this investment grade requirement.

   (B) The asset-backed commercial paper liquidity facility must provide that, prior to any draws, the bank's funding obligation is reduced to cover only those assets that satisfy the funding criteria under the asset quality test as provided in section 3(b)(6)(ii)(A) of this appendix A.

¹⁶ For purposes of this section 3(b)(2)(i), a “performance-based standby letter of credit” is any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment on account of any default by the account party in the performance of a non-financial or commercial obligation. Participations in performance-based standby letters of credit are treated in accordance with section 4 of this appendix A.

¹⁷ Participations in commitments are treated in accordance with section 4 of this appendix A.

¹⁸ See section 1(c)(26) of appendix A to this part.
(iii) Exception to eligibility requirements for assets guaranteed by the United States Government or its agencies, or the central government of an OECD country. Notwithstanding the eligibility requirements for asset-backed commercial paper program liquidity facilities in section 3(b)(6)(i), the unused portion of an asset-backed commercial paper liquidity facility may still qualify for either the 50 percent or 10 percent credit conversion factors under section 3(b)(2)(ii) or 3(b)(4) of this appendix A, if the assets required to be funded by the asset-backed commercial paper liquidity facility are guaranteed, either conditionally or unconditionally, by the United States Government or its agencies, or the central government of an OECD country.

(iv) Transition period for asset-backed commercial paper liquidity facilities. Notwithstanding the eligibility requirements for asset-backed commercial paper program liquidity facilities in section 3(b)(6)(i) of this appendix A, the unused portion of an asset-backed commercial paper liquidity facility will be treated as eligible liquidity facilities pursuant to section 3(b)(6)(ii) of this appendix A regardless of their compliance with the definition of eligible liquidity facilities until September 30, 2005. On that date and thereafter, the unused portions of asset-backed commercial paper liquidity facilities that do not meet the eligibility requirements in section 3(b)(6)(i) of this appendix A will be treated as recourse obligations or direct credit substitutes.

(7) Derivative contracts—(i) Calculation of credit equivalent amounts. The credit equivalent amount of a derivative contract equals the sum of the current credit exposure and the potential future credit exposure of the derivative contract. The calculation of credit equivalent amounts must be measured in U.S. dollars, regardless of the currency or currencies specified in the derivative contract.

(A) Current credit exposure. The current credit exposure for a single derivative contract is determined by the mark-to-market value of the derivative contract. If the mark-to-market value is positive, then the current credit exposure equals that mark-to-market value. If the mark-to-market value is negative, then the current credit exposure is zero. The current credit exposure for multiple derivative contracts executed with a single counterparty is determined as provided by section 3(b)(5)(ii)(A) of this appendix A.

(B) Potential future credit exposure. The potential future credit exposure for a single derivative contract, including a derivative contract with negative mark-to-market value, is calculated by multiplying the notional principal of the derivative contract by one of the credit conversion factors in Table A—Conversion Factor Matrix of this appendix A, for the appropriate category. The potential future credit exposure for gold contracts shall be calculated using the foreign exchange rate conversion factors. For any derivative contract that does not fall within one of the specified categories in Table A—Conversion Factor Matrix of this appendix A, the potential future credit exposure shall be calculated using the other commodity conversion factors. Subject to examiner review, banks should use the effective rather than the apparent or stated notional amount in calculating the potential future credit exposure. The potential future credit exposure for multiple derivatives contracts executed with a single counterparty and subject to a qualifying bilateral netting contract is determined as provided by section 3(b)(5)(ii)(A) of this appendix A.
The adjusted sum of the potential future credit exposure is calculated as:

\[ A_{pot} = 0.4 \times A_{pot} + (0.6 \times NGR \times A_{pot}) \]

where:

- \( A_{pot} \) is the adjusted sum of the potential future credit exposure.
- \( A_{pot} \) is the gross potential future credit exposure.
- NGR is the net to gross ratio.

(ii) Derivative contracts subject to a qualifying bilateral netting contract—(A) Netting calculation. The credit equivalent amount for multiple derivative contracts executed with a single counterparty and subject to a qualifying bilateral netting contract as provided by section 3(b)(5)(i)(B) of this appendix A is calculated by adding the net current credit exposure and the adjusted sum of the potential future credit exposure for all derivative contracts subject to the qualifying bilateral netting contract.

(1) Net current credit exposure. The net current credit exposure is the net sum of all positive and negative mark-to-market values of the individual derivative contracts subject to a qualifying bilateral netting contract. If the net sum of the mark-to-market value is positive, then the net current credit exposure equals that net sum of the mark-to-market value. If the net sum of the mark-to-market value is zero or negative, then the net current credit exposure is zero.

(2) Adjusted sum of the potential future credit exposure. The adjusted sum of the potential future credit exposure is calculated as:

\[ A_{pot} = 0.4 \times A_{pot} + (0.6 \times NGR \times A_{pot}) \]

where:

- \( A_{pot} \) is the adjusted sum of the potential future credit exposure.
- \( A_{pot} \) is the gross potential future credit exposure.
- NGR is the net to gross ratio.

(A) Qualifying bilateral netting contract. In determining the current credit exposure for multiple derivative contracts executed with a single counterparty, a bank may net derivative contracts subject to a qualifying bilateral netting contract by offsetting positive and negative mark-to-market values, provided that:

(1) The qualifying bilateral netting contract is in writing.

(2) The qualifying bilateral netting contract is not subject to a walkaway clause.

(3) The qualifying bilateral netting contract creates a single legal obligation for all individual derivative contracts covered by the qualifying bilateral netting contract. In effect, the qualifying bilateral netting contract must provide that the bank would have a single claim or obligation either to receive or to pay only the net amount of the sum of the positive and negative mark-to-market values on the individual derivative contracts covered by the qualifying bilateral netting contract. The single legal obligation for the net amount is operative in the event that a counterparty, or a counterparty to whom the qualifying bilateral netting contract has been assigned, fails to perform due to any of the following events: default, insolvency, bankruptcy, or other similar circumstances.

(4) The bank obtains a written and reasoned legal opinion(s) that represents, with a high degree of certainty, that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy, or similar circumstances, the relevant court and administrative authorities would find the bank’s exposure to be the net amount under:

(i) 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;

(ii) The law of the jurisdiction that governs the individual derivative contracts covered by the bilateral netting contract; and

(iii) The law of the jurisdiction that governs the qualifying bilateral netting contract.

(5) The bank establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the qualifying bilateral netting contract continues to satisfy the requirement of this section.
(6) The bank maintains in its files documentation adequate to support the netting of a derivative contract. 21

(iii) Risk weighting. Once the bank determines the credit equivalent amount for a derivative contract or a set of derivative contracts subject to a qualifying bilateral netting contract, the bank assigns that amount to the risk weight category appropriate to the counterparty, or, if relevant, the nature of any collateral or guarantee. 22 However, the maximum weight that will be applied to the credit equivalent amount of such derivative contract(s) is 50 percent.

(iv) Exceptions. The following derivative contracts are not subject to the above calculation, and therefore, are not part of the denominator of a national bank’s risk-based capital ratio:

(A) An exchange rate contract with an original maturity of 14 calendar days or less; 23 and

(B) A derivative contract that is traded on an exchange requiring the daily payment of any variations in the market value of the contract.

Section 4. Recourse, Direct Credit Substitutes and Positions in Securitizations

(a) Definitions. For purposes of this section 4 of this appendix A, the following definitions apply:

(1) 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 a “reference asset.”

(2) Credit-enhancing interest-only strip means an on-balance sheet asset that, in form or in substance:

(i) Represents the contractual right to receive some or all of the interest due on transferred assets; and

(ii) Exposes the bank to credit risk directly or indirectly associated with the transferred assets that exceeds its pro rata claim on the assets whether through subordination provisions or other credit enhancing techniques.

(3) Credit-enhancing representations and warranties means representations and warranties that are made or assumed in connection with a transfer of assets (including loan servicing assets) and that obligate a 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:

(i) Early-default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1–4 family residential first mortgage loans (as described in section 3(a)(3)(iii) of this appendix A) 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;

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

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

(4) 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 asset or 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 a bank has no claim on the third-party asset, then the bank’s assumption of any credit risk is a direct credit substitute. Direct credit substitutes include:

(i) Financial standby letters of credit that support financial claims on a third party that exceed a bank’s pro rata share in the financial claim;
(ii) Guarantees, surety arrangements, credit derivatives and similar instruments backing financial claims that exceed a bank’s pro rata share in the financial claim;

(iii) Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets;

(iv) Credit derivative contracts under which the bank assumes more than its pro rata share of credit risk on a third-party asset or exposure;

(v) Loans or lines of credit that provide credit enhancement for the financial obligations of a third party;

(vi) 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 case advances that meet the conditions of section 4(a)(8(ii) and (ii) of this appendix A, are not direct credit substitutes;

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

(viii) Unused portion of noneligible asset-backed commercial paper liquidity facilities.

(5) Externally rated means that an instrument or obligation has received a credit rating from at least one nationally recognized statistical rating organization.

(6) 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.

(7) 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.

(8) Financial standby letter of credit means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

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

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

(9) Mortgage servicer cash advance means funds that a residential mortgage 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:

(i) 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

(ii) For any one loan, the servicer’s obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal amount of that loan.

(10) 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.

(11) Recourse means a bank’s retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold that exceeds a pro rata share of that bank’s claim on the asset. If a bank has no claim on a sold asset, then the retention of any credit risk is recourse. A recourse obligation typically arises when a bank transfers assets and retains an explicit obligation to repurchase assets or to 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:

(i) Credit-enhancing representations and warranties made on transferred assets;

(ii) Loan servicing assets retained pursuant to an agreement under which the bank will be responsible for losses associated with the loans serviced. Mortgage servicer cash advances that meet the conditions of section 4(a)(9)(i) and (ii) of this appendix A, are not recourse arrangements;

(iii) Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets;

(iv) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;

(v) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;

(vi) Credit derivatives issued that absorb more than the bank’s pro rata share of losses from the transferred assets;

(vii) Clean-up calls. Clean-up calls that are 10% or less of the original pool balance and that are exercisable at the option of the bank are not recourse arrangements; and

(viii) Noneligible asset-backed commercial paper liquidity facilities.

(12) 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 a bank to any credit risk directly or indirectly associated with the transferred asset that exceeds a pro rata share of that bank’s claim on the asset, whether through subordination provisions or other credit enhancement techniques. Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests (and other forms of overcollateralization) 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 its sale. Residual interests generally do not include interests purchased from a third party.

(b) An unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan or repurchase agreement for assets transferred.

(c) Credit equivalent amounts and risk weights of recourse obligations and direct credit substitutes—

(1) Credit-equivalent amount. Except as otherwise provided, 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% conversion factor.

(2) Risk-weight factor. To determine the bank’s risk-weighted assets 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.

(3) Credit equivalent amount and risk weight of participations in, and syndications of, direct credit substitutes. The credit equivalent amount for a participation interest in, or syndication of, a direct credit substitute is calculated and risk weighted as follows:

(1) In the case of a direct credit substitute in which a bank has conveyed a risk participation, the full amount of the assets that are supported by the direct credit substitute is converted to a credit equivalent amount using a 100% conversion factor. The pro rata share of the credit equivalent amount that has not been participated out is assigned to whichever risk-weight category is lower: the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral, or the risk-weight category appropriate to the party acquiring the participation. The pro rata share of the credit equivalent amount that has not been participated out is assigned to the risk-weight category appropriate to the obligor after considering any associated guarantees or collateral.

(2) In the case of a direct credit substitute in which the bank has acquired a risk participation, the acquiring bank’s pro rata share of the direct credit substitute is multiplied by the full amount of the assets that are supported by the direct credit substitute and converted using a 100% credit conversion factor. The resulting credit equivalent amount is then assigned to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral.

(3) In the case of a direct credit substitute that takes the form of a syndication where each bank or participating entity is obligated only for its pro rata share of the risk and there is no recourse to the originating entity, each bank’s credit equivalent amount will be calculated by multiplying only its pro rata share of the assets supported by the direct credit substitute by a 100% conversion factor. The resulting credit equivalent amount is then assigned to the risk-weight category appropriate to the obligor in the
underlying transaction, after considering any associated guarantees or collateral.

(d) Externally rated positions: credit-equivalent amounts and risk weights—(1) Traded positions. With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing interest-only strip) or asset- or mortgage-backed security that is a “traded position” and that has received an external rating on a long-term position that is one grade below investment grade, the bank may multiply the face amount of the position by the appropriate risk weight, determined in accordance with Tables C or D of this appendix A. If a traded position receives more than one external rating, the lowest single rating will apply.

### Table C

<table>
<thead>
<tr>
<th>Long-term rating category</th>
<th>Examples</th>
<th>Risk weight (in percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest or second highest investment grade</td>
<td>AAA, AA</td>
<td>20</td>
</tr>
<tr>
<td>Third highest investment grade</td>
<td>A</td>
<td>50</td>
</tr>
<tr>
<td>Lowest investment grade</td>
<td>BBB</td>
<td>100</td>
</tr>
<tr>
<td>One category below investment grade</td>
<td>BB</td>
<td>200</td>
</tr>
</tbody>
</table>

### Table D

<table>
<thead>
<tr>
<th>Short-term rating category</th>
<th>Examples</th>
<th>Risk weight (in percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest investment grade</td>
<td>A-1, P-1</td>
<td>20</td>
</tr>
<tr>
<td>Second highest investment grade</td>
<td>A-2, P-2</td>
<td>50</td>
</tr>
<tr>
<td>Lowest investment grade</td>
<td>A-3, P-3</td>
<td>100</td>
</tr>
</tbody>
</table>

(2) Non-traded positions. A recourse obligation, direct credit substitute, residual interest (but not a credit-enhancing interest-only strip) or asset- or mortgage-backed security extended in connection with a securitization that is not a “traded position” may be assigned a risk weight in accordance with section 4(d)(1) of this appendix A if:

(i) It has been externally rated by more than one NRSRO;

(ii) It has received an external rating on a long-term position that is one category below investment grade or better or a short-term position that is investment grade by all NRSROs providing a rating;

(iii) The ratings are publicly available; and

(iv) 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, residual interest or direct credit substitute will be assigned.

(e) 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 4(d)(1) of this appendix A, based upon the

| Stripped mortgage-backed securities or other similar instruments, such as interest-only or principal-only strips, that are not credit enhancing must be assigned to the 100% risk category. | 41 |
credit-enhancing interest-only strip was retained by the bank and not transferred.

(3) Other residual interests capital requirement. Except as provided in sections (d) or (e) of this section, a bank must maintain risk-based capital for a residual interest (excluding a credit-enhancing interest-only strip) equal to the face 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.

(4) Residual interests and other recourse obligations. Where the aggregate capital requirement for residual interests (including credit-enhancing interest-only strips) and recourse obligations arising from 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 sections 4(f)(1) through (3) of this appendix A or the full risk-based capital requirement for the assets transferred.

(g) Positions that are not rated by an NRSRO. A position (but not a residual interest) extended in connection with a securitization and is not rated by an NRSRO may be risk-weighted based on the bank’s determination of the credit rating of the position, as specified in Table E of this appendix A, multiplied by the face amount of the position. In order to qualify for 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 section 4(g)(1) through (3) of this appendix A.

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**TABLE E**

<table>
<thead>
<tr>
<th>Investment grade</th>
<th>Examples</th>
<th>Risk weight (in percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BB</td>
<td>BBB, or better</td>
<td>100</td>
</tr>
<tr>
<td>BB</td>
<td>BB</td>
<td>200</td>
</tr>
</tbody>
</table>

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(3) Internal risk rating used for asset-backed programs. A direct credit substitute (but not a purchased credit-enhancing interest-only strip) is assumed by a bank 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 OCC, 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:

(i) The internal credit risk system is an integral part of the bank’s risk management system that explicitly incorporates the full range of risks arising from a bank’s participation in securitization activities;

(ii) 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;

(iii) 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;

(iv) The bank’s internal credit risk system must identify gradations of risk among “pass” assets and other risk positions;

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

(vi) The bank must have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

(vii) An internal audit procedure should periodically verify that internal risk ratings are assigned in accordance with the bank’s established criteria.

(viii) The bank must monitor the performance of the internal credit risk ratings assigned to nonrated, nonrated 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

(ix) 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.

(2) Program Ratings. A direct credit substitute or recourse obligation (but not a residual interest) is assumed by or retained by a bank in connection with a structured finance program and a NRSRO has reviewed the 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.

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(h) Limitations on risk-based capital requirements.

(1) Low-level exposure rule. If the maximum contractual exposure to loss retained or assumed by a bank is less than the effective risk-based capital requirement, as determined in accordance with section 4(b) of this appendix A, for the asset supported by the bank’s position, the risk-based capital required under this appendix A is limited to the bank’s 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 that it has sold.

(2) Related on-balance sheet assets. If an asset is included in the calculation of the risk-based capital requirement under this section 4 of this appendix A and also appears as an asset on a bank’s balance sheet, the asset is risk-weighted only under this section 4 of this appendix A, except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In that case, both the on-balance sheet servicing assets and the related recourse obligations or direct credit substitutes must both be separately risk weighted and incorporated into the risk-based capital calculation.

(i) Alternative Capital Calculation for Small Business Obligations—(1) Definitions. For purposes of this section 4(i):

(B) Is adequately capitalized as defined in 12 CFR 6.4 without applying the capital treatment described in this section 4(i) and has received written permission from the appropriate district office of the OCC to apply the capital treatment described in this section 4(i).

(ii) Recourse has the meaning given to such term under generally accepted accounting principles.

(iii) Small business means a business that meets the criteria for a small business concern established by the Small Business Administration in 13 CFR part 121 pursuant to 15 U.S.C. 632.

(2) Capital and reserve requirements. Notwithstanding the risk-based capital treatment outlined in section 2(c)(4) and any other subsection (other than subsection (i)) of this section 4, with respect to a transfer of a small business loan or a lease of personal property with recourse that is a sale under generally accepted accounting principles, a qualified bank may elect to apply the following treatment:

(i) The bank establishes and maintains a non-capital reserve under generally accepted accounting principles sufficient to meet the reasonable estimated liability of the bank under the recourse arrangement; and

(ii) For purposes of calculating the bank’s risk-based capital ratio, the bank includes only the face amount of its recourse in its risk-based capital requirement under this section 4(i).

(3) Limit on aggregate amount of recourse.

The total outstanding amount of recourse retained by a qualified bank with respect to transfers of small business loans and leases of personal property and included in the risk-based assets of the bank as described in section 4(i)(2) of this appendix A may not exceed 15 percent of the bank’s total capital after adjustments and deductions, unless the OCC specifies a greater amount by order.

(4) Bank that ceases to be qualified or that exceeds aggregate limit.

If a bank ceases to be qualified or that exceeds aggregate limit. If a bank ceases to be a qualified bank or exceeds the aggregate limit in section 4(i)(3) of this appendix A, the bank may continue to apply the capital treatment described in section 4(i)(2) of this appendix A to transfers of small business loans and leases of personal property that occurred when the bank was qualified and did not exceed the limit.

(5) Prompt Corrective Action not affected.

(i) A bank shall compute its capital without regard to this section 4(i) for purposes of prompt corrective action (12 U.S.C. 1831o and 12 CFR part 6) unless the bank is an adequately or well capitalized bank (without applying the capital treatment described in this section 4(i)) and, after applying the capital treatment described in this section 4(i), the bank would be well capitalized.

(ii) A bank shall compute its capital without regard to this section 4(i) for purposes of
12 U.S.C. 1831o(g) regardless of the bank’s capital level.

Section 5. Implementation, Transition Rules, and Target Ratios

(a) December 31, 1990 to December 30, 1992. During this time period:

(1) All national banks are expected to maintain a minimum ratio of total capital (after deductions) to risk-weighted assets of 7.25%.

(ii) Fifty percent of this 7.25% must be made up of Tier 1 capital; however, up to 10% of Tier 1 capital can be comprised of Tier 2 capital elements, before any deductions for goodwill. The amount of Tier 2 elements included in Tier 1 will not be subject to the sublimits on the amount of such elements in Tier 2 capital, with the exception of the allowance for loan and lease losses.

(ii) Goodwill that national banks have been allowed to count as capital as a result of the transition rules contained in 12 CFR 3.3 is grandfathered until December 31, 1992, but will be deducted from Tier 1 capital after that date.

(2) The allowance for loan and lease losses can be included in total capital up to a maximum of 1.5% of a bank’s risk-weighted assets, including the portion that can be borrowed to make up Tier 1.

(3) Tier 2 capital elements that are not used as part of Tier 1 capital will qualify as part of a national bank’s total capital base up to a maximum of 100% of the bank’s Tier 1 capital.

(4) In addition to the standards established by these risk-based capital guidelines, all national banks must maintain a minimum capital-to-total assets ratio in accordance with the provisions of 12 CFR part 3.

(b) On December 31, 1992. (1) All national banks are expected to maintain a minimum ratio of total capital (after deductions) to risk-weighted assets of 8.0%.

(2) Tier 2 capital elements qualify as part of a national bank’s total capital base up to a maximum of 100% of that bank’s Tier 1 capital.

(c) In addition to the standards established by these risk-based capital guidelines, all national banks must maintain a minimum capital-to-total assets ratio in accordance with the provisions of 12 CFR part 3.

1 This appendix is based on a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Supervision and endorsed by the Group of Ten Central Bank Governors. The framework is described in a Basle Committee paper entitled “Amendment to the Capital Accord to Incorporate Market Risk,” January 1996.

2 Trading activity means the gross sum of trading assets and liabilities as reported in the bank’s most recent quarterly Consolidated Report of Condition and Income (Call Report).

3 Total assets means quarter-end total assets as reported in the bank’s most recent Call Report.

4A bank that voluntarily complies with the final rule prior to January 1, 1998, must comply with all of its provisions.