APPENDIX A TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: RISK-BASED MEASUREMENT

I. OVERVIEW

The Board of Governors of the Federal Reserve System has adopted a risk-based capital measure to assist in the assessment of the capital adequacy of bank holding companies (banking organizations). The principal objectives of this measure are to: (i) Make regulatory capital requirements more sensitive to differences in risk profiles among banking organizations; (ii) factor off-balance sheet exposures into the assessment of capital adequacy; (iii) minimize disincentives to holding liquid, low-risk assets; and (iv) achieve greater consistency in the evaluation of the capital adequacy of major banking organizations throughout the world.2

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

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

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

The risk-based guidelines apply on a consolidated basis to any bank holding company with consolidated assets of $500 million or more. The risk-based guidelines also apply on a consolidated basis to any bank holding company with consolidated assets of less than $500 million if the holding company (i) is engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) conducts significant off-balance sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; or (iii) has a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission (SEC). The Federal Reserve may apply the risk-based guidelines at its discretion to any bank holding company, regardless of asset size, if such action is warranted for supervisory purposes.

The risk-based guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. Thus, in considering an application filed by a bank holding company, the Federal Reserve will take into account the organization's risk-based capital ratio, the reasonableness of its capital plans, and the degree of progress it has demonstrated toward meeting the interim and final risk-based capital standards.

The risk-based capital ratio focuses principally on broad categories of credit risk, although the framework for assigning assets and off-balance sheet items to risk categories does incorporate elements of transfer risk, as well as limited instances of interest rate and market risk. The risk-based ratio does not, however, incorporate other factors that can affect an organization’s financial condition. These factors include overall interest rate exposure; liquidity, funding and

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1Supervisory ratios that relate capital to total assets for bank holding companies are outlined in appendices B and D of this part.
2The risk-based capital measure is based upon a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Regulations and Supervisory Practices (Basle Supervisors’ Committee) and endorsed by the Group of Ten Central Bank Governors. The framework is described in a paper prepared by the BSC entitled "International Convergence of Capital Measurement," July 1988.
3Banking organizations will initially be expected to utilize period-end amounts in calculating their risk-based capital ratios. When necessary and appropriate, ratios based on average balances may also be calculated on a case-by-case basis. Moreover, to the extent banking organizations have data on average balances that can be used to calculate risk-based ratios, the Federal Reserve will take such data into account.

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market risks; the quality and level of earnings; investment or loan portfolio concentrations; the quality of loans and investments; the effectiveness of loan and investment policies; the efficiency and management of an institution’s ability to monitor and control financial and operating risks.

In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of these other factors, including, in particular, the level and severity of problem and classified assets. For this reason, the final supervisory judgment on an organization’s capital adequacy may differ significantly from conclusions that might be drawn solely from the level of the organization’s risk-based capital ratio.

The risk-based capital guidelines establish minimum ratios of capital to weighted risk assets. In light of the considerations just discussed, banking organizations generally are expected to operate well above the minimum risk-based ratios. In particular, banking organizations contemplating significant expansion proposals are expected to maintain strong capital levels substantially above the minimum ratios and should not allow significant diminution of financial strength below these strong levels to fund their expansion plans. Institutions with high or inordinate levels of risk are also expected to operate above minimum capital standards. In all cases, institutions should hold capital commensurate with the level and nature of the risks to which they are exposed. Banking organizations that do not meet the minimum risk-based standard, or that are otherwise considered to be inadequately capitalized, are expected to develop and implement plans acceptable to the Federal Reserve for achieving adequate levels of capital within a reasonable period of time.

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

II. DEFINITION OF QUALIFYING CAPITAL FOR THE RISK BASED CAPITAL RATIO

(i) A banking organization’s qualifying total capital consists of two types of capital components: "core capital elements" (tier 1 capital elements) and "supplementary capital elements" (tier 2 capital elements). These capital elements and the various limits, restrictions, and deductions to which they are subject, are discussed below. To qualify as an element of tier 1 or tier 2 capital, an instrument must be fully paid up and effectively unsecured. Accordingly, if a banking organization has purchased, or has directly or indirectly funded the purchase of, its own capital instrument, that instrument generally is disqualified from inclusion in regulatory capital. A qualifying tier 1 or tier 2 capital instrument must be subordinated to all senior indebtedness of the organization. If issued by a bank, it also must be subordinated to claims of depositors. In addition, the instrument must not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

(ii) On a case-by-case basis, the Federal Reserve may determine whether, and to what extent, any instrument that does not fit wholly within the terms of a capital element set forth below, or that does not have the characteristics or the ability to absorb losses commensurate with the capital treatment specified below, will qualify as an element of tier 1 or tier 2 capital. In making such a determination, the Federal Reserve will consider the similarity of the instrument to instruments explicitly addressed in the guidelines; the ability of the instrument to absorb losses, particularly while the organization operates as a going concern; the maturity and redemption features of the instrument; and other relevant terms and factors.

(iii) The redemption of capital instruments before stated maturity could have a significant impact on an organization’s overall capital structure. Consequently, an organization should consult with the Federal Reserve before redeeming any equity or other capital instrument included in tier 1 or tier 2 capital prior to stated maturity if such redemption could have a material effect on the level or composition of the organization’s capital base. Such consultation generally would not be necessary when the instrument is to be redeemed with the proceeds of, or replaced by, a like amount of a capital instrument that is of equal or higher quality with regard to terms and maturity and the Federal Reserve considers the organization’s capital position to be fully sufficient.

A. The Definition and Components of Qualifying Capital

1. Tier 1 capital. Tier 1 capital generally is defined as the sum of core capital elements less any amounts of goodwill, other intangible assets, interest-only strips receivables, deferred tax assets, nonfinancial equity investments, and other items that are required to be deducted in accordance with section II.B. of this appendix. Tier 1 capital must represent at least 50 percent of qualifying total capital.
   a. Core capital elements (tier 1 capital elements). The elements qualifying for inclusion in the tier 1 component of a banking organization’s qualifying total capital are:
   i. Qualifying common stockholders’ equity;
   ii. Qualifying noncumulative perpetual preferred stock, including related surplus, and senior perpetual preferred stock issued...
b. Limits on restricted core capital elements—

i. Limits. (1) The aggregate amount of restricted core capital elements that may be included in the tier 1 capital of a banking organization must not exceed 25 percent of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Stated differently, the aggregate amount of restricted core capital elements is limited to one-third of the sum of core capital elements, excluding restricted core capital elements, net of goodwill less any associated deferred tax liability. Notwithstanding the foregoing, the full amount of TARP Subordinated Securities issued by an S-Corp BHC or Mutual BHC may be included in its tier 1 capital, provided that the banking organization must include the TARP Subordinated Securities in restricted core capital elements for the purposes of determining the aggregate amount of other restricted core capital elements that may be included in tier 1 capital in accordance with this section.

(2) In addition, the aggregate amount of restricted core capital elements (other than qualifying mandatory convertible preferred securities) that may be included in the tier 1 capital of an internationally active banking organization must not exceed 15 percent of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability.

(3) Amounts of restricted core capital elements in excess of this limit generally may be included in tier 2 capital. The aggregate amounts of restricted core capital elements that are in the form of Class C minority interest and qualifying trust preferred securities are subject to further limitations within tier 2 capital in accordance with section II.A.2.d.iv. of this appendix. A banking organization may attribute excess amounts of restricted core capital elements first to any qualifying cumulative perpetual preferred stock or to Class B minority interest, and second to qualifying trust preferred securities or to Class C minority interest, which are subject to a tier 2 sublimit.

ii. Transition.

(1) The quantitative limits for restricted core capital elements set forth in sections II.A.1.b.i. and II.A.2.d.iv. of this appendix become effective on March 31, 2011. Prior to that time, a banking organization with restricted core capital elements in amounts that cause it to exceed these limits must consult with the Federal Reserve on a plan for ensuring that the banking organization is not unduly relying on these elements in its

5 Qualifying mandatory convertible preferred securities generally consist of the joint issuance by a bank holding company to investors of trust preferred securities and a forward purchase contract, which the investors fully collateralize with the securities, that obligates the investors to purchase a fixed amount of the bank holding company’s common stock, generally in three years. A bank holding company wishing to issue mandatorily convertible preferred securities and include them in tier 1 capital must consult with the Federal Reserve prior to issuance to ensure that the securities’ terms are consistent with tier 1 capital treatment.

6 For this purpose, an internationally active banking organization is a banking organization that (1) as of its most recent year-end FR Y-9C reports total consolidated assets equal to $250 billion or more or (2) on a consolidated basis, reports total on-balance-sheet foreign exposure of $10 billion or more on its filings of the most recent year-end FFIEC 009 Country Exposure Report.
capital base and, where appropriate, for reducing such reliance to ensure that the organization complies with these limits as of March 31, 2011.

(2) Until March 31, 2011, the aggregate amount of qualifying cumulative perpetual preferred stock (including related surplus) and qualifying trust preferred securities that a banking organization may include in tier 1 capital is limited to 25 percent of the sum of the following core capital elements: qualifying common stockholders’ equity, qualifying noncumulative and cumulative perpetual preferred stock (including related surplus), qualifying minority interest in the equity accounts of consolidated subsidiaries, and qualifying trust preferred securities. Amounts of qualifying cumulative perpetual preferred stock (including related surplus) and qualifying trust preferred securities in excess of this limit may be included in tier 2 capital.

(3) Until March 31, 2011, internationally active banking organizations generally are expected to limit the amount of qualifying cumulative perpetual preferred stock (including related surplus) and qualifying trust preferred securities included in tier 1 capital to 15 percent of the sum of core capital elements set forth in section II.A.1.b.ii.2. of this appendix.

c. Definitions and requirements for core capital elements—i. Qualifying common stockholders’ equity.

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

(2) Restrictions on terms and features. A capital instrument that has a stated maturity date or that has a preference with regard to liquidation or the payment of dividends is not deemed to be a component of qualifying common stockholders’ equity, regardless of whether or not it is called common equity. Terms or features that grant other preferences also may call into question whether the capital instrument would be deemed to be qualifying common stockholders’ equity. Features that require, or provide significant incentives for, the issuer to redeem the instrument before its maturity are considered an element of qualifying common stockholders’ equity.

(3) Reliance on voting common stockholders’ equity. Although section II.A.1. of this appendix allows for the inclusion of elements other than common stockholders’ equity within tier 1 capital, voting common stockholders’ equity, which is the most desirable capital element from a supervisory standpoint, generally should be the dominant element within tier 1 capital. Thus, banking organizations should avoid over-reliance on preferred stock and nonvoting elements within tier 1 capital. Such nonvoting elements can include portions of common stockholders’ equity where, for example, a banking organization has a class of nonvoting common equity, or a class of voting common equity that has substantially fewer voting rights per share than another class of voting common equity. Where a banking organization relies excessively on nonvoting elements within tier 1 capital, the Federal Reserve generally will require the banking organization to allocate a portion of the nonvoting elements to tier 2 capital.

ii. Qualifying perpetual preferred stock.

(1) Qualifying requirements. Perpetual preferred stock qualifying for inclusion in tier 1 capital has no maturity date and cannot be redeemed at the option of the holder. Perpetual preferred stock will qualify for inclusion in tier 1 capital only if it can absorb losses while the issuer operates as a going concern.

(2) Restrictions on terms and features. Perpetual preferred stock included in tier 1 capital may not have any provisions restricting the banking organization’s ability or legal right to defer or waive dividends, other than provisions requiring prior or concurrent deferral or waiver of payments on more junior instruments, which the Federal Reserve generally expects in such instruments consistent with the notion that the most junior capital elements should absorb losses first. Dividend deferrals or waivers for preferred stock, which the Federal Reserve expects will occur either voluntarily or at its discretion when an organization is in a weakened condition, must not be subject to arrangements that would diminish the ability of the deferral to shore up the banking organization’s resources. Any perpetual preferred stock with a feature permitting redemption at the option of the holder may qualify as tier 1 capital only if the redemption is subject to prior approval of the Federal Reserve. Features that require, or create significant incentives for the issuer to redeem the instrument for cash or cash equivalents will render the instrument ineligible for inclusion in tier 1 capital. For example, perpetual preferred stock that has a credit-sensitive dividend feature—that is, a dividend rate that is reset periodically based, in whole or in part, on the banking organization’s current credit standing—generally does not
qualify for inclusion in tier 1 capital. Simi-
larly, perpetual preferred stock that has a
dividend rate step-up or a market value con-
version feature—that is, a feature whereby
the holder must or can convert the preferred
stock into common stock at the market
price prevailing at the time of conversion—
generally does not qualify for inclusion in
tier 1 capital.8

(3) Noncumulative and cumulative features.
Perpetual preferred stock that is noncumu-
lative generally may not permit the accumu-
lation or payment of unpaid dividends in any
form, including in the form of common stock.
Perpetual preferred stock that pro-
vides for the accumulation or future pay-
ment of unpaid dividends is deemed to be cu-
mulative, regardless of whether or not it is
called noncumulative.

iii. Qualifying minority interest. Minority in-
terest in the common and preferred stock-
holders' equity accounts of a consolidated
subsidiary (minority interest) represents
stockholders' equity associated with com-
mon or preferred equity instruments issued
by a banking organization's consolidated
subsidiary that are held by investors other
than the banking organization. Minority in-
terest is included in tier 1 capital because, as
a general rule, it represents equity that is
freely available to absorb losses in the
issuing subsidiary. Nonetheless, minority in-
terest typically is not available to absorb
losses in the banking organization as a
whole, a feature that is a particular concern
when the minority interest is issued by a
subsidiary that is neither a U.S. depository
institution nor a foreign bank. For this rea-
son, this appendix distinguishes among three
types of qualifying minority interest. Class
A minority interest is minority interest re-
lated to qualifying common and noncumu-
lative perpetual preferred equity instru-
ments issued directly (that is, not through a
subsidiary) by a consolidated U.S. depository
institutions9 or foreign bank 10 subsidiary of a
banking organization. Class B minority in-
terest is not subject to a formal limitation
within tier 1 capital. Class B minority in-
terest is minority interest related to qualifying
accumulative perpetual preferred equity in-
struments issued directly by a consolidated
U.S. depository institution or foreign bank
subsidiary of a banking organization. Class B
minority interest is a restricted core capital
element subject to the limitations set forth
in section II.A.1.b.i. of this appendix, but is
not subject to a tier 2 sub-limit. Class C mi-
nority interest is minority interest related to
qualifying common or perpetual preferred
stock issued by a banking organization's con-
solidated subsidiary that is neither a U.S.
banking institution nor a foreign bank.
Class C minority interest is eligible for in-
clusion in tier 1 capital as a restricted core
capital element and is subject to the limita-
tions set forth in sections II.A.1.b.i. and
II.A.2.d.iv. of this appendix. Minority in-
terest in small business investment companies,
investment funds that hold nonfinancial eq-
ity investments (as defined in section
II.B.5.b. of this appendix), and subsidiaries
engaged in nonfinancial activities are not in-
cluded in the banking organization's tier 1 or
total capital if the banking organization's
interest in the company or fund is held under
one of the legal authorities listed in section
II.B.5.b. of this appendix. In addition, minor-
ity interest in consolidated asset-backed
commercial paper programs (ABCP) (as de-
defined in section III.B.6. of this appendix) that
are sponsored by a banking organization are
not included in the organization's tier 1 or
total capital if the organization excludes the
consolidated assets of such programs from
risk-weighted assets pursuant to section
III.B.6. of this appendix.

iv. Qualifying trust preferred securities.

7 U.S. depositary institutions are defined to
include branches (foreign and domestic) of
federally insured banks and depository insti-
tutions chartered and headquartered in the
50 states of the United States, the District of
Columbia, Puerto Rico, and U.S. territories
and possessions. The definition encompasses
banks, mutual or stock savings banks, sav-
ings or building and loan associations, coop-
erative banks, credit unions, and inter-
national banking facilities of domestic
banks.

8 For this purpose, a foreign bank is de-
finied as an institution that engages in the
business of banking; is recognized as a bank
by the bank supervisory or monetary au-
thorities of the country of its organization
or principal banking operations; receives de-
posits to a substantial extent in the regular
course of business; and has the power to ac-
cept demand deposits.
Federal Reserve System

(1) A banking organization that wishes to issue trust preferred securities and include them in tier 1 capital must first consult with the Federal Reserve. Trust preferred securities are defined as undated preferred securities issued by a trust or similar entity sponsored (but generally not consolidated) by a banking organization that is the sole common equity holder of the trust. Qualifying trust preferred securities must allow for dividends to be deferred for at least twenty consecutive quarters without an event of default, unless an event of default leading to acceleration permitted under section II.A.1.c.iv.(2) has occurred. The required notification period for such deferral must be reasonably short, no more than 15 business days prior to the payment date. Qualifying trust preferred securities are otherwise subject to the same restrictions on terms and features as qualifying perpetual preferred stock under section II.A.1.c.ii.(2) of this appendix.

(2) The sole asset of the trust must be a junior subordinated note issued by the sponsoring banking organization that has a minimum maturity of thirty years, is subordinated with regard to both liquidation and priority of periodic payments to all senior and subordinated debt of the sponsoring banking organization (other than other junior subordinated notes underlying trust preferred securities). Otherwise the terms of a junior subordinated note must mirror those of the preferred securities issued by the trust. 11 The note must comply with section II.A.2.d. of this appendix and the Federal Reserve's subordinated debt policy statement set forth in 12 CFR 250.166 except that the note may provide for an event of default and the acceleration of principal and accrued interest upon (a) nonpayment of interest for 20 or more consecutive quarters or (b) termination of the trust without redemption of the trust preferred securities, distribution of the notes to investors, or assumption of the obligation by a successor to the banking organization.

(3) In the last five years before the maturity of the note, the outstanding amount of the associated trust preferred securities is excluded from tier 1 capital and included in tier 2 capital, where the trust preferred securities are subject to the amortization provisions and quantitative restrictions set forth in sections II.A.2.d.iii and iv. of this appendix as if the trust preferred securities were limited-life preferred stock.

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

(i) Allowance for loan and lease losses (subject to limitations discussed below);
(ii) Perpetual preferred stock and related surplus (subject to conditions discussed below);
(iii) Hybrid capital instruments (as defined below), perpetual debt, and mandatory convertible debt securities;
(iv) Term subordinated debt and intermediate-term preferred stock, including related surplus (subject to limitations discussed below);
(v) Unrealized holding gains on equity securities (subject to limitations discussed in section II.A.2.e. of this appendix).

The maximum amount of tier 2 capital that may be included in an institution's unsupervised capital must consist of the following items, subject to the limitations set forth in section II.A.1.d.

11 Under generally accepted accounting principles, the trust issuing the preferred securities generally is not consolidated on the banking organization's balance sheet; rather the underlying subordinated note is recorded as a liability on the organization's balance sheet. Only the amount of the trust preferred securities issued, which generally is equal to the amount of the underlying subordinated note less the amount of the sponsoring banking organization's common equity investment in the trust (which is recorded as an asset on the banking organization's consolidated balance sheet), may be included in tier 1 capital. Because this calculation method effectively deducts the banking organization's common stock investment in the trust in computing the numerator of the capital ratio, the common equity investment in the trust should be excluded from the calculation of risk-weighted assets in accordance with footnote 17 of this appendix. Where a banking organization has issued trust preferred securities as part of a pooled issuance, the organization generally must not buy back a security issued from the pool. Where a banking organization does hold such a security (for example, as a result of an acquisition of another banking organization), the

12 Trust preferred securities issued before April 15, 2005, generally would be includable in tier 1 capital despite noncompliance with sections II.A.1.c.iv. or II.A.2.d. of this appendix or 12 CFR 250.166 provided the noncomplying terms of the instrument (i) have been commonly used by banking organizations, (ii) do not provide an unreasonably high degree of protection to the holder in circumstances other than bankruptcy of the banking organization, and (iii) do not effectively allow a holder in due course of the note to stand ahead of senior or subordinated debt holders in the event of bankruptcy of the banking organization.
c. Hybrid capital instruments, perpetual debt, and mandatory convertible debt securities. Hybrid capital instruments include instruments that are essentially permanent in nature and that have certain characteristics of both equity and debt. Such instruments may be included in Tier 2 without limit. The general criteria hybrid capital instruments must meet in order to qualify for inclusion in Tier 2 capital are listed below:

1. The instrument must be unsecured; fully paid-up and subordinated to general creditors. If issued by a bank, it must also be subordinated to claims or depositors.

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

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

4. The instrument must provide the option for the issuer to defer interest payments if:
   a) the issuer does not report a profit in the preceding annual period (defined as combined profits for the most recent four quarters); and
   b) the issuer eliminates cash dividends on common and preferred stock.

Perpetual debt and mandatory convertible debt securities that meet the criteria set forth in 12 CFR part 225, appendix B, also qualify as unlimited elements of Tier 2 capital for bank holding companies.

c. Subordinated debt and intermediate-term preferred stock—i. Five-year minimum maturity. Subordinated debt and intermediate-term preferred stock must have an original weighted average maturity of at least five years to qualify as tier 2 capital. If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing bank.
ii. Other restrictions on subordinated debt. Subordinated debt included in tier 2 capital must comply with the Federal Reserve’s subordinated debt policy statement set forth in 12 CFR 250.166. Accordingly, such subordinated debt must meet the following requirements:

1. The subordinated debt must be unsecured.
2. The subordinated debt must clearly state on its face that it is not a deposit and is not insured by a Federal agency.
3. The subordinated debt must not have credit-sensitive features or other provisions that are inconsistent with safe and sound banking practice.
4. Subordinated debt issued by a subsidiary U.S. depository institution or foreign bank of a bank holding company must be subordinated in right of payment to the claims of all the institution’s general creditors and depositors, and generally must not contain provisions permitting debt holders to accelerate payment of principal or interest upon the occurrence of any event other than receivership of the institution. Subordinated debt issued by a bank holding company or its subsidiaries that are neither U.S. depository institutions nor foreign banks must be subordinated to all senior indebtedness of the issuer; that is, the debt must be subordinated at a minimum to all borrowed money, similar obligations arising from off-balance sheet guarantees and direct credit substitutes, and obligations associated with derivative products such as interest rate and foreign exchange contracts, commodity contracts, and similar arrangements. Subordinated debt issued by a bank holding company or any of its subsidiaries that is not a U.S. depository institution or foreign bank must not contain provisions permitting debt holders to accelerate payment of principal or interest upon the occurrence of any event other than the bankruptcy of the bank holding company or the receivership of a major subsidiary depository institution. Thus, a provision permitting acceleration in the event that any other affiliate of the bank holding company issuer enters into bankruptcy or receivership makes the instrument ineligible for inclusion in tier 2 capital.

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

iv. Limits. The aggregate amount of term subordinated debt (excluding mandatory convertible debt) and limited-life preferred stock as well as, beginning March 31, 2011, qualifying trust preferred securities and Class C minority interest in excess of the limits set forth in section II.A.1.b.i. of this appendix that may be included in tier 2 capital is limited to 50 percent of tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix). Amounts of these instruments in excess of this limit, although not included in tier 2 capital, will be taken into account by the Federal Reserve in its overall assessment of a banking organization’s funding and financial condition.

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

f. Revaluation reserves. Such reserves reflect the formal balance sheet restatement or revaluation for capital purposes of asset carrying values to reflect current market values. The Federal Reserve generally has not included unrealized asset appreciation in capital ratio calculations, although it has long taken such values into account as a separate factor in assessing the overall financial strength of a banking organization.
ii. Consistent with long-standing supervisory practice, the excess of market values over book values for assets held by bank holding companies will generally not be recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all bank holding companies are encouraged to disclose their equivalent of premises (building) and security revaluation reserves. The Federal Reserve will consider any appreciation, as well as any depreciation, in specific asset values as additional considerations in assessing overall capital strength and financial condition.

B. Deductions from Capital and Other Adjustments

Certain assets are deducted from an organization’s capital for the purpose of calculating the risk-based capital ratio. These assets include:

(i) Goodwill—deducted from the sum of core capital elements.
(ii) Certain identifiable intangible assets, that is, intangible assets other than goodwill—deducted from the sum of core capital elements in accordance with section II.B.1.b. of this appendix.
(iii) Credit-enhancing interest-only strips receivables—deducted from the sum of core capital elements in accordance with sections II.B.1.c. through e. of this appendix.
(iv) Deferred tax assets—portions are deducted from the sum of core capital elements in accordance with section II.B.4. of this appendix.
(v) Nonfinancial equity investments—portions are deducted from the sum of core capital elements in accordance with section II.B.3. of this appendix.

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

Other intangible assets. All servicing assets, including servicing assets on assets other than mortgages (i.e., nonmortgage servicing assets), are included in this appendix as identifiable intangible assets. The only types of identifiable intangible assets that may be included are those that are not deducted from, an organization’s capital are readily marketable mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships.

The Federal Reserve will look to the economic substance of the transaction.

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

The amount of credit-enhancing I/Os that a bank holding company may include in capital...
shall be its fair value. If both the application of the limits on mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships and the adjustment of the balance sheet amount for these assets would result in an amount being deducted from capital, the bank holding company would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

e. Tier 1 capital limitation. i. The total amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that may be included in capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. Nonmortgage servicing assets and purchased credit card relationships are subject, in the aggregate, to a separate sublimit of 25 percent of tier 1 capital. In addition, the total amount of credit-enhancing I/Os (both purchased and retained) that may be included in capital cannot exceed 25 percent of tier 1 capital.\(^{18}\)

ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing I/Os, tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

iii. Bank holding companies may elect to deduct goodwill, disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, and disallowed credit-enhancing I/Os (both purchased and retained) on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets that are dependent upon future taxable income.

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

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

2. Investments in certain subsidiaries— a. Unconsolidated banking or finance subsidiaries. The aggregate amount of investments in banking or finance subsidiaries\(^{19}\) whose financial statements are not consolidated for accounting or regulatory reporting purposes, regardless of whether the investment is made by the parent bank holding company or its direct or indirect subsidiaries, will be deducted from the consolidated parent banking organization's total capital components.\(^{20}\) Generally, investments for this purpose are defined as equity and debt capital investments and any other instruments that

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\(^{18}\)Amounts of servicing assets, purchased credit card relationships, and credit-enhancing I/Os (both retained and purchased) in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a bank holding company's core capital elements in determining tier 1 capital. However, identifiable intangible assets (other than mortgage servicing assets and purchased credit card relationships) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

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\(^{19}\)For this purpose, a banking and finance subsidiary generally is defined as any company engaged in banking or finance in which the parent institution holds directly or indirectly more than 50 percent of the outstanding voting stock, or which is otherwise controlled or capable of being controlled by the parent institution. For purposes of this section, the definition of banking and finance subsidiary does not include a trust or other special purpose entity used to issue trust preferred securities.

\(^{20}\)An exception to this deduction would be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith. The requirements for consolidation are spelled out in the instructions to the FR Y–9C Report.
are deemed to be capital in the particular subsidiary.

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

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

b. Other subsidiaries and investments. The deduction of investments, regardless of whether they are made by the parent bank holding company or by its direct or indirect subsidiaries, from a consolidated banking organization's capital will also be applied in the case of any subsidiaries, that, while consolidated for accounting purposes, are not consolidated for certain specified supervisory or regulatory purposes, such as to facilitate functional regulation. For this purpose, aggregate capital investments (that is, the sum of any equity or debt instruments that are deemed to be capital) in these subsidiaries will be deducted from the consolidated parent banking organization's total capital components.21

Advances (that is, loans, extensions of credit, guarantees, commitments, or any other forms of credit exposure) to such subsidiaries that are not deemed to be capital will generally not be deducted from capital. Rather, such advances will normally be included in the parent banking organization's consolidated assets and assigned to the 100 percent risk category, unless such obligations are backed by recognized collateral or guarantees, in which case they will be assigned to the risk category appropriate to such collateral or guarantees. These advances may, however, be deducted from the consolidated parent banking organization's capital if, in the judgment of the Federal Reserve, the risks stemming from such advances are comparable to the risks associated with capital investments or if such advances involve other risk factors that warrant such an adjustment to capital for supervisory purposes. These other factors could include, for example, the absence of collateral support.22

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

21 Investments in unconsolidated subsidiaries will be deducted from both Tier 1 and Tier 2 capital. As a general rule, one-half (50 percent) of the aggregate amount of capital investments will be deducted from the bank holding company's Tier 1 capital and one-half (50 percent) from its Tier 2 capital. However, the Federal Reserve may, on a case-by-case basis, deduct a proportionately greater amount from Tier 1 if the risks associated with the subsidiary so warrant. If the amount deductible from Tier 2 capital exceeds actual Tier 2 capital, the excess would be deducted from Tier 1 capital. Bank holding companies' risk-based capital ratios, net of these deductions, must exceed the minimum standards set forth in section IV.

22 In assessing the overall capital adequacy of a banking organization, the Federal Reserve may also consider the organization's fully consolidated capital position.

23 If the subsidiary's assets are consolidated with the parent banking organization for financial reporting purposes, this adjustment will involve excluding the subsidiary's assets on a line-by-line basis from the consolidated parent organization's assets. The parent banking organization's capital ratio will then be calculated on a consolidated basis with the exception that the assets of the excluded subsidiary will not be consolidated with the remainder of the parent banking organization.
Federal Reserve System

The Federal Reserve will not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies. None-theless, the resources invested in these entities, like investments in unconsolidated banking and finance subsidiaries, support assets not consolidated with the rest of the banking organization’s activities and, therefore, may not be generally available to support additional lever-age or absorb losses elsewhere in the banking organization. Moreover, experience has shown that banking organizations stand behind the losses of affiliated institutions, such as joint ventures and associated companies, in order to protect the reputation of the organization as a whole. In some cases, this has led to losses that have exceeded the investments in such organizations.

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

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

1. The parent banking organization has significant influence over the financial or managerial policies or operations of the subsidiary, joint venture, or associated company;

2. The banking organization is the largest investor in the affiliated company; or

3. Other circumstances prevail that appear to closely tie the activities of the affiliated company to the parent banking organization.

3. Reciprocal holdings of banking organizations’ capital instruments. Reciprocal holdings of banking organizations’ capital instruments (that is, investments that qualify as Tier 1 or Tier 2 capital) will be deducted from an organization’s total capital components for the purpose of determining the numerator of the risk-based capital ratio.

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

i. The amount of these deferred-tax assets that the bank holding company is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year, or

ii. 10 percent of tier 1 capital.

The definition of such entities is contained in the instructions to the Consolidated Financial Statements for Bank Holding Companies. Under regulatory reporting procedures, associated companies and joint ventures generally are defined as companies in which the banking organization owns 20 to 50 percent of the voting stock.

Reciprocal holdings are cross-holdings resulting from formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other’s capital instruments. Generally, deductions will be limited to intentional cross-holdings. At present, the Board does not intend to require banking organizations to deduct non-reciprocal holdings of such capital instruments.

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

i. The amount of these deferred-tax assets that the bank holding company is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year, or

ii. 10 percent of tier 1 capital.

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i. The amount of these deferred-tax assets that the bank holding company is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year, or

ii. 10 percent of tier 1 capital.

The Federal Reserve will not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies. Nonetheless, the resources invested in these entities, like investments in unconsolidated banking and finance subsidiaries, support assets not consolidated with the rest of the banking organization’s activities and, therefore, may not be generally available to support additional lever-age or absorb losses elsewhere in the banking organization. Moreover, experience has shown that banking organizations stand behind the losses of affiliated institutions, such as joint ventures and associated companies, in order to protect the reputation of the organization as a whole. In some cases, this has led to losses that have exceeded the investments in such organizations.

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

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

1. The parent banking organization has significant influence over the financial or managerial policies or operations of the subsidiary, joint venture, or associated company;

2. The banking organization is the largest investor in the affiliated company; or

3. Other circumstances prevail that appear to closely tie the activities of the affiliated company to the parent banking organization.

3. Reciprocal holdings of banking organizations’ capital instruments. Reciprocal holdings of banking organizations’ capital instruments (that is, investments that qualify as Tier 1 or Tier 2 capital) will be deducted from an organization’s total capital components for the purpose of determining the numerator of the risk-based capital ratio.

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

i. The amount of these deferred-tax assets that the bank holding company is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year, or

ii. 10 percent of tier 1 capital.

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

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

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

1. The parent banking organization has significant influence over the financial or managerial policies or operations of the subsidiary, joint venture, or associated company;

2. The banking organization is the largest investor in the affiliated company; or

3. Other circumstances prevail that appear to closely tie the activities of the affiliated company to the parent banking organization.

3. Reciprocal holdings of banking organizations’ capital instruments. Reciprocal holdings of banking organizations’ capital instruments (that is, investments that qualify as Tier 1 or Tier 2 capital) will be deducted from an organization’s total capital components for the purpose of determining the numerator of the risk-based capital ratio.

The definition of such entities is contained in the instructions to the Consolidated Financial Statements for Bank Holding Companies. Under regulatory reporting procedures, associated companies and joint ventures generally are defined as companies in which the banking organization owns 20 to 50 percent of the voting stock.

Reciprocal holdings are cross-holdings resulting from formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other’s capital instruments. Generally, deductions will be limited to intentional cross-holdings. At present, the Board does not intend to require banking organizations to deduct non-reciprocal holdings of such capital instruments.

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

i. The amount of these deferred-tax assets that the bank holding company is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year, or

ii. 10 percent of tier 1 capital.

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

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

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

1. The parent banking organization has significant influence over the financial or managerial policies or operations of the subsidiary, joint venture, or associated company;

2. The banking organization is the largest investor in the affiliated company; or

3. Other circumstances prevail that appear to closely tie the activities of the affiliated company to the parent banking organization.

3. Reciprocal holdings of banking organizations’ capital instruments. Reciprocal holdings of banking organizations’ capital instruments (that is, investments that qualify as Tier 1 or Tier 2 capital) will be deducted from an organization’s total capital components for the purpose of determining the numerator of the risk-based capital ratio.

The definition of such entities is contained in the instructions to the Consolidated Financial Statements for Bank Holding Companies. Under regulatory reporting procedures, associated companies and joint ventures generally are defined as companies in which the banking organization owns 20 to 50 percent of the voting stock.

Reciprocal holdings are cross-holdings resulting from formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other’s capital instruments. Generally, deductions will be limited to intentional cross-holdings. At present, the Board does not intend to require banking organizations to deduct non-reciprocal holdings of such capital instruments.
b. The reported amount of deferred-tax assets, net of any valuation allowance for deferred-tax assets, in excess of the lesser of these two amounts is to be deducted from a banking organization's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os, any disallowed deferred-tax assets, and any nonfinancial equity investments. There generally is no limit in tier 1 capital on the amount of deferred-tax assets that can be realized from taxes paid in prior carry-back years or from future reversals of existing taxable temporary differences.

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

b. Scope of nonfinancial investments. A nonfinancial equity investment means any equity investment held by the bank holding company: under the merchant banking authority of section 4(k)(4)(H) of the BHC Act and subpart J of the Board's Regulation Y (12 CFR 225.175 et seq.); under section 4(c)(6) or 4(c)(7) of the BHC Act in a nonfinancial company or in a company that makes investments in nonfinancial companies; in a nonfinancial company under the portfolio investment provisions of the Board's Regulation K (12 CFR 211.8(c)(3)); or in a nonfinancial company under section 24 of the Federal Deposit Insurance Act (other than section 24(f)). A nonfinancial company is an entity that engages in any activity that has not been determined to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act (12 U.S.C. 1843(k)).

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

### Table 1—Deduction for Nonfinancial Equity Investments

<table>
<thead>
<tr>
<th>Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank holding company (as a percentage of the Tier 1 capital of the parent banking organization)</th>
<th>Deduction from Core Capital Elements (as a percentage of the adjusted carrying value of the investment)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 15 percent</td>
<td>8 percent.</td>
</tr>
<tr>
<td>15 percent to 24.99 percent</td>
<td>12 percent.</td>
</tr>
<tr>
<td>25 percent and above</td>
<td>25 percent.</td>
</tr>
</tbody>
</table>

1. For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of Tier 1 capital, Tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, but prior to the deduction for any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

ii. These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent holding company's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank holding company equals 20 percent of the Tier 1 capital of the bank holding company, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the company’s Tier 1 capital, and 12 percent acting directly in exceptional cases and after a review of the proposed activity, has permitted a lesser capital deduction for an investment approved by the Board of Directors under section 24 of the Federal Deposit Insurance Act, such deduction shall also apply to the consolidated bank holding company capital calculation so long as the bank’s investments under section 24 and SBIC investments represent, in the aggregate, less than 15 percent of the Tier 1 capital of the bank.
of the adjusted carrying value of all investments in excess of 15 percent of the company's Tier 1 capital.

iii. The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under this paragraph is excluded from the bank holding company's risk-weighted assets for purposes of computing the denominator of the company's risk-based capital ratio. 29

d. SBIC investments. i. No deduction is required for nonfinancial equity investments that are held by a bank holding company through one or more SBICs that are consolidated with the bank holding company or in one or more SBICs that are not consolidated with the bank holding company to the extent that all such investments, in the aggregate, do not exceed 15 percent of the aggregate Tier 1 capital of the company's subsidiary banks. Any nonfinancial equity investment that is held through or in an SBIC and required to be deducted from Tier 1 capital under this section II.B.5.d. will be assigned a 100 percent risk-weight and included in the parent holding company's consolidated risk-weighted assets. 30

ii. To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holding company holds through one or more SBICs that are consolidated with the bank holding company or in one or more SBICs that are not consolidated with the bank holding company exceeds, in the aggregate, 15 percent of the aggregate Tier 1 capital of the company's subsidiary banks, the appropriate percentage of such amounts (as set forth in Table I) must be deducted from the bank holding company's core capital elements. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held through a consolidated SBIC and in a non-consolidated SBIC (including any investments for which no deduction is required) must be included in determining, for purposes of Table I, the total amount of nonfinancial equity investments held by the bank holding company in relation to its Tier 1 capital.

e. Transition provisions. No deduction under this section II.B.5 is required to be made with respect to the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that was made by the bank holding company prior to March 13, 2000, or that was made after such time.

Footnotes:

29 If a bank holding company has an investment in an SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank holding company, the adjusted carrying value of the bank holding company's nonfinancial equity investments through the SBIC is equal to the holding company's proportionate share of the adjusted carrying value of the SBIC's equity investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (i.e. the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank holding company. If a bank holding company 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 holding company may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the appropriate adjustment to the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. If a bank holding company reduces the adjusted carrying value of its investment in a non-consolidated SBIC to reflect financial investments of the SBIC, the amount of the adjustment will be risk weighted at 100 percent and included in the bank's risk-weighted assets.
date pursuant to a binding written commitment 31 entered into by the bank holding company prior to March 13, 2000, provided that in either case the bank holding company has continuously held the investment since the relevant investment date. 32 For purposes of this section II.B.5.e., a nonfinancial equity investment made prior to March 13, 2000, includes any shares or other interests received by the bank holding company through a stock split or stock dividend on an investment made prior to March 13, 2000, provided the bank holding company provides no consideration for the shares or interests received and the transaction does not materially increase the bank’s holding company’s proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired prior to March 13, 2000, is not considered to be an investment made prior to March 13, 2000, if the bank holding company provides no consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.5.e. must be included in determining the total amount of nonfinancial equity investments held by the bank holding company in relation to its Tier 1 capital for purposes of Table I. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.5.e. will be assigned a 100-percent risk weight and included in the bank holding company’s consolidated risk-weighted assets.

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

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

33 Unrealized gains on AFS investments may be included in supplementary capital to the extent permitted under section II.A.2.e of this appendix A. In addition, the unrealized losses on AFS equity investments are deducted from Tier 1 capital in accordance with section II.A.1.a of this appendix A.
trust certificates and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity where the instrument or feature is held under one of the legal authorities listed in section II.B.6.b. of this appendix. An investment in any other instrument (including subordinated debt) may be treated as an equity investment if, in the judgment of the Federal Reserve, the instrument is the functional equivalent of equity or exposes the state member bank to essentially the same risks as an equity instrument.

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

[Using the Year-End 1992 Standard]

<table>
<thead>
<tr>
<th>Components</th>
<th>Minimum requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>CORE CAPITAL (Tier 1)</td>
<td>Must equal or exceed 4% of weighted-risk assets.</td>
</tr>
<tr>
<td>Common stockholders’ equity</td>
<td>No limit.</td>
</tr>
<tr>
<td>Qualifying noncumulative perpetual preferred stock</td>
<td>Limited to 25% of the sum of common stock, qualifying per</td>
</tr>
<tr>
<td>Qualifying cumulative perpetual preferred stock</td>
<td></td>
</tr>
<tr>
<td>Minority interest in equity accounts of consolidated subsidiaries.</td>
<td>Organizations should avoid using minority interests to in</td>
</tr>
<tr>
<td>Risk assets and off-balance sheet items</td>
<td>stroduce elements not otherwise qualifying for tier 1 cap</td>
</tr>
<tr>
<td>Risk assets and off-balance sheet items</td>
<td>tial.</td>
</tr>
<tr>
<td>A. Procedures</td>
<td></td>
</tr>
</tbody>
</table>
| Risk weights for all off-balance sheet items are determined by a two-step process. First, the “credit equivalent amount” of off-balance sheet items is determined, in most cases, by multiplying the off-balance sheet item by a credit conversion factor. Second, the credit equivalent amount is treated like any balance sheet asset and generally is assigned to the appropriate risk category according to the obligor, or, if relevant, the guarantor or the nature of the collateral.

In general, if a particular item qualifies for placement in more than one risk category, it is assigned to the category that has the lowest risk weight. A holding of a U.S. municipal revenue bond that is fully guaranteed by a U.S. bank, for example, would be assigned the 20 percent risk weight appropriate to claims guaranteed by U.S. banks, rather than the 5 percent risk weight associated with a trust certificate.

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

1. Requirements for the deduction of other intangible assets and residual interests are set forth in section II.B.7. of this appendix.

2. Amounts in excess of limitations are permitted but do not qualify as capital.

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

4. See discussion in section II of the guidelines for a complete description of the requirements for, and the limitations on, the components of qualifying capital.
than the 50 percent risk weight appropriate to U.S. municipal revenue bonds. 34

The Federal Reserve will, on a case-by-case basis, determine the appropriate risk weight for any asset or credit equivalent amount of an off-balance sheet item that does not fit wholly within the terms of one of the risk weight categories set forth below or that imposes risks on a banking organization that are incommensurate with the risk weight otherwise specified below for the asset or off-balance sheet item. In making such a determination, the Federal Reserve will consider the similarity of the asset or off-balance sheet item to assets or off-balance sheet items explicitly treated in the guidelines, as well as other relevant factors.

B. Collateral, Guarantees, and Other Considerations

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

With regard to collateralized claims that may be assigned to the 20 percent risk-weight category, the extent to which qualifying securities are recognized as collateral is determined by their current market value. If such a claim is only partially secured, that is, the market value of the pledged securities is less than the face amount of a balance-sheet asset or an off-balance-sheet item, the...
portion that is covered by the market value of the qualifying collateral is assigned to the 20 percent risk category, and the portion of the claim that is not covered by collateral is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor. For example, to the extent that a claim on a prior purchase of a state guarantee, is to be apportioned between the two risk categories appropriate to the guarantors. The existence of other forms of collateral or guarantees that the risk-based capital framework does not formally recognize may be taken into consideration in evaluating the risks inherent in an organization's loan portfolio—which, in turn, would affect the overall supervisory assessment of the organization's capital adequacy.

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

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

ii. Credit-enhancing representations and warranties that are made or assumed in connection with a transfer of assets (including loan servicing assets) and that obligate the bank holding company 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 of another party or from an insufficiency in the value of the collateral. Credit-enhancing representations and warranties do not include:

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

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

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

iii. Direct credit substitute means an arrangement in which a bank holding company assumes, in form or in substance, credit risk associated with an on- or off-balance sheet credit exposure that was not previously owned by the bank holding company. If the bank holding company exceeds the pro rata share of the bank holding company’s interest in the third-party asset, then the bank holding company’s assumption of any credit risk with respect to the third party asset is a direct credit substitute. Direct credit substitutes include, but are not limited to:

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

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

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

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

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

6. Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with
respect to the loans serviced. Mortgage servicer cash advances that meet the conditions of section III.B.3.a.viii. of this appendix are not direct credit substitutes.

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

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

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

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

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

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

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

1. To repay money borrowed by, or advanced to, or for the account of, a second party (the account party), or
2. To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

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

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

1. The servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or
2. For any one loan, the servicer’s obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal balance of that loan.

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

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

1. Credit-enhancing representations and warranties made on the transferred assets;
2. Loan servicing assets retained pursuant to an agreement under which the bank holding company will be responsible for credit losses associated with the loans being serviced. Mortgage servicer cash advances that meet the conditions of section III.B.3.a.x. of this appendix are not recourse arrangements;
3. Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets;
4. Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;
5. Loan strips sold without contractual recourse where the maturity of the transferred
6. Credit derivatives issued that absorb more than the bank holding company's pro rata share of losses from the transferred assets;
7. Clean-up calls at inception that are greater than 10 percent of the balance of the original pool of transferred loans. Clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option of the bank holding company are not recourse arrangements; and
8. Liquidity facilities that provide liquidity support to ABCP (other than eligible ABCP liquidity facilities).

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

xiv. Risk participation means a participation in which the originating party remains liable to the beneficiary for the full amount of an obligation (e.g., a direct credit substitute) notwithstanding that another party has acquired a participation in that obligation. The treatment of direct credit substitutes that have been syndicated or in which risk participations have been conveyed or acquired is set forth in section III.D.1 of this appendix.

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

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

xvii. Structured finance program means a program where receivable interests and asset-backed securities issued by multiple participants are purchased by a special purpose entity that repackages those exposures into securities that can be sold to investors. Structured finance programs allocate credit risks, generally, between the participants and credit enhancement provided to the program.

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

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

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

3. Externally-rated positions: credit-equivalent amounts and risk weights of recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities (including asset-backed commercial paper)—i. Traded positions. With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing IO/Ostriп) or asset- and mortgage-backed security (including asset-backed commercial paper) that is a traded position and that has received an external rating on a long-term
position that is one grade below investment grade or better or a short-term rating that is investment grade, the bank holding company may multiply the face amount of the position by the appropriate risk weight, determined in accordance with the tables below. Stripped mortgage-backed securities and other similar instruments, such as interest-only or principal-only strips that are not credit enhancements, must be assigned to the 100 percent risk category. If a traded position has received more than one external rating, the lowest single rating will apply.

<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–1, A–2</td>
<td>50</td>
</tr>
<tr>
<td>Lowest investment grade</td>
<td>BBB</td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Short-term rating</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>

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

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

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

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

e. Capital requirement for residual interests—
   i. Capital requirement for credit-enhancing I/O strips. After applying the concentration limit to credit-enhancing I/O strips (both purchased and retained) in accordance with sections II.B.2.c. through e. of this appendix, a bank holding company must maintain risk-based capital for a credit-enhancing I/O strip (both purchased and retained), regardless of the external rating on that position, equal to the remaining amount of the credit-enhancing I/O (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing I/O strip will be treated as if the credit-enhancing I/O strip was retained by the bank holding company and not transferred.
   ii. Capital requirement for other residual interests. If a residual interest does not meet the requirements of sections III.B.3.c. or d. of this appendix, a bank holding company must maintain risk-based capital equal to the remaining amount of the residual interest that is retained on the balance sheet (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest was retained by the bank holding company and not transferred.

Where the aggregate capital requirement for residual interests and other recourse obligations in connection with the same transfer of assets exceed the full risk-based capital requirement for those assets, a bank holding company must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under section III.B.3.e.ii.i. of...
The bank holding company must have an internal credit risk system that is an integral part of the bank holding company's risk management system, which explicitly incorporates the full range of risks arising from a bank holding company's participation in securitization activities.

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

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

4. The bank holding company's internal credit risk system must identify gradations of risk among “pass” assets and other risk positions.

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

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

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

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

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

Program Ratings. A direct credit substitute or recourse obligation (other than a purchased credit-enhancing I/O) is assumed in connection with a structured finance program sponsored by the bank holding company to use this approach on a programmatic basis. The bank holding company must demonstrate to the Federal Reserve’s satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular position. If a bank holding company participates in a securitization sponsored by another party, the Federal Reserve may authorize the bank holding company to use this approach based on a programmatic rating obtained by the sponsor of the program.

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

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

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

iii. Related on-balance sheet assets. If a recourse obligation or direct credit substitute is subject to section III.B.3. of this appendix also appears as a balance sheet asset, the balance sheet asset is not included in an organization’s risk-weighted assets to the extent the value of the balance sheet asset is already included in the off-balance sheet credit equivalent amount for the recourse obligation or direct credit substitute, except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In that case, both the on-balance sheet assets and the related recourse obligations and direct credit substitutes are incorporated into the risk-based capital calculation.

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

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

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

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

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

b. A bank holding company that qualifies as a primary beneficiary and must consolidate an ABCP program that is defined as a variable interest entity under GAAP may exclude the consolidated ABCP program assets from risk-weighted assets provided that the bank holding company is the sponsor of the ABCP program. If a bank holding company excludes such consolidated ABCP program assets, the ABCP program must meet the criteria set forth in section III.B.5.d. of this appendix.
assets, the bank holding company must assess the appropriate risk-based capital charge against any exposures of the organization arising in connection with such ABCP programs, including direct credit substitutes, recourse obligations, residual interests, liquidity facilities, and loans, in accordance with sections III.B.3., III.C., and III.D. of this appendix.

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

C. Risk Weights

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

1. Category 1: zero percent. This category includes cash (domestic and foreign) owned and held in all offices of subsidiary depository institutions or in transit and gold bullion held in either a subsidiary depository institution’s own vaults or in another’s vaults on an allocated basis, to the extent it is offset by gold bullion liabilities.36 The category also includes all direct claims (including securities, loans, and leases) on, and the portions of claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that subsidiary depository institutions have liabilities booked in that currency. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. Government or its agencies that are actively traded in financial markets, such as GNMA securities, are considered to be unconditionally guaranteed.

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

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

2. Category 2: 20 percent. a. This category includes cash items in the process of collection, both foreign and domestic; short-term claims (including demand deposits) on, and the portions of short-term claims that are

36All other holdings of bullion are assigned to the 100 percent risk category.

37A central government is defined to include departments and ministries, including the central bank, of the central government. The U.S. central bank includes the 12 Federal Reserve Banks, and stock held in these banks as a condition of membership is assigned to the zero percent risk category. The definition of central government does not include state, provincial, or local governments; or commercial enterprises whose obligations are guaranteed by the central government, although any claims on such entities guaranteed by central governments are placed in the same general risk category as other claims guaranteed by central governments. OECD central governments are defined as central governments of the OECD-based group of countries; non-OECD central governments are defined as central governments of countries that do not belong to the OECD-based group of countries.

38A U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government. Such agencies include the Government National Mortgage Association (GNMA), the Veterans Administration (VA), the Federal Housing Administration (FHA), the Export-Import Bank (Exim Bank), the Overseas Private Investment Corporation (OPIC), the Commodity Credit Corporation (CCC), and the Small Business Administration (SBA).
guaranteed by, U.S. depository institutions and foreign banks; and long-term claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions or regional development banks. This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. government agencies, as well as the portions of local currency claims that are conditionally guaranteed by non-OECD central governments, to the extent that subsidiary depository institutions have liabilities booked in that currency. In addition, this category also includes claims on, and the portions of claims that are guaranteed by, U.S. government-sponsored agencies and claims on, government to serve public purposes specifically established or chartered by the Federal government. For this purpose, the definition also includes U.S.-chartered depository institutions owned by foreigners. However, branches and agencies of foreign banks located in the U.S., as well as all bank holding companies, are excluded. Claims guaranteed by U.S. depository institutions and foreign banks include risk participations in both bankers acceptances and standby letters of credit, as well as participations in commitments, that are conveyed to U.S. depository institutions or foreign banks.

### For this purpose, the definition also includes U.S.-chartered depository institutions owned by foreigners. However, branches and agencies of foreign banks located in the U.S., as well as all bank holding companies, are excluded.###

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

### For this purpose, the definition also includes U.S.-chartered depository institutions owned by foreigners. However, branches and agencies of foreign banks located in the U.S., as well as all bank holding companies, are excluded.###

Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirement are not eligible for this risk weight.

### With regard to securities firms incorporated in the United States, qualifying securities firms are those securities firms that are broker-dealers registered with the Securities and Exchange Commission and are in compliance with the SEC’s net capital rule, 17 CFR 240.15c3-1. With regard to securities firms incorporated in other countries in the OECD-based group of countries, qualifying securities firms are those securities firms that a banking organization is able to demonstrate are subject to consolidated supervision and regulation (covering their direct and indirect subsidiaries, but not necessarily their parent organizations) comparable to that imposed on banks in OECD countries.

Claims on, or guaranteed by, a qualifying securities firm incorporated in the United States or on a qualifying securities firm incorporated in another country in the OECD-based group of countries are placed in the 100 percent risk category. Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirement are not eligible for this risk weight.

### Claims on, or guaranteed by, a qualifying securities firm incorporated in the United States or on a qualifying securities firm incorporated in another country in the OECD-based group of countries are placed in the 100 percent risk category.###

Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirement are not eligible for this risk weight.

### Claims on, or guaranteed by, a qualifying securities firm incorporated in the United States or on a qualifying securities firm incorporated in another country in the OECD-based group of countries are placed in the 100 percent risk category.###

Claims on, or guaranteed by, a qualifying securities firm incorporated in the United States or on a qualifying securities firm incorporated in another country in the OECD-based group of countries are placed in the 100 percent risk category. Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirement are not eligible for this risk weight.

### Claims on, or guaranteed by, a qualifying securities firm incorporated in the United States or on a qualifying securities firm incorporated in another country in the OECD-based group of countries are placed in the 100 percent risk category.###

Claims on, or guaranteed by, a qualifying securities firm incorporated in the United States or on a qualifying securities firm incorporated in another country in the OECD-based group of countries are placed in the 100 percent risk category. Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirement are not eligible for this risk weight.

### Claims on, or guaranteed by, a qualifying securities firm incorporated in the United States or on a qualifying securities firm incorporated in another country in the OECD-based group of countries are placed in the 100 percent risk category.###

Claims on, or guaranteed by, a qualifying securities firm incorporated in the United States or on a qualifying securities firm incorporated in another country in the OECD-based group of countries are placed in the 100 percent risk category. Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirement are not eligible for this risk weight.

### Claims on, or guaranteed by, a qualifying securities firm incorporated in the United States or on a qualifying securities firm incorporated in another country in the OECD-based group of countries are placed in the 100 percent risk category.###

Claims on, or guaranteed by, a qualifying securities firm incorporated in the United States or on a qualifying securities firm incorporated in another country in the OECD-based group of countries are placed in the 100 percent risk category. Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirement are not eligible for this risk weight.
other member of the OECD-based group of countries provided that: the qualifying securities firm has a long-term issuer credit rating, or a rating on at least one issue of long-term debt, in one of the three highest investment grade rating categories from a nationally recognized statistical rating organization; or the claim is guaranteed by the firm’s parent company and the parent company has such a rating. If ratings are available from more than one rating agency, the lowest rating will be used to determine whether the rating requirement has been met. This category also includes a collateralized claim on a qualifying securities firm in such a country, without regard to satisfaction of the rating standard, provided the claim arises under a contract that:

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

Category 3: 50 percent. This category includes loans fully secured by first liens on 1- to 4-family residential properties, either owner-occupied or rented, or on multifamily residential properties. Loans in this category must have been made in accordance with prudent underwriting standards; be performed in accordance with their original terms; and not be 90 days or more past due or carried in nonaccrual status. For purposes of this 50 percent risk weight category, a loan modified on a permanent or trial basis solely pursuant to the U.S. Department of Treasury’s Home Affordable Mortgage Program

47For example, a claim is exempt from the automatic stay in bankruptcy in the United States if it arises under a securities contract or repurchase agreement subject to section 559 of the Bankruptcy Code, respectively (11 U.S.C. 559 or 559), a qualified financial contract under section 11A(b)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1829(a)(8)), or a netting contract between financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4402–4407), or the Board’s Regulation EE (12 CFR Part 231).

48If a banking organization holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purposes of determining the loan-to-value ratio and assigning a risk weight.
will be considered to be performing in accordance with its original terms. The following additional criteria must also be applied to a loan secured by a multifamily residential property, each underlying mortgage meets the criteria described above in this section for eligibility for the 50 percent risk category at the time the pool is originated; (3) If the security is backed by privately-issued mortgage-backed securities, each underlying security qualifies for the 50 percent risk category; and (4) If the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due. Privately-issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

Also assigned to this category are revenue (non-general obligation) bonds or similar obligations, including loans and leases, that are obligations of states or other political subdivisions of the U.S. (for example, municipal revenue bonds) or other countries of the OECD-based group, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds. Credit equivalent amounts of derivative contracts involving standard risk obligors (that is, obligors whose loans or debt securities would be assigned to the 100 percent risk category) are included in the 50 percent category, unless they are backed by collateral or guarantees that allow them to be placed in a lower risk category.

4. Category 4: 100 percent. a. All assets not included in the categories above are assigned to this category, which comprises standard credit risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

b. This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk. This category includes all claims on foreign and domestic private parties, for which no credit equivalent amounts of derivative contracts involving standard risk obligors are assigned to the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight). This category also includes claims representing capital of qualifying securities firms.

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

52 Such assets include all nonlocal currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local currency claims on, or guaranteed by, non-OECD central governments that exceed the local currency liabilities held by subsidiary depository institutions.

53 Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.
all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

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

D. Off-Balance Sheet Items

The face amount of an off-balance sheet item is generally incorporated into risk-weighted assets in two steps. The face amount is first multiplied by a credit conversion factor, except for direct credit substitutes and recourse obligations as discussed in section III.D.1 of this appendix. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor, the nature of any collateral, or external credit ratings.54

1. Items with a 100 percent conversion factor.

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

b. Sale and repurchase agreements and forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,55 and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

c. Securities lent by a banking organization are treated in one of two ways, depending upon whether the lender is at risk of loss. If a banking organization, as agent for a customer, lends the customer’s securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. If, alternatively, a banking organization lends its own securities or, acting as agent for a customer, lends the customer’s securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor, or, if applicable, to any collateral delivered to the lending organization, or the independent custodian acting on the lending organization’s behalf. Where a banking organization is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the banking organization, the transaction is deemed to be collateralized by cash on deposit in a subsidiary depository institution for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

d. In the case of direct credit substitutes in which a risk participation56 has been conveyed, the full amount of the assets that are supported, in whole or in part, by the credit enhancement are converted to a credit equivalent amount at 100 percent. However, the pro rata share of the credit equivalent amount that has been conveyed through a risk participation is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after considering any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation.57 Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the pro rata share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the 20 percent risk category.58

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

55 Forward forward deposits accepted are treated as interest rate contracts.

56 That is, a participation in which the originating banking organization remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

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

58 Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk...
e. In the case of direct credit substitutes in which a risk participation has been acquired, the acquiring banking organization's percentage share of the direct credit substitute is multiplied by the full amount of the assets that are supported, in whole or in part, by the credit enhancement and converted to a credit equivalent amount at 100 percent. The credit equivalent amount of an acquisition of a risk participation in a direct credit substitute is assigned to the risk category appropriate to the account party obligor or, if relevant, the nature of the collateral or guarantees.

f. In the case of direct credit substitutes that take the form of a syndication where each banking organization is obligated only for its pro rata share of the risk and there is no recourse to the originating banking organization, each banking organization will only include its pro rata share of the assets supported, in whole or in part, by the direct credit substitute in its risk-based capital calculation.59

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

b. The unused portion of commitments with an original maturity exceeding one year, including underwriting commitments, and commercial and consumer credit commitments also are converted at 50 percent. Original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which: (1) The banking organization can, at its option, unconditionally (without cause) cancel the commitment;60 and (2) the banking organization is deemed able to unconditionally cancel the commitment for the purpose of this criterion if, at its option, it can prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by relevant Federal law.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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<th>Conversion Factors</th>
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<td>(In percent)</td>
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<tr>
<td>Remaining maturity</td>
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<td>One year or less</td>
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(d) For a contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity is equal to the time until the next reset date. For an interest rate contract with a remaining maturity of more than one year that meets these criteria, the minimum conversion factor is 0.5 percent.

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

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

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

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

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

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

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

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

3. The law that governs the netting contract.

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

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

b. A contract containing a walkaway clause is not eligible for netting for purposes
of calculating the credit equivalent amount.\(^6\)

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

d. The credit equivalent amount of contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract (net current exposure) and (ii) the sum of the estimates of potential future credit exposures on all individual contracts subject to the netting contract (gross potential future exposure) adjusted to reflect the effects of the netting contract.\(^6\)

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

\(^6\)A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than would otherwise be required under the contract, or no payment at all, to a defaultor or to the estate of a defaultor, even if the defaultor or the estate of the defaultor is a net creditor under the contract.

\(^6\)For purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.

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

\(^6\)For purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.

\(^6\)A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than would otherwise be required under the contract, or no payment at all, to a defaultor or to the estate of a defaultor, even if the defaultor or the estate of the defaultor is a net creditor under the contract.

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\(^6\)For purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.
of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the credit equivalent amount of such contracts is 50 percent. However, the maximum risk weight applicable to the credit equivalent amount of such contracts is 50 percent.

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

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

IV. Minimum Supervisory Ratios and Standards

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

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

Upon adoption of the risk-based framework, any organization that does not meet the interim or final supervisory ratios, or whose capital is otherwise considered inadequate, is expected to develop and implement a plan acceptable to the Federal Reserve for achieving an adequate level of capital consistent with the provisions of these guidelines or with the special circumstances affecting the individual organization. In addition, such organizations should avoid any actions, including increased risk-taking or unwarranted expansion, that would lower or further erode their capital positions.

A. Minimum Risk-Based Ratio After Transition Period

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

Qualifying total capital is calculated by adding Tier 1 capital and Tier 2 capital (limited to 100 percent of Tier 1 capital) and then deducting from this sum certain investments in banking or finance subsidiaries that are not consolidated for accounting or supervisory purposes, reciprocal holdings of banking organizations' capital securities, or other...

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63For derivative contracts, sufficiency of collateral or guarantees is generally determined by the market value of the collateral or the amount of the guarantee in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B. of this appendix A.

64As noted in section I, bank holding companies with less than $500 million in consolidated assets would generally be exempt from the calculation and analysis of risk-based ratios on a consolidated holding company basis, subject to certain terms and conditions.
items at the direction of the Federal Reserve. The conditions under which these deductions are to be made and the procedures for making the deductions are discussed above in section II(B).

B. Transition Arrangements

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

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

ATTACHMENT I—SAMPLE CALCULATION OF RISK-BASED CAPITAL RATIO FOR BANK HOLDING COMPANIES

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

**Balance Sheet Assets:**
- Cash ........................................................... $5,000
- U.S. Treasuries ........................................... 20,000
- Balances at domestic banks ...................... 5,000
- Loans secured by first liens on 1–4 family residential properties ........... 5,000
- Loans to private corporations ................. 65,000
- Total Balance Sheet Assets ................... $100,000

**Off-Balance Sheet Items:**
- Standby letters of credit ("SLCs") backing general obligation debt issues of U.S. municipalities ("GOs") .................... $10,000
- Long-term legally binding commitments to private corporations ........... $20,000
- Total Off/Balance Sheet Items ................ $30,000

This bank holding company’s total capital to total assets (leverage) ratio would be: ($6,000/$100,000)=6.00%.

To compute the bank holding company’s weighted risk assets:

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

<table>
<thead>
<tr>
<th>OBS Item</th>
<th>Face Value</th>
<th>Conversion Factor</th>
<th>Credit Equivalent Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>SLCs backing municipal GOs</td>
<td>$10,000</td>
<td>1.00</td>
<td>$10,000</td>
</tr>
<tr>
<td>Long-term commitments to private corporations</td>
<td>$20,000</td>
<td>0.50</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

2. Multiply each balance sheet asset and the credit equivalent amount of each OBS item by the appropriate risk weight.

<table>
<thead>
<tr>
<th>Category</th>
<th>Asset</th>
<th>Risk Weight</th>
<th>Credit Equivalent Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>0% Category</td>
<td>Cash</td>
<td>0%</td>
<td>$5,000</td>
</tr>
<tr>
<td></td>
<td>U.S. Treasuries</td>
<td>0%</td>
<td>$20,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$25,000</td>
</tr>
<tr>
<td>20% Category</td>
<td>Balances at domestic banks</td>
<td>20%</td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td>Credit equivalent amounts of SLCs backing GOs of U.S. municipalities</td>
<td>20%</td>
<td>$10,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$25,000</td>
</tr>
<tr>
<td>50% Category</td>
<td>Loans secured by first liens on 1–4 family residential properties</td>
<td>50%</td>
<td>$2,500</td>
</tr>
<tr>
<td>100% Category</td>
<td>Loans to private corporations</td>
<td>100%</td>
<td>$75,000</td>
</tr>
<tr>
<td></td>
<td>Credit equivalent amounts of long-term commitments to private corporations</td>
<td>100%</td>
<td>$10,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$85,000</td>
</tr>
</tbody>
</table>

Total Risk-weighted Assets .................................................. 80,500

This bank holding company’s ratio of total capital to weighted risk assets (risk-based capital ratio) would be: ($6,000/$80,500)=7.45%.
The Board of Governors of the Federal Reserve System has adopted minimum capital ratios and guidelines to provide a framework for assessing the adequacy of the capital of bank holding companies and state member banks (collectively “banking organizations’’). The guidelines generally apply to all state member banks and bank holding companies regardless of size and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board of Governors will review the guidelines from time to time for possible adjustment commensurate with changes in the economy, financial markets, and banking practices. In this regard, the Board has determined that during the transition period through year-end 1990 for implementation of the risk-based capital guidelines contained in appendix A to part 225, a banking organization may choose to fulfill the requirements of the guidelines relating capital to total assets contained in this appendix in two manners. Until year-end 1990, a banking organization may choose to conform to either the 5.5 percent and 6 percent minimum primary and total capital standards set forth in this appendix, or the 7.25 percent year-end 1990 minimum risk-based capital standard set forth in appendix A to part 208. These organizations that choose to conform during this period to the 7.25 percent year-end 1990 risk-based capital standard will be deemed to be in compliance with the capital adequacy guidelines set forth in this appendix.

Two principal measurements of capital are used—the primary capital ratio and the total capital ratio. The definitions of primary and total capital for banks and bank holding companies and formulas for calculating the capital ratios are set forth below in the definitional sections of these guidelines.

**Capital Guidelines**

The Board has established a minimum level of primary capital to total assets of 5.5 percent and a minimum level of total capital to total assets of 6.0 percent. Generally, banking organizations are expected to operate above the minimum primary and total capital levels. Those organizations whose operations involve or are exposed to high or inordinate degrees of risk will be expected to hold additional capital to compensate for these risks.

In addition, the Board has established the following three zones for total capital for banking organizations of all sizes:

<table>
<thead>
<tr>
<th>Zone</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zone 1</td>
<td>Above 7.0.</td>
</tr>
<tr>
<td>Zone 2</td>
<td>6.0 to 7.0.</td>
</tr>
<tr>
<td>Zone 3</td>
<td>Below 6.0.</td>
</tr>
</tbody>
</table>

The capital guidelines assume adequate liquidity and a moderate amount of risk in the loan and investment portfolios and in off-balance sheet activities. The Board is concerned that some banking organizations may attempt to comply with the guidelines in ways that reduce their liquidity or increase risk. Banking organizations should avoid the practice of attempting to meet the guidelines by decreasing the level of liquid assets in relation to total assets. In assessing compliance with the guidelines, the Federal Reserve will take into account liquidity and the overall degree of risk associated with an organization’s operations, including the volume of assets exposed to risk.

The Federal Reserve will also take into account the sale of loans or other assets with recourse and the volume and nature of all off-balance sheet risk. Particularly close attention will be directed to risks associated with standby letters of credit and participation in joint venture activities. The Federal Reserve will review the relationship of all on- and off-balance sheet risks to capital and will require those institutions with high or inordinate levels of risk to hold additional primary capital. In addition, the Federal Reserve will continue to review the need for more explicit procedures for factoring on- and off-balance sheet risks into the assessment of capital adequacy.

The capital guidelines apply to both banks and bank holding companies on a consolidated basis. Some banking organizations are engaged in significant nonbanking activities that typically require capital ratios.