more than 50 per centum of the total value of shares of all classes of stock.

[Reg. X, 48 FR 56572, Dec. 22, 1983, as amended by Reg. X, 63 FR 2839, Jan. 16, 1998]

§ 224.3 Margin regulations to be applied by nonexempted borrowers.

(a) *Credit transactions outside the United States.* No borrower shall obtain purpose credit from outside the United States unless it conforms to the following margin regulations:

(1) Regulation T (12 CFR part 220) if the credit is obtained from a foreign branch of a broker-dealer;

(2) Regulation U (12 CFR part 221), as it applies to banks, if the credit is obtained from a foreign branch of a bank, except for the requirement of a purpose statement (12 CFR 221.3(c)(1)(i) and (c)(2)(i)); and

(3) Regulation U (12 CFR part 221), as it applies to nonbank lenders, if the credit is obtained from any other lender outside the United States, except for the requirement of a purpose statement (12 CFR 221.3(c)(1)(ii) and (c)(2)(ii)).

(b) *Credit transactions within the United States.* Any borrower who willfully causes credit to be extended in contravention of Regulations T and U (12 CFR parts 220 and 221), and who, therefore, is not exempted by § 224.1(b)(1), must conform the credit to the margin regulation that applies to the lender.

[Reg. X, 63 FR 2839, Jan. 16, 1998]

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

REGULATIONS

Subpart A—General Provisions

Subpart B—Acquisition of Bank Securities or Assets

Subpart C—Nonbanking Activities and Acquisitions by Bank Holding Companies

Subpart D—Control and Divestiture Proceedings

Subpart E—Change in Bank Control

Subpart F—Limitations on Nonbank Banks

Subpart G—Appraisal Standards for Federally Related Transactions

Subpart H—Notice of Addition or Change of Directors and Senior Executive Officers

Subpart I—Financial Holding Companies

INTERPRETATIONS

AUTHORITY: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p–1, 1843(c)(8), 1844(b), 1851, 1972(1), 3106, 3108, 3310, 3331–3351, 3907, and 3909; 15 U.S.C. 6801 and 6805.

SOURCE: Reg. Y, 49 FR 818, Jan. 5, 1984, unless otherwise noted.

EDITORIAL NOTE: Nomenclature changes for part 225 appear at 69 FR 77618, Dec. 28, 2004.

REGULATIONS

Subpart A—General Provisions

SOURCE: Reg. Y, 62 FR 9319, Feb. 28, 1997, unless otherwise noted.

§ 225.1 Authority, purpose, and scope.

(a) *Authority*. This part[1] (Regulation Y) is issued by the Board of Governors of the Federal Reserve System (*Board*) under section 5(b) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1844(b)) (*BHC Act*); sections 8 and 13(a) of the International Banking Act of 1978 (12 U.S.C. 3106 and 3108); section 7(j)(13) of the Federal Deposit Insurance Act, as amended by the Change in Bank Control Act of 1978 (12 U.S.C. 1817(j)(13)) (*Bank Control Act*); section 8(b) of the Federal Deposit Insurance Act (12 U.S.C. 1818(b)); section 914 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (12 U.S.C. 1831i); section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972); and the International Lending Supervision Act of 1983 (Pub. L. 98–181, title IX). The BHC Act is codified at 12 U.S.C. 1841, *et seq.*

(b) *Purpose*. The principal purposes of this part are to:

(1) Regulate the acquisition of control of banks by companies and individuals;

[1] Code of Federal Regulations, title 12, chapter II, part 225.

(2) Define and regulate the nonbanking activities in which bank holding companies and foreign banking organizations with United States operations may engage; and

(3) Set forth the procedures for securing approval for these transactions and activities.

(c) *Scope*—(1) *Subpart A* contains general provisions and definitions of terms used in this regulation.

(2) *Subpart B* governs acquisitions of bank or bank holding company securities and assets by bank holding companies or by any company that will become a bank holding company as a result of the acquisition.

(3) *Subpart C* defines and regulates the nonbanking activities in which bank holding companies and foreign banking organizations may engage directly or through a subsidiary. The Board's Regulation K governs certain nonbanking activities conducted by foreign banking organizations and certain foreign activities conducted by bank holding companies (12 CFR part 211, International Banking Operations).

(4) *Subpart D* specifies situations in which a company is presumed to control voting securities or to have the power to exercise a controlling influence over the management or policies of a bank or other company; sets forth the procedures for making a control determination; and provides rules governing the effectiveness of divestitures by bank holding companies.

(5) *Subpart E* governs changes in bank control resulting from the acquisition by individuals or companies (other than bank holding companies) of voting securities of a bank holding company or state member bank of the Federal Reserve System.

(6) *Subpart F* specifies the limitations that govern companies that control so-called nonbank banks and the activities of nonbank banks.

(7) *Subpart G* prescribes minimum standards that apply to the performance of real estate appraisals and identifies transactions that require state certified appraisers.

(8) *Subpart H* identifies the circumstances when written notice must be provided to the Board prior to the appointment of a director or senior officer of a bank holding company and establishes procedures for obtaining the required Board approval.

(9) Subpart I establishes the procedure by which a bank holding company may elect to become a financial holding company, enumerates the consequences if a financial holding company ceases to meet a requirement applicable to a financial holding company, lists the activities in which a financial holding company may engage, establishes the procedure by which a person may request the Board to authorize additional activities as financial in nature or incidental thereto, and establishes the procedure by which a financial holding company may seek approval to engage in an activity that is complementary to a financial activity.

(10) *Subpart J* governs the conduct of merchant banking investment activities by financial holding companies as permitted under section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)).

(11) *Subpart K* governs the period of time that firms subject to section 13 of the Bank Holding Company Act (12 U.S.C. 1851) have to bring their activities, investments and relationships into compliance with the requirements of such section.

(12) *Appendix B* contains the Board's Capital Adequacy Guidelines for measuring leverage for bank holding companies and state member banks.

(13) *Appendix C* contains the Board's policy statement governing small bank holding companies.

(14) *Appendix D* contains the Board's Capital Adequacy Guidelines for measuring tier 1 leverage for bank holding companies.

(15) *Appendix E* contains the Board's Capital Adequacy Guidelines for measuring market risk of bank holding companies.

(16) *Appendix F* contains the Interagency Guidelines Establishing Information Security Standards.

[Reg. Y, 62 FR 9319, Feb. 28, 1997, as amended at 65 FR 16472, Mar. 28, 2000; 66 FR 414, Jan. 3, 2001; 66 FR 8484, Jan. 31, 2001; 66 FR 8636, Feb. 1, 2001; 76 FR 8275, Feb. 14, 2011]

§ 225.2 Definitions.

Except as modified in this regulation or unless the context otherwise requires, the terms used in this regulation have the same meaning as set forth in the relevant statutes.

(a) *Affiliate* means any company that controls, is controlled by, or is under common control with, another company.

(b)(1) *Bank* means:

(i) An insured bank as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)); or

(ii) An institution organized under the laws of the United States which both:

(A) Accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and

(B) Is engaged in the business of making commercial loans.

(2) *Bank* does not include those institutions qualifying under the exceptions listed in section 2(c)(2) of the BHC Act (12 U.S.C. 1841(c)(2)).

(c)(1) *Bank holding company* means any company (including a bank) that has direct or indirect control of a bank, other than control that results from the ownership or control of:

(i) Voting securities held in good faith in a fiduciary capacity (other than as provided in paragraphs (e)(2)(ii) and (iii) of this section) without sole discretionary voting authority, or as otherwise exempted under section 2(a)(5)(A) of the BHC Act;

(ii) Voting securities acquired and held only for a reasonable period of time in connection with the underwriting of securities, as provided in section 2(a)(5)(B) of the BHC Act;

(iii) Voting rights to voting securities acquired for the sole purpose and in the course of participating in a proxy solicitation, as provided in section 2(a)(5)(C) of the BHC Act;

(iv) Voting securities acquired in satisfaction of debts previously contracted in good faith, as provided in section 2(a)(5)(D) of the BHC Act, if the securities are divested within two years of acquisition (or such later period as the Board may permit by order); or

(v) Voting securities of certain institutions owned by a thrift institution or a trust company, as provided in sections 2(a)(5)(E) and (F) of the BHC Act.

(2) Except for the purposes of § 225.4(b) of this subpart and subpart E of this part, or as otherwise provided in this regulation, *bank holding company* includes a foreign banking organization. For the purposes of subpart B of this part, *bank holding company* includes a foreign banking organization only if it owns or controls a bank in the United States.

(d)(1) *Company* includes any bank, corporation, general or limited partnership, association or similar organization, business trust, or any other trust unless by its terms it must terminate either within 25 years, or within 21 years and 10 months after the death of individuals living on the effective date of the trust.

(2) *Company* does not include any organization, the majority of the voting securities of which are owned by the United States or any state.

(3) *Testamentary trusts exempt.* Unless the Board finds that the trust is being operated as a business trust or company, a trust is presumed not to be a company if the trust:

(i) Terminates within 21 years and 10 months after the death of grantors or beneficiaries of the trust living on the effective date of the trust or within 25 years;

(ii) Is a testamentary or *inter vivos* trust established by an individual or individuals for the benefit of natural persons (or trusts for the benefit of natural persons) who are related by blood, marriage or adoption;

(iii) Contains only assets previously owned by the individual or individuals who established the trust;

(iv) Is not a Massachusetts business trust; and

(v) Does not issue shares, certificates, or any other evidence of ownership.

(4) *Qualified limited partnerships exempt.* Company does not include a qualified limited partnership, as defined in section 2(o)(10) of the BHC Act.

(e)(1) *Control* of a bank or other company means (except for the purposes of subpart E of this part):

(i) Ownership, control, or power to vote 25 percent or more of the outstanding shares of any class of voting securities of the bank or other company, directly or indirectly or acting through one or more other persons;

(ii) Control in any manner over the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of the bank or other company;

(iii) The power to exercise, directly or indirectly, a controlling influence over the management or policies of the bank or other company, as determined by the Board after notice and opportunity for hearing in accordance with §225.31 of subpart D of this part; or

(iv) Conditioning in any manner the transfer of 25 percent or more of the outstanding shares of any class of voting securities of a bank or other company upon the transfer of 25 percent or more of the outstanding shares of any class of voting securities of another bank or other company.

(2) A bank or other company is deemed to control voting securities or assets owned, controlled, or held, directly or indirectly:

(i) By any subsidiary of the bank or other company;

(ii) In a fiduciary capacity (including by pension and profit-sharing trusts) for the benefit of the shareholders, members, or employees (or individuals serving in similar capacities) of the bank or other company or any of its subsidiaries; or

(iii) In a fiduciary capacity for the benefit of the bank or other company or any of its subsidiaries.

(f) *Foreign banking organization* and *qualifying foreign banking organization* have the same meanings as provided in §211.21(n) and §211.23 of the Board's Regulation K (12 CFR 211.21(n) and 211.23).

(g) *Insured depository institution* includes an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)) and a savings association.

(h) *Lead insured depository institution* means the largest insured depository institution controlled by the bank holding company as of the quarter ending immediately prior to the proposed filing, based on a comparison of the average total risk-weighted assets controlled during the previous 12-month period by each insured depository institution subsidiary of the holding company.

(i) *Management official* means any officer, director (including honorary or advisory directors), partner, or trustee of a bank or other company, or any employee of the bank or other company with policy-making functions.

(j) *Nonbank bank* means any institution that:

(1) Became a bank as a result of enactment of the Competitive Equality Amendments of 1987 (Pub. L. 100–86), on the date of enactment (August 10, 1987); and

(2) Was not controlled by a bank holding company on the day before the enactment of the Competitive Equality Amendments of 1987 (August 9, 1987).

(k) *Outstanding shares* means any voting securities, but does not include securities owned by the United States or by a company wholly owned by the United States.

(l) Person includes an individual, bank, corporation, partnership, trust, association, joint venture, pool, syndicate, sole proprietorship, unincorporated organization, or any other form of entity.

(m) *Savings association* means:

(1) Any federal savings association or federal savings bank;

(2) Any building and loan association, savings and loan association, homestead association, or cooperative bank if such association or cooperative bank is a member of the Savings Association Insurance Fund; and

(3) Any savings bank or cooperative that is deemed by the director of the Office of Thrift Supervision to be a savings association under section 10(l) of the Home Owners Loan Act.

(n) *Shareholder*—(1) *Controlling shareholder* means a person that owns or controls, directly or indirectly, 25 percent or more of any class of voting securities of a bank or other company.

(2) *Principal shareholder* means a person that owns or controls, directly or indirectly, 10 percent or more of any class of voting securities of a bank or other company, or any person that the Board determines has the power, directly or indirectly, to exercise a controlling influence over the management or policies of a bank or other company.

(o) *Subsidiary* means a bank or other company that is controlled by another company, and refers to a direct or indirect subsidiary of a bank holding company. An indirect subsidiary is a bank or other company that is controlled by a subsidiary of the bank holding company.

(p) *United States* means the United States and includes any state of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, and the Virgin Islands.

(q)(1) *Voting securities* means shares of common or preferred stock, general or limited partnership shares or interests, or similar interests if the shares or interest, by statute, charter, or in any manner, entitle the holder:

(i) To vote for or to select directors, trustees, or partners (or persons exercising similar functions of the issuing company); or

(ii) To vote on or to direct the conduct of the operations or other significant policies of the issuing company.

(2) *Nonvoting shares.* Preferred shares, limited partnership shares or interests, or similar interests are not *voting securities* if:

(i) Any voting rights associated with the shares or interest are limited solely to the type customarily provided by statute with regard to matters that would significantly and adversely affect the rights or preference of the security or other interest, such as the issuance of additional amounts or classes of senior securities, the modification of the terms of the security or interest, the dissolution of the issuing company, or the payment of dividends by the issuing company when preferred dividends are in arrears;

(ii) The shares or interest represent an essentially passive investment or financing device and do not otherwise provide the holder with control over the issuing company; and

(iii) The shares or interest do not entitle the holder, by statute, charter, or in any manner, to select or to vote for the selection of directors, trustees, or partners (or persons exercising similar functions) of the issuing company.

(3) *Class of voting shares.* Shares of stock issued by a single issuer are deemed to be the same class of voting shares, regardless of differences in dividend rights or liquidation preference, if the shares are voted together as a single class on all matters for which the shares have voting rights other than matters described in paragraph (o)(2)(i) of this section that affect solely the rights or preferences of the shares.

(r) *Well-capitalized*—(1) *Bank holding company.* In the case of a bank holding company,[2] *well-capitalized* means that:

(i) On a consolidated basis, the bank holding company maintains a total risk-based capital ratio of 10.0 percent or greater, as defined in appendix A of this part;

(ii) On a consolidated basis, the bank holding company maintains a Tier 1 risk-based capital ratio of 6.0 percent or greater, as defined in appendix A of this part; and

(iii) The bank holding company is not subject to any written agreement, order, capital directive, or prompt corrective action directive issued by the Board to meet and maintain a specific capital level for any capital measure.

(2) *Insured and uninsured depository institution*—(i) *Insured depository institution.* In the case of an insured depository institution, ‘‘well capitalized’’ means that the institution has and maintains at least the capital levels required to be well capitalized under the capital adequacy regulations or guidelines applicable to the institution that have been adopted by the appropriate Federal banking agency for the institution under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).

(ii) *Uninsured depository institution.* In the case of a depository institution the deposits of which are not insured by the Federal Deposit Insurance Corporation, ‘‘well capitalized’’ means that the institution has and maintains at least the capital levels required for an insured depository institution to be well capitalized.

[2] For purposes of this subpart and subparts B and C of this part, a bank holding company with consolidated assets of less than $500 million that is subject to the Small Bank Holding Company Policy Statement in appendix C of this part will be deemed to be ‘‘well-capitalized’’ if the bank holding company meets the requirements for expedited/waived processing in appendix C.

(3) *Foreign banks*—(i) *Standards applied.* For purposes of determining whether a foreign banking organization qualifies under paragraph (r)(1) of this section:

(A) A foreign banking organization whose home country supervisor, as defined in § 211.21 of the Board's Regulation K (12 CFR 211.21), has adopted capital standards consistent in all respects with the Capital Accord of the Basle Committee on Banking Supervision (Basle Accord) may calculate its capital ratios under the home country standard; and

(B) A foreign banking organization whose home country supervisor has not adopted capital standards consistent in all respects with the Basle Accord shall obtain a determination from the Board that its capital is equivalent to the capital that would be required of a U.S. banking organization under paragraph (r)(1) of this section.

(ii) *Branches and agencies.* For purposes of determining, under paragraph (r)(1) of this section, whether a branch or agency of a foreign banking organization is well-capitalized, the branch or agency shall be deemed to have the same capital ratios as the foreign banking organization.

(s) *Well managed*—(1) *In general.* Except as otherwise provided in this part, a company or depository institution is well managed if:

(i) At its most recent inspection or examination or subsequent review by the appropriate Federal banking agency for the company or institution (or the appropriate state banking agency in an examination described in section 10(d) of the Federal Deposit Insurance Act (12 U.S.C. 1820(d)), the company or institution received:

(A) At least a satisfactory composite rating; and

(B) At least a satisfactory rating for management, if such rating is given.

(ii) In the case of a company or depository institution that has not received an inspection or examination rating, the Board has determined, after a review of the managerial and other resources of the company or depository institution and after consulting with the appropriate Federal and state banking agencies, as applicable, for the company or institution, that the company or institution is well managed.

(2) *Merged depository institutions*—(i) *Merger involving well managed institutions.* A depository institution that results from the merger of two or more depository institutions that are well managed shall be considered to be well managed unless the Board determines otherwise after consulting with the appropriate Federal and state banking agencies, as applicable, for each depository institution involved in the merger.

(ii) *Merger involving a poorly rated institution.* A depository institution that results from the merger of a depository institution that is well managed with one or more depository institutions that are not well managed or have not been examined shall be considered to be well managed if the Board determines, after a review of the managerial and other resources of the resulting depository institution and after consulting with the appropriate Federal and state banking agencies for the institutions involved in the merger, as applicable, that the resulting institution is well managed.

(3) *Foreign banking organizations.* Except as otherwise provided in this part, a foreign banking organization is considered well managed if the combined operations of the foreign banking organization in the United States have received at least a satisfactory composite rating at the most recent annual assessment.

(t) *Depository institution.* For purposes of this part, the term ''depository institution'' has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)).

[Reg. Y, 62 FR 9319, Feb. 28, 1997, as amended at 65 FR 3791, Jan. 25, 2000; 65 FR 15055, Mar. 21, 2000; 66 FR 414, Jan. 3, 2001; 71 FR 9901, Feb. 28, 2006]

§ 225.3 Administration.

(a) *Delegation of authority.* Designated Board members and officers and the Federal Reserve Banks are authorized by the Board to exercise various functions prescribed in this regulation and in the Board's Rules Regarding Delegation of Authority (12 CFR part 265) and the Board's Rules of Procedure (12 CFR part 262).

(b) *Appropriate Federal Reserve Bank*. In administering this regulation, unless a different Federal Reserve Bank is designated by the Board, the appropriate Federal Reserve Bank is as follows:

(1) For a bank holding company (or a company applying to become a bank holding company): the Reserve Bank of the Federal Reserve district in which the company's banking operations are principally conducted, as measured by total domestic deposits in its subsidiary banks on the date it became (or will become) a bank holding company;

(2) For a foreign banking organization that has no subsidiary bank and is not subject to paragraph (b)(1) of this section: the Reserve Bank of the Federal Reserve district in which the total assets of the organization's United States branches, agencies, and commercial lending companies are the largest as of the later of January 1, 1980, or the date it becomes a foreign banking organization;

(3) For an individual or company submitting a notice under subpart E of this part: The Reserve Bank of the Federal Reserve district in which the banking operations of the bank holding company or state member bank to be acquired are principally conducted, as measured by total domestic deposits on the date the notice is filed.

§ 225.4 Corporate practices.

(a) *Bank holding company policy and operations*. (1) A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner.

(2) Whenever the Board believes an activity of a bank holding company or control of a nonbank subsidiary (other than a nonbank subsidiary of a bank) constitutes a serious risk to the financial safety, soundness, or stability of a subsidiary bank of the bank holding company and is inconsistent with sound banking principles or the purposes of the BHC Act or the Financial Institutions Supervisory Act of 1966, as amended (12 U.S.C. 1818(b) *et seq.*), the Board may require the bank holding company to terminate the activity or to terminate control of the subsidiary, as provided in section 5(e) of the BHC Act.

(b) *Purchase or redemption by bank holding company of its own securities*—(1) *Filing notice*. Except as provided in paragraph (b)(6) of this section, a bank holding company shall give the Board prior written notice before purchasing or redeeming its equity securities if the gross consideration for the purchase or redemption, when aggregated with the net consideration paid by the company for all such purchases or redemptions during the preceding 12 months, is equal to 10 percent or more of the company's consolidated net worth. For the purposes of this section, ''net consideration'' is the gross consideration paid by the company for all of its equity securities purchased or redeemed during the period minus the gross consideration received for all of its equity securities sold during the period.

(2) *Contents of notice*. Any notice under this section shall be filed with the appropriate Reserve Bank and shall contain the following information:

(i) The purpose of the transaction, a description of the securities to be purchased or redeemed, the total number of each class outstanding, the gross consideration to be paid, and the terms and sources of funding for the transaction;

(ii) A description of all equity securities redeemed within the preceding 12 months, the net consideration paid, and the terms of any debt incurred in connection with those transactions; and

(iii) (A) If the bank holding company has consolidated assets of $500 million or more, consolidated *pro forma* risk-based capital and leverage ratio calculations for the bank holding company as of the most recent quarter, and, if the redemption is to be debt funded, a parent-only *pro forma* balance sheet as of the most recent quarter; or

(B) If the bank holding company has consolidated assets of less than $500 million, a *pro forma* parent-only balance sheet as of the most recent quarter, and, if the redemption is to be debt funded, one-year income statement and cash flow projections.

(3) *Acting on notice*. Within 15 calendar days of receipt of a notice under

this section, the appropriate Reserve Bank shall either approve the transaction proposed in the notice or refer the notice to the Board for decision. If the notice is referred to the Board for decision, the Board shall act on the notice within 30 calendar days after the Reserve Bank receives the notice.

(4) *Factors considered in acting on notice.* (i) The Board may disapprove a proposed purchase or redemption if it finds that the proposal would constitute an unsafe or unsound practice, or would violate any law, regulation, Board order, directive, or any condition imposed by, or written agreement with, the Board.

(ii) In determining whether a proposal constitutes an unsafe or unsound practice, the Board shall consider whether the bank holding company's financial condition, after giving effect to the proposed purchase or redemption, meets the financial standards applied by the Board under section 3 of the BHC Act, including the Board's Capital Adequacy Guidelines (appendix A of this part) and the Board's Policy Statement for Small Bank Holding Companies (appendix C of this part).

(5) *Disapproval and hearing.* (i) The Board shall notify the bank holding company in writing of the reasons for a decision to disapprove any proposed purchase or redemption. Within 10 calendar days of receipt of a notice of disapproval by the Board, the bank holding company may submit a written request for a hearing.

(ii) The Board shall order a hearing within 10 calendar days of receipt of the request if it finds that material facts are in dispute, or if it otherwise appears appropriate. Any hearing conducted under this paragraph shall be held in accordance with the Board's Rules of Practice for Formal Hearings (12 CFR part 263).

(iii) At the conclusion of the hearing, the Board shall by order approve or disapprove the proposed purchase or redemption on the basis of the record of the hearing.

(6) *Exception for well-capitalized bank holding companies.* A bank holding company is not required to obtain prior Board approval for the redemption or purchase of its equity securities under this section provided:

(i) Both before and immediately after the redemption, the bank holding company is well-capitalized;

(ii) The bank holding company is well-managed; and

(iii) The bank holding company is not the subject of any unresolved supervisory issues.

(7) *Exception for certain bank holding companies.* This section 225.4(b) shall not apply to any bank holding company that is subject to § 225.8 of Regulation Y (12 CFR 225.8).

(c) *Deposit insurance.* Every bank that is a bank holding company or a subsidiary of a bank holding company shall obtain Federal Deposit Insurance and shall remain an *insured bank* as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)).

(d) *Acting as transfer agent or clearing agent.* A bank holding company or any nonbanking subsidiary that is a ''bank,'' as defined in section 3(a)(6) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(6)), and that is a transfer agent of securities, a clearing agency, or a participant in a clearing agency (as those terms are defined in section 3(a) of the Securities Exchange Act (15 U.S.C. 78c(a)), shall be subject to §§ 208.31–208.33 of the Board's Regulation H (12 CFR 208.31–208.33) as if it were a state member bank.

(e) *Reporting requirement for credit secured by certain bank holding company stock.* Each executive officer or director of a bank holding company the shares of which are not publicly traded shall report annually to the board of directors of the bank holding company the outstanding amount of any credit that was extended to the executive officer or director and that is secured by shares of the bank holding company. For purposes of this paragraph, the terms ''executive officer'' and ''director'' shall have the meaning given in § 215.2 of Regulation O (12 CFR 215.2).

(f) *Suspicious activity report.* A bank holding company or any nonbank subsidiary thereof, or a foreign bank that is subject to the BHC Act or any nonbank subsidiary of such foreign bank operating in the United States, shall file a suspicious activity report in accordance with the provisions of § 208.62 of the Board's Regulation H (12 CFR 208.62).

(g) *Requirements for financial holding companies engaged in securities underwriting, dealing, or market-making activities*. (1) Any intra-day extension of credit by a bank or thrift, or U.S. branch or agency of a foreign bank to an affiliated company engaged in underwriting, dealing in, or making a market in securities pursuant to section 4(k)(4)(E) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(E)) must be on market terms consistent with section 23B of the Federal Reserve Act. (12 U.S.C. 371c–1).

(2) A foreign bank that is or is treated as a financial holding company under this part shall ensure that:

(i) Any extension of credit by any U.S. branch or agency of such foreign bank to an affiliated company engaged in underwriting, dealing in, or making a market in securities pursuant to section 4(k)(4)(E) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(E)), conforms to sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c and 371c–1) as if the branch or agency were a member bank;

(ii) Any purchase by any U.S. branch or agency of such foreign bank, as principal or fiduciary, of securities for which a securities affiliate described in paragraph (g)(2)(i) of this section is a principal underwriter conforms to sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c and 371c–1) as if the branch or agency were a member bank; and

(iii) Its U.S. branches and agencies not advertise or suggest that they are responsible for the obligations of a securities affiliate described in paragraph (g)(2)(i) of this section, consistent with section 23B(c) of the Federal Reserve Act (12 U.S.C. 371c–1(c)) as if the branches or agencies were member banks.

(h) *Protection of customer information and consumer information*. A bank holding company shall comply with the Interagency Guidelines Establishing Information Security Standards, as set forth in appendix F of this part, prescribed pursuant to sections 501 and 505 of the Gramm-Leach-Bliley Act (15 U.S.C. 6801 and 6805). A bank holding company shall properly dispose of consumer information in accordance with the rules set forth at 16 CFR part 682.

[Reg. Y, 62 FR 9319, Feb. 28, 1997, as amended at 63 FR 58621, Nov. 2, 1998; 65 FR 14442, Mar. 17, 2000; 66 FR 8636, Feb. 1, 2001; 69 FR 77618, Dec. 28, 2004; 71 FR 9901, Feb. 28, 2006; 76 FR 74644, Dec. 1, 2011]

§ 225.5 Registration, reports, and inspections.

(a) *Registration of bank holding companies*. Each company shall register within 180 days after becoming a bank holding company by furnishing information in the manner and form prescribed by the Board. A company that receives the Board's prior approval under subpart B of this part to become a bank holding company may complete this registration requirement through submission of its first annual report to the Board as required by paragraph (b) of this section.

(b) *Reports of bank holding companies*. Each bank holding company shall furnish, in the manner and form prescribed by the Board, an annual report of the company's operations for the fiscal year in which it becomes a bank holding company, and for each fiscal year during which it remains a bank holding company. Additional information and reports shall be furnished as the Board may require.

(c) *Examinations and inspections*. The Board may examine or inspect any bank holding company and each of its subsidiaries and prepare a report of their operations and activities. With respect to a foreign banking organization, the Board may also examine any branch or agency of a foreign bank in any state of the United States and may examine or inspect each of the organization's subsidiaries in the United States and prepare reports of their operations and activities. The Board shall rely, as far as possible, on the reports of examination made by the primary federal or state supervisor of the subsidiary bank of the bank holding company or of the branch or agency of the foreign bank.

§ 225.6 Penalties for violations.

(a) *Criminal and civil penalties*. (1) Section 8 of the BHC Act provides criminal penalties for willful violation, and civil penalties for violation, by any company or individual, of the BHC Act or any regulation or order issued under it, or for making a false entry in any book, report, or statement of a bank holding company.

(2) Civil money penalty assessments for violations of the BHC Act shall be made in accordance with subpart C of the Board's Rules of Practice for Hearings (12 CFR part 263, subpart C). For any willful violation of the Bank Control Act or any regulation or order issued under it, the Board may assess a civil penalty as provided in 12 U.S.C. 1817(j)(15).

(b) *Cease-and-desist proceedings.* For any violation of the BHC Act, the Bank Control Act, this regulation, or any order or notice issued thereunder, the Board may institute a cease-and-desist proceeding in accordance with the Financial Institutions Supervisory Act of 1966, as amended (12 U.S.C. 1818(b) *et seq.*).

§ 225.7 Exceptions to tying restrictions.

(a) *Purpose.* This section establishes exceptions to the anti-tying restrictions of section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1971, 1972(1)). These exceptions are in addition to those in section 106. The section also restricts tying of electronic benefit transfer services by bank holding companies and their nonbank subsidiaries.

(b) *Exceptions to statute.* Subject to the limitations of paragraph (c) of this section, a bank may:

(1) *Extension to affiliates of statutory exceptions preserving traditional banking relationships.* Extend credit, lease or sell property of any kind, or furnish any service, or fix or vary the consideration for any of the foregoing, on the condition or requirement that a customer:

(i) Obtain a loan, discount, deposit, or trust service from an affiliate of the bank; or

(ii) Provide to an affiliate of the bank some additional credit, property, or service that the bank could require to be provided to itself pursuant to section 106(b)(1)(C) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972(1)(C)).

(2) *Safe harbor for combined-balance discounts.* Vary the consideration for any product or package of products based on a customer's maintaining a combined minimum balance in certain products specified by the bank (eligible products), if:

(i) The bank offers deposits, and all such deposits are eligible products; and

(ii) Balances in deposits count at least as much as nondeposit products toward the minimum balance.

(3) *Safe harbor for foreign transactions.* Engage in any transaction with a customer if that customer is:

(i) A corporation, business, or other person (other than an individual) that:

(A) Is incorporated, chartered, or otherwise organized outside the United States; and

(B) Has its principal place of business outside the United States; or

(ii) An individual who is a citizen of a foreign country and is not resident in the United States.

(c) *Limitations on exceptions.* Any exception granted pursuant to this section shall terminate upon a finding by the Board that the arrangement is resulting in anti-competitive practices. The eligibility of a bank to operate under any exception granted pursuant to this section shall terminate upon a finding by the Board that its exercise of this authority is resulting in anti-competitive practices.

(d) *Extension of statute to electronic benefit transfer services.* A bank holding company or nonbank subsidiary of a bank holding company that provides electronic benefit transfer services shall be subject to the anti-tying restrictions applicable to such services set forth in section 7(i)(11) of the Food Stamp Act of 1977 (7 U.S.C. 2016(i)(11)).

(e) For purposes of this section, *bank* has the meaning given that term in section 106(a) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1971), but shall also include a United States branch, agency, or commercial lending company subsidiary of a foreign bank that is subject to section 106 pursuant to section 8(d) of the International Banking Act of 1978 (12 U.S.C. 3106(d)), and any company made subject to section 106 by section 4(f)(9) or 4(h) of the BHC Act.

§ 225.8 Capital planning.

(a) *Purpose.* This section establishes capital planning and prior notice and approval requirements for capital distributions by certain bank holding companies.

(b) *Scope and effective date.* (1) This section applies to every top-tier bank holding company domiciled in the United States:

(i) With total consolidated assets greater than or equal to $50 billion computed on the basis of the average of the company's total consolidated assets over the course of the previous four calendar quarters, as reflected on the bank holding company's consolidated financial statement for bank holding companies (FR Y–9C (the calculation shall be effective as of the due date of the bank holding company's most recent FR Y–9C required to be filed under 12 CFR 225.5(b))); or

(ii) That is subject to this section, in whole or in part, by order of the Board based on the institution's size, level of complexity, risk profile, scope of operations, or financial condition.

(2) Beginning on December 30, 2011, the provisions of this section shall apply to any bank holding company that is subject to this section pursuant to paragraph (b)(1) of this section, provided that:

(i) Until July 21, 2015, this section will not apply to any bank holding company subsidiary of a foreign banking organization that is currently relying on Supervision and Regulation Letter SR 01–01 issued by the Board (as in effect on May 19, 2010); and

(ii) A bank holding company that becomes subject to this section pursuant to paragraph (b)(1)(i) of this section after the 5th of January of a calendar year shall not be subject to the requirements of paragraphs (d)(1)(ii), (d)(4), and (f)(1)(iii) of this section until January 1 of the next calendar year.

(3) Nothing in this section shall limit the authority of the Federal Reserve to issue a capital directive or take any other supervisory or enforcement action, including action to address unsafe or unsound practices or conditions or violations of law.

(c) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Capital action* means any issuance of a debt or equity capital instrument, any capital distribution, and any similar action that the Federal Reserve determines could impact a bank holding company's consolidated capital.

(2) *Capital distribution* means a redemption or repurchase of any debt or equity capital instrument, a payment of common or preferred stock dividends, a payment that may be temporarily or permanently suspended by the issuer on any instrument that is eligible for inclusion in the numerator of any minimum regulatory capital ratio, and any similar transaction that the Federal Reserve determines to be in substance a distribution of capital.

(3) *Capital plan* means a written presentation of a bank holding company's capital planning strategies and capital adequacy process that includes the mandatory elements set forth in paragraph (d)(2) of this section.

(4) *Capital policy* means a bank holding company's written assessment of the principles and guidelines used for capital planning, capital issuance, usage and distributions, including internal capital goals; the quantitative or qualitative guidelines for dividend and stock repurchases; the strategies for addressing potential capital shortfalls; and the internal governance procedures around capital policy principles and guidelines.

(5) *Minimum regulatory capital ratio* means any minimum regulatory capital ratio that the Federal Reserve may require of a bank holding company, by regulation or order, including the bank holding company's leverage ratio and tier 1 and total risk-based capital ratios as calculated under Appendices A, D, E, and G to this part (12 CFR part 225), or any successor regulation.

(6) *Planning horizon* means the period of at least nine quarters, beginning with the quarter preceding the quarter in which the bank holding company submits its capital plan, over which the relevant projections extend.

(7) *Tier 1 capital* has the same meaning as under Appendix A to this part or any successor regulation.

(8) *Tier 1 common capital* means tier 1 capital less the non-common elements of tier 1 capital, including perpetual

preferred stock and related surplus, minority interest in subsidiaries, trust preferred securities and mandatory convertible preferred securities.

(9) *Tier 1 common ratio* means the ratio of a bank holding company's tier 1 common capital to total risk-weighted assets. This definition will remain in effect until the Board adopts an alternative *tier 1 common ratio* definition as a minimum regulatory capital ratio.

(10) *Total risk-weighted assets* has the same meaning as under Appendices A, E, and G to this part, or any successor regulation.

(d) *General requirements*—(1) *Annual capital planning*. (i) A bank holding company must develop and maintain a capital plan.

(ii) A bank holding company must submit its complete capital plan to the appropriate Reserve Bank and the Board each year by the 5th of January, or such later date as directed by the Board or the appropriate Reserve Bank, after consultation with the Board.

(iii) The bank holding company's board of directors or a designated committee thereof must at least annually and prior to submission of the capital plan under paragraph (d)(1)(ii) of this section:

(A) Review the robustness of the bank holding company's process for assessing capital adequacy,

(B) Ensure that any deficiencies in the bank holding company's process for assessing capital adequacy are appropriately remedied; and

(C) Approve the bank holding company's capital plan.

(2) *Mandatory elements of capital plan*. A capital plan must contain at least the following elements:

(i) An assessment of the expected uses and sources of capital over the planning horizon that reflects the bank holding company's size, complexity, risk profile, and scope of operations, assuming both expected and stressful conditions, including:

(A) Estimates of projected revenues, losses, reserves, and pro forma capital levels, including any minimum regulatory capital ratios (for example, leverage, tier 1 risk-based, and total risk-based capital ratios) and any additional capital measures deemed relevant by the bank holding company, over the planning horizon under expected conditions and under a range of stressed scenarios, including any scenarios provided by the Federal Reserve and at least one stressed scenario developed by the bank holding company appropriate to its business model and portfolios;

(B) A calculation of the pro forma tier 1 common ratio over the planning horizon under expected conditions and under a range of stressed scenarios and discussion of how the company will maintain a pro forma tier 1 common ratio above 5 percent under expected conditions and the stressed scenarios required under paragraphs (d)(2)(i)(A) and (ii) of this section;

(C) A discussion of the results of any stress test required by law or regulation, and an explanation of how the capital plan takes these results into account; and

(D) A description of all planned capital actions over the planning horizon.

(ii) A detailed description of the bank holding company's process for assessing capital adequacy, including:

(A) A discussion of how the bank holding company will, under expected and stressful conditions, maintain capital commensurate with its risks, maintain capital above the minimum regulatory capital ratios and above a tier 1 common ratio of 5 percent, and serve as a source of strength to its subsidiary depository institutions;

(B) A discussion of how the bank holding company will, under expected and stressful conditions, maintain sufficient capital to continue its operations by maintaining ready access to funding, meeting its obligations to creditors and other counterparties, and continuing to serve as a credit intermediary;

(iii) The bank holding company's capital policy; and

(iv) A discussion of any expected changes to the bank holding company's business plan that are likely to have a material impact on the firm's capital adequacy or liquidity.

(3) *Data collection*. Upon the request of the Board or appropriate Reserve Bank, the bank holding company shall provide the Federal Reserve with information regarding—

(i) The bank holding company's financial condition, including its capital;

(ii) The bank holding company's structure;

(iii) Amount and risk characteristics of the bank holding company's on- and off-balance sheet exposures, including exposures within the bank holding company's trading account, other trading-related exposures (such as counterparty-credit risk exposures) or other items sensitive to changes in market factors, including, as appropriate, information about the sensitivity of positions to changes in market rates and prices;

(iv) The bank holding company's relevant policies and procedures, including risk management policies and procedures;

(v) The bank holding company's liquidity profile and management; and

(vi) Any other relevant qualitative or quantitative information requested by the Board or the appropriate Reserve Bank to facilitate review of the bank holding company's capital plan under this section.

(4) *Re-submission of a capital plan.* (i) A bank holding company must update and re-submit its capital plan to the appropriate Reserve Bank within 30 calendar days of the occurrence of one of the following events:

(A) The bank holding company determines there has been or will be a material change in the bank holding company's risk profile, financial condition, or corporate structure since the bank holding company adopted the capital plan;

(B) The Board or the appropriate Reserve Bank objects to the capital plan; or

(C) The Board or the appropriate Reserve Bank, after consultation with the Board, directs the bank holding company in writing to revise and resubmit its capital plan for any of the following reasons:

(*1*) The capital plan is incomplete or the capital plan, or the bank holding company's internal capital adequacy process, contains material weaknesses;

(*2*) There has been or will likely be a material change in the bank holding company's risk profile (including a material change in its business strategy or any risk exposure), financial condition, or corporate structure;

(*3*) The stressed scenario(s) developed by the bank holding company is not appropriate to its business model and portfolios, or changes in financial markets or the macro-economic outlook that could have a material impact on a bank holding company's risk profile and financial condition require the use of updated scenarios; or

(*4*) The capital plan or the condition of the bank holding company raise any of the issues described in paragraph (e)(2)(ii) of this section.

(ii) The Board or the appropriate Reserve Bank, after consultation with the Board, may, at its discretion, extend the 30-day period in paragraph (d)(4)(i) of this section for up to an additional 60 calendar days.

(iii) Any updated capital plan must satisfy all the requirements of this section; however, a bank holding company may continue to rely on information submitted as part of a previously submitted capital plan to the extent that the information remains accurate and appropriate.

(e) *Review of capital plans by the Federal Reserve*—(1) *Considerations and inputs.* (i) The Board or the appropriate Reserve Bank, after consultation with the Board, will consider the following factors in reviewing a bank holding company's capital plan:

(A) The comprehensiveness of the capital plan, including the extent to which the analysis underlying the capital plan captures and addresses potential risks stemming from activities across the firm and the company's capital policy;

(B) The reasonableness of the bank holding company's assumptions and analysis underlying the capital plan and its methodologies for reviewing the robustness of its capital adequacy process; and

(C) The bank holding company's ability to maintain capital above each minimum regulatory capital ratio and above a tier 1 common ratio of 5 percent on a pro forma basis under expected and stressful conditions throughout the planning horizon, including but not limited to any stressed scenarios required under paragraphs (d)(2)(i)(A) and (ii) of this section.

(ii) The Board or the appropriate Reserve Bank, after consultation with the Board, will also consider the following information in reviewing a bank holding company's capital plan:

(A) Relevant supervisory information about the bank holding company and its subsidiaries;

(B) The bank holding company's regulatory and financial reports, as well as supporting data that would allow for an analysis of the bank holding company's loss, revenue, and reserve projections;

(C) As applicable, the Federal Reserve's own pro forma estimates of the firm's potential losses, revenues, reserves, and resulting capital adequacy under expected and stressful conditions, including but not limited to any stressed scenarios required under paragraphs (d)(2)(i)(A) and (ii) of this section, as well as the results of any stress tests conducted by the bank holding company or the Federal Reserve; and

(D) Other information requested or required by the appropriate Reserve Bank or the Board, as well as any other information relevant, or related, to the bank holding company's capital adequacy.

(2) *Federal Reserve action on a capital plan.* (i) The Board or the appropriate Reserve Bank, after consultation with the Board, will object, in whole or in part, to the capital plan or provide the bank holding company with a notice of non-objection to the capital plan:

(A) By March 31 of the calendar year in which a capital plan was submitted pursuant to paragraph (d)(1)(ii) of this section, and

(B) By the date that is 75 calendar days after the date on which a capital plan was resubmitted pursuant to paragraph (d)(4) of this section.

(ii) The Board or the appropriate Reserve Bank, after consultation with the Board, may object to a capital plan if it determines that:

(A) The bank holding company has material unresolved supervisory issues, including but not limited to issues associated with its capital adequacy process;

(B) The assumptions and analysis underlying the bank holding company's capital plan, or the bank holding company's methodologies for reviewing the robustness of its capital adequacy process, are not reasonable or appropriate;

(C) The bank holding company has not demonstrated an ability to maintain capital above each minimum regulatory capital ratio and above a tier 1 common ratio of 5 percent, on a pro forma basis under expected and stressful conditions throughout the planning horizon; or

(D) The bank holding company's capital planning process or proposed capital distributions otherwise constitute an unsafe or unsound practice, or would violate any law, regulation, Board order, directive, or any condition imposed by, or written agreement with, the Board. In determining whether a capital plan or any proposed capital distribution would constitute an unsafe or unsound practice, the appropriate Reserve Bank would consider whether the bank holding company is and would remain in sound financial condition after giving effect to the capital plan and all proposed capital distributions.

(iii) The Board or the appropriate Reserve Bank, after consultation with the Board, will notify the bank holding company in writing of the reasons for a decision to object to a capital plan.

(iv) If the Board or the appropriate Reserve Bank, after consultation with the Board, objects to a capital plan and until such time as the Board or the appropriate Reserve Bank, after consultation with the Board, issues a non-objection to the bank holding company's capital plan, the bank holding company may not make any capital distribution, other than those capital distributions with respect to which the Board or the appropriate Reserve Bank has indicated in writing its non-objection.

(3) *Request for reconsideration or hearing.* Within 10 calendar days of receipt of a notice of objection to a capital plan by the Board or the appropriate Reserve Bank:

(i) A bank holding company may submit a written request to the Board requesting reconsideration of the objection, including an explanation of why reconsideration should be granted. Within 10 calendar days of receipt of the bank holding company's request, the Board will notify the company of its decision to affirm or withdraw the objection to the bank holding company's capital plan or a specific capital distribution; or

(ii) As an alternative to paragraph (e)(3)(i) of this section, a bank holding company may submit a written request to the Board for a hearing. Any hearing shall follow the procedures described in paragraph (f)(5)(ii)–(iii) of this section.

(f) *Approval requirements for certain capital actions*—(1) *Circumstances requiring approval*. Notwithstanding a notice of non-objection under paragraph (e)(2)(i) of this section a bank holding company may not make a capital distribution under the following circumstances, unless it receives approval from the Board or appropriate Reserve Bank pursuant to paragraph (f)(4) of this section:

(i) After giving effect to the capital distribution, the bank holding company would not meet a minimum regulatory capital ratio or a tier 1 common ratio of at least 5 percent;

(ii) The Board or the appropriate Reserve Bank, after consultation with the Board, notifies the company in writing that the Federal Reserve has determined that the capital distribution would result in a material adverse change to the organization's capital or liquidity structure or that the company's earnings were materially underperforming projections;

(iii) Except as provided in paragraph (f)(2) of this section, the dollar amount of the capital distribution will exceed the amount described in the capital plan for which a non-objection was issued under this section; or

(iv) The capital distribution would occur after the occurrence of an event requiring resubmission under paragraphs (d)(4)(A) and (C) of this section and before the Federal Reserve acted on the resubmitted capital plan.

(2) *Exception for well capitalized bank holding companies*. (i) A bank holding company may make a capital distribution for which the dollar amount exceeds the amount described in the capital plan for which a non-objection was issued under this section if the following conditions are satisfied:

(A) The bank holding company is, and after the capital distribution would remain, well capitalized as defined in § 225.2(r) of Regulation Y (12 CFR 225.2(r));

(B) The bank holding company's performance and capital levels are, and after the capital distribution would remain, consistent with its projections under expected conditions as set forth in its capital plan under paragraph (d)(2)(i) of this section;

(C) The annual aggregate dollar amount of all capital distributions (beginning on April 1 of a calendar year and ending on March 31 of the following calendar year) would not exceed the total amounts described in the company's capital plan for which the bank holding company received a notice of non-objection by more than 1.00 percent multiplied by the bank holding company's tier 1 capital, as reported to the Federal Reserve on the bank holding company's first quarter FR Y–9C;

(D) The bank holding company provides the appropriate Reserve Bank with notice 15 calendar days prior to a capital distribution that includes the elements described in paragraph (f)(3) of this section; and

(E) The Board or the appropriate Reserve Bank, after consultation with the Board, does not object to the transaction proposed in the notice. In determining whether to object to the proposed transaction, the Board or the appropriate Reserve Bank, after consultation with the Board, shall apply the criteria described in paragraph (f)(4)(iv) of this section.

(ii) The exception in this paragraph (f)(2) shall not apply if the Board or the appropriate Reserve Bank notifies the bank holding company in writing that it may not take advantage of this exception.

(3) *Contents of request*. (i) A request for a capital distribution under this section shall be filed with the appropriate Reserve Bank and the Board and shall contain the following information:

(A) The bank holding company's current capital plan or an attestation that there have been no changes to the capital plan since it was last submitted to the Federal Reserve;

(B) The purpose of the transaction;

(C) A description of the capital distribution, including for redemptions or repurchases of securities, the gross consideration to be paid and the terms and sources of funding for the transaction, and for dividends, the amount of the dividend(s); and

(D) Any additional information requested by the Board or the appropriate Reserve Bank (which may include, among other things, an assessment of the bank holding company's capital adequacy under a revised stress scenario provided by the Federal Reserve, a revised capital plan, and supporting data).

(ii) Any request submitted with respect to a capital distribution described in paragraph (f)(1)(i) of this section shall also include a plan for restoring the bank holding company's capital to an amount above a minimum level within 30 days and a rationale for why the capital distribution would be appropriate.

(4) *Approval of certain capital distributions.* (i) A bank holding company must obtain approval from the Board or the appropriate Reserve Bank, after consultation with the Board, before making a capital distribution described in paragraph (f)(1) of this section.

(ii) A request for a capital distribution under this section must be filed with the appropriate Reserve Bank and contain all the information set forth in paragraph (f)(3) of this section.

(iii) The Board or the appropriate Reserve Bank, after consultation with the Board, will act on a request under this paragraph (f)(4) within 30 calendar days after the receipt of a complete request under paragraph (f)(4)(ii) of this section. The Board or the appropriate Reserve Bank may, at any time, request additional information that it believes is necessary for its decision.

(iv) In acting on a request under this paragraph, the Board or appropriate Reserve Bank will apply the considerations and principles in paragraph (e) of this section. In addition, the Board or the appropriate Reserve Bank may disapprove the transaction if the bank holding company does not provide all of the information required to be submitted under paragraphs (f)(3) and (f)(5)(iii) of this section.

(5) *Disapproval and hearing.* (i) The Board or the appropriate Reserve Bank will notify the bank holding company in writing of the reasons for a decision to disapprove any proposed capital distribution. Within 10 calendar days after receipt of a disapproval by the Board, the bank holding company may submit a written request for a hearing.

(ii) The Board will order a hearing within 10 calendar days of receipt of the request if it finds that material facts are in dispute, or if it otherwise appears appropriate. Any hearing conducted under this paragraph shall be held in accordance with the Board's Rules of Practice for Formal Hearings (12 CFR part 263).

(iii) At the conclusion of the hearing, the Board will by order approve or disapprove the proposed capital distribution on the basis of the record of the hearing.

[76 FR 74644, Dec. 1, 2011]

Subpart B—Acquisition of Bank Securities or Assets

SOURCE: Reg. Y, 62 FR 9324, Feb. 28, 1997, unless otherwise noted.

§ 225.11 Transactions requiring Board approval.

The following transactions require the Board's prior approval under section 3 of the Bank Holding Company Act except as exempted under § 225.12 or as otherwise covered by § 225.17 of this subpart:

(a) *Formation of bank holding company.* Any action that causes a bank or other company to become a bank holding company.

(b) *Acquisition of subsidiary bank.* Any action that causes a bank to become a subsidiary of a bank holding company.

(c) *Acquisition of control of bank or bank holding company securities.* (1) The acquisition by a bank holding company of direct or indirect ownership or control of any voting securities of a bank or bank holding company, if the acquisition results in the company's control of more than 5 percent of the outstanding shares of any class of voting securities of the bank or bank holding company.

(2) An acquisition includes the purchase of additional securities through the exercise of preemptive rights, but does not include securities received in a stock dividend or stock split that

does not alter the bank holding company's proportional share of any class of voting securities.

(d) *Acquisition of bank assets.* The acquisition by a bank holding company or by a subsidiary thereof (other than a bank) of all or substantially all of the assets of a bank.

(e) *Merger of bank holding companies.* The merger or consolidation of bank holding companies, including a merger through the purchase of assets and assumption of liabilities.

(f) *Transactions by foreign banking organization.* Any transaction described in paragraphs (a) through (e) of this section by a foreign banking organization that involves the acquisition of an interest in a U.S. bank or in a bank holding company for which application would be required if the foreign banking organization were a bank holding company.

§ 225.12 Transactions not requiring Board approval.

The following transactions do *not* require the Board's approval under § 225.11 of this subpart:

(a) *Acquisition of securities in fiduciary capacity.* The acquisition by a bank or other company (other than a trust that is a company) of control of voting securities of a bank or bank holding company in good faith in a fiduciary capacity, unless:

(1) The acquiring bank or other company has sole discretionary authority to vote the securities and retains this authority for more than two years; or

(2) The acquisition is for the benefit of the acquiring bank or other company, or its shareholders, employees, or subsidiaries.

(b) *Acquisition of securities in satisfaction of debts previously contracted.* The acquisition by a bank or other company of control of voting securities of a bank or bank holding company in the regular course of securing or collecting a debt previously contracted in good faith, if the acquiring bank or other company divests the securities within two years of acquisition. The Board or Reserve Bank may grant requests for up to three one-year extensions.

(c) *Acquisition of securities by bank holding company with majority control.* The acquisition by a bank holding company of additional voting securities of a bank or bank holding company if more than 50 percent of the outstanding voting securities of the bank or bank holding company is lawfully controlled by the acquiring bank holding company prior to the acquisition.

(d) *Acquisitions involving bank mergers and internal corporate reorganizations*—(1) *Transactions subject to Bank Merger Act.* The merger or consolidation of a subsidiary bank of a bank holding company with another bank, or the purchase of assets by the subsidiary bank, or a similar transaction involving subsidiary banks of a bank holding company, if the transaction requires the prior approval of a federal supervisory agency under the Bank Merger Act (12 U.S.C. 1828(c)) and does not involve the acquisition of shares of a bank. This exception does not include:

(i) The merger of a nonsubsidiary bank and a nonoperating subsidiary bank formed by a company for the purpose of acquiring the nonsubsidiary bank; or

(ii) Any transaction requiring the Board's prior approval under § 225.11(e) of this subpart.

The Board may require an application under this subpart if it determines that the merger or consolidation would have a significant adverse impact on the financial condition of the bank holding company, or otherwise requires approval under section 3 of the BHC Act.

(2) *Certain acquisitions subject to Bank Merger Act.* The acquisition by a bank holding company of shares of a bank or company controlling a bank or the merger of a company controlling a bank with the bank holding company, if the transaction is part of the merger or consolidation of the bank with a subsidiary bank (other than a nonoperating subsidiary bank) of the acquiring bank holding company, or is part of the purchase of substantially all of the assets of the bank by a subsidiary bank (other than a nonoperating subsidiary bank) of the acquiring bank holding company, and if:

(i) The bank merger, consolidation, or asset purchase occurs simultaneously with the acquisition of the shares of the bank or bank holding company or the merger of holding companies, and the bank is not operated by the acquiring bank holding company as a separate entity other than as the survivor of the merger, consolidation, or asset purchase;

(ii) The transaction requires the prior approval of a federal supervisory agency under the Bank Merger Act (12 U.S.C. 1828(c));

(iii) The transaction does not involve the acquisition of any nonbank company that would require prior approval under section 4 of the BHC Act (12 U.S.C. 1843);

(iv) Both before and after the transaction, the acquiring bank holding company meets the Board's Capital Adequacy Guidelines (appendices A, B, C, D, and E of this part);

(v) At least 10 days prior to the transaction, the acquiring bank holding company has provided to the Reserve Bank written notice of the transaction that contains:

(A) A copy of the filing made to the appropriate federal banking agency under the Bank Merger Act; and

(B) A description of the holding company's involvement in the transaction, the purchase price, and the source of funding for the purchase price; and

(vi) Prior to expiration of the period provided in paragraph (d)(2)(v) of this section, the Reserve Bank has not informed the bank holding company that an application under §225.11 is required.

(3) *Internal corporate reorganizations.* (i) Subject to paragraph (d)(3)(ii) of this section, any of the following transactions performed in the United States by a bank holding company:

(A) The merger of holding companies that are subsidiaries of the bank holding company;

(B) The formation of a subsidiary holding company; [1]

(C) The transfer of control or ownership of a subsidiary bank or a subsidiary holding company between one subsidiary holding company and another subsidiary holding company or the bank holding company.

(ii) A transaction described in paragraph (d)(3)(i) of this section qualifies for this exception if:

(A) The transaction represents solely a corporate reorganization involving companies and insured depository institutions that, both preceding and following the transaction, are lawfully controlled and operated by the bank holding company;

(B) The transaction does not involve the acquisition of additional voting shares of an insured depository institution that, prior to the transaction, was less than majority owned by the bank holding company;

(C) The bank holding company is not organized in mutual form; and

(D) Both before and after the transaction, the bank holding company meets the Board's Capital Adequacy Guidelines (appendices A, B, C, D, and E of this part).

(e) *Holding securities in escrow.* The holding of any voting securities of a bank or bank holding company in an escrow arrangement for the benefit of an applicant pending the Board's action on an application for approval of the proposed acquisition, if title to the securities and the voting rights remain with the seller and payment for the securities has not been made to the seller.

(f) *Acquisition of foreign banking organization.* The acquisition of a foreign banking organization where the foreign banking organization does not directly or indirectly own or control a bank in the United States, unless the acquisition is also by a foreign banking organization and otherwise subject to §225.11(f) of this subpart.

§225.13 Factors considered in acting on bank acquisition proposals.

(a) *Factors requiring denial.* As specified in section 3(c) of the BHC Act, the Board may not approve any application under this subpart if:

(1) The transaction would result in a monopoly or would further any combination or conspiracy to monopolize, or to attempt to monopolize, the business of banking in any part of the United States;

(2) The effect of the transaction may be substantially to lessen competition in any section of the country, tend to

[1] In the case of a transaction that results in the formation or designation of a new bank holding company, the new bank holding company must complete the registration requirements described in §225.5.

create a monopoly, or in any other manner be in restraint of trade, unless the Board finds that the transaction's anti-competitive effects are clearly outweighed by its probable effect in meeting the convenience and needs of the community;

(3) The applicant has failed to provide the Board with adequate assurances that it will make available such information on its operations or activities, and the operations or activities of any affiliate of the applicant, that the Board deems appropriate to determine and enforce compliance with the BHC Act and other applicable federal banking statutes, and any regulations thereunder; or

(4) In the case of an application involving a foreign banking organization, the foreign banking organization is not subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country, as provided in §211.24(c)(1)(ii) of the Board's Regulation K (12 CFR 211.24(c)(1)(ii)).

(b) *Other factors.* In deciding applications under this subpart, the Board also considers the following factors with respect to the applicant, its subsidiaries, any banks related to the applicant through common ownership or management, and the bank or banks to be acquired:

(1) *Financial condition.* Their financial condition and future prospects, including whether current and projected capital positions and levels of indebtedness conform to standards and policies established by the Board.

(2) *Managerial resources.* The competence, experience, and integrity of the officers, directors, and principal shareholders of the applicant, its subsidiaries, and the banks and bank holding companies concerned; their record of compliance with laws and regulations; and the record of the applicant and its affiliates of fulfilling any commitments to, and any conditions imposed by, the Board in connection with prior applications.

(3) *Convenience and needs of community.* The convenience and needs of the communities to be served, including the record of performance under the Community Reinvestment Act of 1977 (12 U.S.C. 2901 *et seq.*) and regulations issued thereunder, including the Board's Regulation BB (12 CFR part 228).

(c) *Interstate transactions.* The Board may approve any application or notice under this subpart by a bank holding company to acquire control of all or substantially all of the assets of a bank located in a state other than the home state of the bank holding company, without regard to whether the transaction is prohibited under the law of any state, if the transaction complies with the requirements of section 3(d) of the BHC Act (12 U.S.C. 1842(d)).

(d) *Conditional approvals.* The Board may impose conditions on any approval, including conditions to address competitive, financial, managerial, safety and soundness, convenience and needs, compliance or other concerns, to ensure that approval is consistent with the relevant statutory factors and other provisions of the BHC Act.

§ 225.14 Expedited action for certain bank acquisitions by well-run bank holding companies.

(a) *Filing of notice*—(1) *Information required and public notice.* As an alternative to the procedure provided in §225.15, a bank holding company that meets the requirements of paragraph (c) of this section may satisfy the prior approval requirements of §225.11 in connection with the acquisition of shares, assets or control of a bank, or a merger or consolidation between bank holding companies, by providing the appropriate Reserve Bank with a written notice containing the following:

(i) A certification that all of the criteria in paragraph (c) of this section are met;

(ii) A description of the transaction that includes identification of the companies and insured depository institutions involved in the transaction[2] and

[2] If, in connection with a transaction under this subpart, any person or group of persons proposes to acquire control of the acquiring bank holding company for purposes of the Bank Control Act or §225.41, the person or group of persons may fulfill the notice requirements of the Bank Control Act and §225.43 by providing, as part of the submission by the acquiring bank holding company under this subpart, identifying and biographical information required in paragraph

identification of each banking market affected by the transaction;

(iii) A description of the effect of the transaction on the convenience and needs of the communities to be served and of the actions being taken by the bank holding company to improve the CRA performance of any insured depository institution subsidiary that does not have at least a satisfactory CRA performance rating at the time of the transaction;

(iv) Evidence that notice of the proposal has been published in accordance with § 225.16(b)(1);

(v)(A) If the bank holding company has consolidated assets of $500 million or more, an abbreviated consolidated *pro forma* balance sheet as of the most recent quarter showing credit and debit adjustments that reflect the proposed transaction, consolidated *pro forma* risk-based capital ratios for the acquiring bank holding company as of the most recent quarter, and a description of the purchase price and the terms and sources of funding for the transaction;

(B) If the bank holding company has consolidated assets of less than $500 million, a *pro forma* parent-only balance sheet as of the most recent quarter showing credit and debit adjustments that reflect the proposed transaction, and a description of the purchase price, the terms and sources of funding for the transaction, and the sources and schedule for retiring any debt incurred in the transaction;

(vi) If the bank holding company has consolidated assets of less than $300 million, a list of and biographical information regarding any directors or senior executive officers of the resulting bank holding company that are not directors or senior executive officers of the acquiring bank holding company or of a company or institution to be acquired;

(vii) For each insured depository institution whose Tier 1 capital, total capital, total assets or risk-weighted assets change as a result of the transaction, the total risk-weighted assets, total assets, Tier 1 capital and total capital of the institution on a *pro forma* basis; and

(viii) The market indexes for each relevant banking market reflecting the *pro forma* effect of the transaction.

(2) *Waiver of unnecessary information.* The Reserve Bank may reduce the information requirements in paragraph (a)(1)(v) through (viii) of this section as appropriate.

(b)(1) *Action on proposals under this section.* The Board or the appropriate Reserve Bank shall act on a proposal submitted under this section or notify the bank holding company that the transaction is subject to the procedure in § 225.15 within 5 business days after the close of the public comment period. The Board and the Reserve Bank shall not approve any proposal under this section prior to the third business day following the close of the public comment period, unless an emergency exists that requires expedited or immediate action. The Board may extend the period for action under this section for up to 5 business days.

(2) *Acceptance of notice in event expedited procedure not available.* In the event that the Board or the Reserve Bank determines after the filing of a notice under this section that a bank holding company may not use the procedure in this section and must file an application under § 225.15, the application shall be deemed accepted for purposes of § 225.15 as of the date that the notice was filed under this section.

(c) *Criteria for use of expedited procedure.* The procedure in this section is available only if:

(1) *Well-capitalized organization*—(i) *Bank holding company.* Both at the time of and immediately after the proposed transaction, the acquiring bank holding company is well-capitalized;

(ii) *Insured depository institutions.* Both at the time of and immediately after the proposed transaction:

(A) The lead insured depository institution of the acquiring bank holding company is well-capitalized;

(B) Well-capitalized insured depository institutions control at least 80 percent of the total risk-weighted assets of insured depository institutions controlled by the acquiring bank holding company; and

(6)(A) of the Bank Control Act (12 U.S.C. 1817(j)(6)(A)), as well as any financial or other information requested by the Reserve Bank under § 225.43.

(C) No insured depository institution controlled by the acquiring bank holding company is undercapitalized;

(2) *Well managed organization*—(i) *Satisfactory examination ratings.* At the time of the transaction, the acquiring bank holding company, its lead insured depository institution, and insured depository institutions that control at least 80 percent of the total risk-weighted assets of insured depository institutions controlled by the holding company are well managed and have received at least a satisfactory rating for compliance at their most recent examination if such rating was given;

(ii) *No poorly managed institutions.* No insured depository institution controlled by the acquiring bank holding company has received 1 of the 2 lowest composite ratings at the later of the institution's most recent examination or subsequent review by the appropriate federal banking agency for the institution;

(iii) *Recently acquired institutions excluded.* Any insured depository institution that has been acquired by the bank holding company during the 12-month period preceding the date on which written notice is filed under paragraph (a) of this section may be excluded for purposes of paragraph (c)(2)(ii) of this section if :

(A) The bank holding company has developed a plan acceptable to the appropriate federal banking agency for the institution to restore the capital and management of the institution; and

(B) All insured depository institutions excluded under this paragraph represent, in the aggregate, less than 10 percent of the aggregate total risk-weighted assets of all insured depository institutions controlled by the bank holding company;

(3) *Convenience and needs criteria*—(i) *Effect on the community.* The record indicates that the proposed transaction would meet the convenience and needs of the community standard in the BHC Act; and

(ii) *Established CRA performance record.* At the time of the transaction, the lead insured depository institution of the acquiring bank holding company and insured depository institutions that control at least 80 percent of the total risk-weighted assets of insured institutions controlled by the holding company have received a satisfactory or better composite rating at the most recent examination under the Community Reinvestment Act;

(4) *Public comment.* No comment that is timely and substantive as provided in § 225.16 is received by the Board or the appropriate Reserve Bank other than a comment that supports approval of the proposal;

(5) *Competitive criteria*—(i) *Competitive screen.* Without regard to any divestitures proposed by the acquiring bank holding company, the acquisition does not cause:

(A) Insured depository institutions controlled by the acquiring bank holding company to control in excess of 35 percent of market deposits in any relevant banking market; or

(B) The Herfindahl-Hirschman index to increase by more than 200 points in any relevant banking market with a post-acquisition index of at least 1800; and

(ii) *Department of Justice.* The Department of Justice has not indicated to the Board that consummation of the transaction is likely to have a significantly adverse effect on competition in any relevant banking market;

(6) *Size of acquisition*—(i) *In general*—(A) *Limited Growth.* Except as provided in paragraph (c)(6)(ii) of this section, the sum of the aggregate risk-weighted assets to be acquired in the proposal and the aggregate risk- weighted assets acquired by the acquiring bank holding company in all other qualifying transactions does not exceed 35 percent of the consolidated risk-weighted assets of the acquiring bank holding company. For purposes of this paragraph *other qualifying transactions* means any transaction approved under this section or § 225.23 during the 12 months prior to filing the notice under this section; and

(B) *Individual size limitation.* The total risk-weighted assets to be acquired do not exceed $7.5 billion;

(ii) *Small bank holding companies.* Paragraph (c)(6)(i)(A) of this section shall not apply if, immediately following consummation of the proposed transaction, the consolidated risk-weighted assets of the acquiring bank holding company are less than $300 million;

(7) *Supervisory actions.* During the 12-month period ending on the date on which the bank holding company proposes to consummate the proposed transaction, no formal administrative order, including a written agreement, cease and desist order, capital directive, prompt corrective action directive, asset maintenance agreement, or other formal enforcement action, is or was outstanding against the bank holding company or any insured depository institution subsidiary of the holding company, and no formal administrative enforcement proceeding involving any such enforcement action, order, or directive is or was pending;

(8) *Interstate acquisitions.* Board-approval of the transaction is not prohibited under section 3(d) of the BHC Act;

(9) *Other supervisory considerations.* Board approval of the transaction is not prohibited under the informational sufficiency or comprehensive home country supervision standards set forth in section 3(c)(3) of the BHC Act; and

(10) *Notification.* The acquiring bank holding company has not been notified by the Board, in its discretion, prior to the expiration of the period in paragraph (b)(1) of this section that an application under §225.15 is required in order to permit closer review of any financial, managerial, competitive, convenience and needs or other matter related to the factors that must be considered under this part.

(d) *Comment by primary banking supervisor*—(1) *Notice.* Upon receipt of a notice under this section, the appropriate Reserve Bank shall promptly furnish notice of the proposal and a copy of the information filed pursuant to paragraph (a) of this section to the primary banking supervisor of the insured depository institutions to be acquired.

(2) *Comment period.* The primary banking supervisor shall have 30 calendar days (or such shorter time as agreed to by the primary banking supervisor) from the date of the letter giving notice in which to submit its views and recommendations to the Board.

(3) *Action subject to supervisor's comment.* Action by the Board or the Reserve Bank on a proposal under this section is subject to the condition that the primary banking supervisor not recommend in writing to the Board disapproval of the proposal prior to the expiration of the comment period described in paragraph (d)(2) of this section. In such event, any approval given under this section shall be revoked and, if required by section 3(b) of the BHC Act, the Board shall order a hearing on the proposal.

(4) *Emergencies.* Notwithstanding paragraphs (d)(2) and (d)(3) of this section, the Board may provide the primary banking supervisor with 10 calendar days' notice of a proposal under this section if the Board finds that an emergency exists requiring expeditious action, and may act during the notice period or without providing notice to the primary banking supervisor if the Board finds that it must act immediately to prevent probable failure.

(5) *Primary banking supervisor.* For purposes of this section and §225.15(b), *the primary banking supervisor* for an institution is:

(i) The Office of the Comptroller of the Currency, in the case of a national banking association or District bank;

(ii) The appropriate supervisory authority for the State in which the bank is chartered, in the case of a State bank;

(iii) The Director of the Office of Thrift Supervision, in the case of a savings association.

(e) *Branches and agencies of foreign banking organizations.* For purposes of this section, a U.S. branch or agency of a foreign banking organization shall be considered to be an insured depository institution. A U.S. branch or agency of a foreign banking organization shall be subject to paragraph (c)(3)(ii) of this section only to the extent it is insured by the Federal Deposit Insurance Corporation in accordance with section 6 of the International Banking Act of 1978 (12 U.S.C. 3104).

[Reg. Y, 62 FR 9324, Feb. 28, 1997, as amended at 66 FR 415, Jan. 3, 2001; 71 FR 9901, Feb. 28, 2006]

§ 225.15 Procedures for other bank acquisition proposals.

(a) *Filing application.* Except as provided in §225.14, an application for the

Board's prior approval under this subpart shall be governed by the provisions of this section and shall be filed with the appropriate Reserve Bank on the designated form.

(b) *Notice to primary banking supervisor.* Upon receipt of an application under this subpart, the Reserve Bank shall promptly furnish notice and a copy of the application to the primary banking supervisor of each bank to be acquired. The primary supervisor shall have 30 calendar days from the date of the letter giving notice in which to submit its views and recommendations to the Board.

(c) *Accepting application for processing.* Within 7 calendar days after the Reserve Bank receives an application under this section, the Reserve Bank shall accept it for processing as of the date the application was filed or return the application if it is substantially incomplete. Upon accepting an application, the Reserve Bank shall immediately send copies to the Board. The Reserve Bank or the Board may request additional information necessary to complete the record of an application at any time after accepting the application for processing.

(d) *Action on applications*—(1) *Action under delegated authority.* The Reserve Bank shall approve an application under this section within 30 calendar days after the acceptance date for the application, unless the Reserve Bank, upon notice to the applicant, refers the application to the Board for decision because action under delegated authority is not appropriate.

(2) *Board action.* The Board shall act on an application under this subpart that is referred to it for decision within 60 calendar days after the acceptance date for the application, unless the Board notifies the applicant that the 60-day period is being extended for a specified period and states the reasons for the extension. In no event may the extension exceed the 91-day period provided in § 225.16(f). The Board may, at any time, request additional information that it believes is necessary for its decision.

§ 225.16 Public notice, comments, hearings, and other provisions governing applications and notices.

(a) *In general.* The provisions of this section apply to all notices and applications filed under § 225.14 and § 225.15.

(b) *Public notice*—(1) *Newspaper publication*—(i) *Location of publication.* In the case of each notice or application submitted under § 225.14 or § 225.15, the applicant shall publish a notice in a newspaper of general circulation, in the form and at the locations specified in § 262.3 of the Rules of Procedure (12 CFR 262.3);

(ii) *Contents of notice.* A newspaper notice under this paragraph shall provide an opportunity for interested persons to comment on the proposal for a period of at least 30 calendar days;

(iii) *Timing of publication.* Each newspaper notice published in connection with a proposal under this paragraph shall be published no more than 15 calendar days before and no later than 7 calendar days following the date that a notice or application is filed with the appropriate Reserve Bank.

(2) FEDERAL REGISTER *notice.* (i) *Publication by Board.* Upon receipt of a notice or application under § 225.14 or § 225.15, the Board shall promptly publish notice of the proposal in the FEDERAL REGISTER and shall provide an opportunity for interested persons to comment on the proposal for a period of no more than 30 days;

(ii) *Request for advance publication.* A bank holding company may request that, during the 15-day period prior to filing a notice or application under § 225.14 or § 225.15, the Board publish notice of a proposal in the FEDERAL REGISTER. A request for advance FEDERAL REGISTER publication shall be made in writing to the appropriate Reserve Bank and shall contain the identifying information prescribed by the Board for FEDERAL REGISTER publication;

(3) *Waiver or shortening of notice.* The Board may waive or shorten the required notice periods under this section if the Board determines that an emergency exists requiring expeditious action on the proposal, or if the Board finds that immediate action is necessary to prevent the probable failure of an insured depository institution.

(c) *Public comment*—(1) *Timely comments.* Interested persons may submit information and comments regarding a proposal filed under this subpart. A comment shall be considered timely for purposes of this subpart if the comment, together with all supplemental information, is submitted in writing in accordance with the Board's Rules of Procedure and received by the Board or the appropriate Reserve Bank prior to the expiration of the latest public comment period provided in paragraph (b) of this section.

(2) *Extension of comment period*—(i) *In general.* The Board may, in its discretion, extend the public comment period regarding any proposal submitted under this subpart.

(ii) *Requests in connection with obtaining application or notice.* In the event that an interested person has requested a copy of a notice or application submitted under this subpart, the Board may, in its discretion and based on the facts and circumstances, grant such person an extension of the comment period for up to 15 calendar days.

(iii) *Joint requests by interested person and acquiring company.* The Board will grant a joint request by an interested person and the acquiring bank holding company for an extension of the comment period for a reasonable period for a purpose related to the statutory factors the Board must consider under this subpart.

(3) *Substantive comment.* A comment will be considered substantive for purposes of this subpart unless it involves individual complaints, or raises frivolous, previously-considered or wholly unsubstantiated claims or irrelevant issues.

(d) *Notice to Attorney General.* The Board or Reserve Bank shall immediately notify the United States Attorney General of approval of any notice or application under § 225.14 or § 225.15.

(e) *Hearings.* As provided in section 3(b) of the BHC Act, the Board shall order a hearing on any application or notice under § 225.15 if the Board receives from the primary supervisor of the bank to be acquired, within the 30-day period specified in § 225.15(b), a written recommendation of disapproval of an application. The Board may order a formal or informal hearing or other proceeding on the application or notice, as provided in § 262.3(i)(2) of the Board's Rules of Procedure. Any request for a hearing (other than from the primary supervisor) shall comply with § 262.3(e) of the Rules of Procedure (12 CFR 262.3(e)).

(f) *Approval through failure to act*—(1) *Ninety-one day rule.* An application or notice under § 225.14 or § 225.15 shall be deemed approved if the Board fails to act on the application or notice within 91 calendar days after the date of submission to the Board of the complete record on the application. For this purpose, the Board acts when it issues an order stating that the Board has approved or denied the application or notice, reflecting the votes of the members of the Board, and indicating that a statement of the reasons for the decision will follow promptly.

(2) *Complete record.* For the purpose of computing the commencement of the 91-day period, the record is complete on the latest of:

(i) The date of receipt by the Board of an application or notice that has been accepted by the Reserve Bank;

(ii) The last day provided in any notice for receipt of comments and hearing requests on the application or notice;

(iii) The date of receipt by the Board of the last relevant material regarding the application or notice that is needed for the Board's decision, if the material is received from a source outside of the Federal Reserve System; or

(iv) The date of completion of any hearing or other proceeding.

(g) *Exceptions to notice and hearing requirements*—(1) *Probable bank failure.* If the Board finds it must act immediately on an application or notice in order to prevent the probable failure of a bank or bank holding company, the Board may modify or dispense with the notice and hearing requirements of this section.

(2) *Emergency.* If the Board finds that, although immediate action on an application or notice is not necessary, an emergency exists requiring expeditious action, the Board shall provide the primary supervisor 10 days to submit its recommendation. The Board may act

on such an application or notice without a hearing and may modify or dispense with the other notice and hearing requirements of this section.

(h) *Waiting period.* A transaction approved under § 225.14 or § 225.15 shall not be consummated until 30 days after the date of approval of the application, except that a transaction may be consummated:

(1) Immediately upon approval, if the Board has determined under paragraph (g) of this section that the application or notice involves a probable bank failure;

(2) On or after the 5th calendar day following the date of approval, if the Board has determined under paragraph (g) of this section that an emergency exists requiring expeditious action; or

(3) On or after the 15th calendar day following the date of approval, if the Board has not received any adverse comments from the United States Attorney General relating to the competitive factors and the Attorney General has consented to the shorter waiting period.

§ 225.17 Notice procedure for one-bank holding company formations.

(a) *Transactions that qualify under this section.* An acquisition by a company of control of a bank may be consummated 30 days after providing notice to the appropriate Reserve Bank in accordance with paragraph (b) of this section, provided that all of the following conditions are met:

(1) The shareholder or shareholders who control at least 67 percent of the shares of the bank will control, immediately after the reorganization, at least 67 percent of the shares of the holding company in substantially the same proportion, except for changes in shareholders' interests resulting from the exercise of dissenting shareholders' rights under state or federal law; [3]

(2) No shareholder, or group of shareholders acting in concert, will, following the reorganization, own or control 10 percent or more of any class of voting shares of the bank holding company, unless that shareholder or group of shareholders was authorized, after review under the Change in Bank Control Act of 1978 (12 U.S.C. 1817(j)) by the appropriate federal banking agency for the bank, to own or control 10 percent or more of any class of voting shares of the bank; [4]

(3) The bank is adequately capitalized (as defined in section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o));

(4) The bank received at least a composite ''satisfactory'' rating at its most recent examination, in the event that the bank was examined;

(5) At the time of the reorganization, neither the bank nor any of its officers, directors, or principal shareholders is involved in any unresolved supervisory or enforcement matters with any appropriate federal banking agency;

(6) The company demonstrates that any debt that it incurs at the time of the reorganization, and the proposed means of retiring this debt, will not place undue burden on the holding company or its subsidiary on a *pro forma* basis; [5]

(7) The holding company will not, as a result of the reorganization, acquire control of any additional bank or engage in any activities other than those of managing and controlling banks; and

(8) During this period, neither the appropriate Reserve Bank nor the Board objected to the proposal or required the

[3] A shareholder of a bank in reorganization will be considered to have the same proportional interest in the holding company if the shareholder interest increases, on a *pro rata* basis, as a result of either the redemption of shares from dissenting shareholders by the bank or bank holding company, or the acquisition of shares of dissenting shareholders by the remaining shareholders.

[4] This procedure is not available in cases in which the exercise of dissenting shareholders' rights would cause a company that is not a bank holding company (other than the company in formation) to be required to register as a bank holding company. This procedure also is not available for the formation of a bank holding company organized in mutual form.

[5] For a banking organization with consolidated assets, on a *pro forma* basis, of less than $500 million (other than a banking organization that will control a de novo bank), this requirement is satisfied if the proposal complies with the Board's Small Bank Holding Company Policy Statement (appendix C of this part).

filing of an application under § 225.15 of this subpart.

(b) *Contents of notice.* A notice filed under this paragraph shall include:

(1) Certification by the notificant's board of directors that the requirements of 12 U.S.C. 1842(a)(C) and this section are met by the proposal;

(2) A list identifying all principal shareholders of the bank prior to the reorganization and of the holding company following the reorganization, and specifying the percentage of shares held by each principal shareholder in the bank and proposed to be held in the new holding company;

(3) A description of the resulting management of the proposed bank holding company and its subsidiary bank, including:

(i) Biographical information regarding any senior officers and directors of the resulting bank holding company who were not senior officers or directors of the bank prior to the reorganization; and

(ii) A detailed history of the involvement of any officer, director, or principal shareholder of the resulting bank holding company in any administrative or criminal proceeding; and

(4) *Pro forma* financial statements for the holding company, and a description of the amount, source, and terms of debt, if any, that the bank holding company proposes to incur, and information regarding the sources and timing for debt service and retirement.

(c) *Acknowledgment of notice.* Within 7 calendar days following receipt of a notice under this section, the Reserve Bank shall provide the notificant with a written acknowledgment of receipt of the notice. This written acknowledgment shall indicate that the transaction described in the notice may be consummated on the 30th calendar day after the date of receipt of the notice if the Reserve Bank or the Board has not objected to the proposal during that time.

(d) *Application required upon objection.* The Reserve Bank or the Board may object to a proposal during the notice period by providing the bank holding company with a written explanation of the reasons for the objection. In such case, the bank holding company may file an application for prior approval of the proposal pursuant to § 225.15 of this subpart.

[Reg. Y, 62 FR 9319, Feb. 28, 1997, as amended at 71 FR 9902, Feb. 28, 2006]

Subpart C—Nonbanking Activities and Acquisitions by Bank Holding Companies

SOURCE: Reg. Y, 62 FR 9329, Feb. 28, 1997, unless otherwise noted.

§ 225.21 Prohibited nonbanking activities and acquisitions; exempt bank holding companies.

(a) *Prohibited nonbanking activities and acquisitions.* Except as provided in § 225.22 of this subpart, a bank holding company or a subsidiary may not engage in, or acquire or control, directly or indirectly, voting securities or assets of a company engaged in, any activity other than:

(1) Banking or managing or controlling banks and other subsidiaries authorized under the BHC Act; and

(2) An activity that the Board determines to be so closely related to banking, or managing or controlling banks as to be a proper incident thereto, including any incidental activities that are necessary to carry on such an activity, if the bank holding company has obtained the prior approval of the Board for that activity in accordance with the requirements of this regulation.

(b) *Exempt bank holding companies.* The following bank holding companies are exempt from the provisions of this subpart:

(1) *Family-owned companies.* Any company that is a ''company covered in 1970'' (as defined in section 2(b) of the BHC Act), more than 85 percent of the voting securities of which was collectively owned on June 30, 1968, and continuously thereafter, by members of the same family (or their spouses) who are lineal descendants of common ancestors.

(2) *Labor, agricultural, and horticultural organizations.* Any company that was on January 4, 1977, both a

bank holding company and a labor, agricultural, or horticultural organization exempt from taxation under section 501 of the Internal Revenue Code (26 U.S.C. 501(c)).

(3) *Companies granted hardship exemption.* Any bank holding company that has controlled only one bank since before July 1, 1968, and that has been granted an exemption by the Board under section 4(d) of the BHC Act, subject to any conditions imposed by the Board.

(4) *Companies granted exemption on other grounds.* Any company that acquired control of a bank before December 10, 1982, without the Board's prior approval under section 3 of the BHC Act, on the basis of a narrow interpretation of the term *demand deposit* or *commercial loan,* if the Board has determined that:

(i) Coverage of the company as a bank holding company under this subpart would be unfair or represent an unreasonable hardship; and

(ii) Exclusion of the company from coverage under this part is consistent with the purposes of the BHC Act and section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1971, 1972(1)). The provisions of §225.4 of subpart A of this part do not apply to a company exempt under this paragraph.

§ 225.22 Exempt nonbanking activities and acquisitions.

(a) *Certain de novo activities.* A bank holding company may, either directly or indirectly, engage *de novo* in any nonbanking activity listed in §225.28(b) (other than operation of an insured depository institution) without obtaining the Board's prior approval if the bank holding company:

(1) Meets the requirements of paragraphs (c) (1), (2), and (6) of §225.23;

(2) Conducts the activity in compliance with all Board orders and regulations governing the activity; and

(3) Within 10 business days after commencing the activity, provides written notice to the appropriate Reserve Bank describing the activity, identifying the company or companies engaged in the activity, and certifying that the activity will be conducted in accordance with the Board's orders and regulations and that the bank holding company meets the requirements of paragraphs (c) (1), (2), and (6) of §225.23.

(b) *Servicing activities.* A bank holding company may, without the Board's prior approval under this subpart, furnish services to or perform services for, or establish or acquire a company that engages solely in servicing activities for:

(1) The bank holding company or its subsidiaries in connection with their activities as authorized by law, including services that are necessary to fulfill commitments entered into by the subsidiaries with third parties, if the bank holding company or servicing company complies with the Board's published interpretations and does not act as principal in dealing with third parties; and

(2) The internal operations of the bank holding company or its subsidiaries. Services for the internal operations of the bank holding company or its subsidiaries include, but are not limited to:

(i) Accounting, auditing, and appraising;

(ii) Advertising and public relations;

(iii) Data processing and data transmission services, data bases, or facilities;

(iv) Personnel services;

(v) Courier services;

(vi) Holding or operating property used wholly or substantially by a subsidiary in its operations or for its future use;

(vii) Liquidating property acquired from a subsidiary;

(viii) Liquidating property acquired from any sources either prior to May 9, 1956, or the date on which the company became a bank holding company, whichever is later; and

(ix) Selling, purchasing, or underwriting insurance, such as blanket bond insurance, group insurance for employees, and property and casualty insurance.

(c) *Safe deposit business.* A bank holding company or nonbank subsidiary may, without the Board's prior approval, conduct a safe deposit business, or acquire voting securities of a company that conducts such a business.

(d) *Nonbanking acquisitions not requiring prior Board approval.* The Board's prior approval is not required under this subpart for the following acquisitions:

(1) *DPC acquisitions.* (i) Voting securities or assets, acquired by foreclosure or otherwise, in the ordinary course of collecting a debt previously contracted (DPC property) in good faith, if the DPC property is divested within two years of acquisition.

(ii) The Board may, upon request, extend this two-year period for up to three additional years. The Board may permit additional extensions for up to 5 years (for a total of 10 years), for shares, real estate or other assets where the holding company demonstrates that each extension would not be detrimental to the public interest and either the bank holding company has made good faith attempts to dispose of such shares, real estate or other assets or disposal of the shares, real estate or other assets during the initial period would have been detrimental to the company.

(iii) Transfers of DPC property within the bank holding company system do not extend any period for divestiture of the property.

(2) *Securities or assets required to be divested by subsidiary.* Voting securities or assets required to be divested by a subsidiary at the request of an examining federal or state authority (except by the Board under the BHC Act or this regulation), if the bank holding company divests the securities or assets within two years from the date acquired from the subsidiary.

(3) *Fiduciary investments.* Voting securities or assets acquired by a bank or other company (other than a trust that is a company) in good faith in a fiduciary capacity, if the voting securities or assets are:

(i) Held in the ordinary course of business; and

(ii) Not acquired for the benefit of the company or its shareholders, employees, or subsidiaries.

(4) *Securities eligible for investment by national bank.* Voting securities of the kinds and amounts explicitly eligible by federal statute (other than section 4 of the Bank Service Corporation Act, 12 U.S.C. 1864) for investment by a national bank, and voting securities acquired prior to June 30, 1971, in reliance on section 4(c)(5) of the BHC Act and interpretations of the Comptroller of the Currency under section 5136 of the Revised Statutes (12 U.S.C. 24(7)).

(5) *Securities or property representing 5 percent or less of a company.* Voting securities of a company or property that, in the aggregate, represent 5 percent or less of the outstanding shares of any class of voting securities of a company, or that represent a 5 percent interest or less in the property, subject to the provisions of 12 CFR 225.137.

(6) *Securities of investment company.* Voting securities of an investment company that is solely engaged in investing in securities and that does not own or control more than 5 percent of the outstanding shares of any class of voting securities of any company.

(7) *Assets acquired in ordinary course of business.* Assets of a company acquired in the ordinary course of business, subject to the provisions of 12 CFR 225.132, if the assets relate to activities in which the acquiring company has previously received Board approval under this regulation to engage.

(8) *Asset acquisitions by lending company or industrial bank.* Assets of an office(s) of a company, all or substantially all of which relate to making, acquiring, or servicing loans if:

(i) The acquiring company has previously received Board approval under this regulation or is not required to obtain prior Board approval under this regulation to engage in lending activities or industrial banking activities;

(ii) The assets acquired during any 12-month period do not represent more than 50 percent of the risk-weighted assets (on a consolidated basis) of the acquiring lending company or industrial bank, or more than $100 million, whichever amount is less;

(iii) The assets acquired do not represent more than 50 percent of the selling company's consolidated assets that are devoted to lending activities or industrial banking business;

(iv) The acquiring company notifies the Reserve Bank of the acquisition within 30 days after the acquisition; and

(v) The acquiring company, after giving effect to the transaction, meets the Board's Capital Adequacy Guidelines (appendix A of this part), and the

Board has not previously notified the acquiring company that it may not acquire assets under the exemption in this paragraph.

(e) *Acquisition of securities by subsidiary banks*—(1) *National bank.* A national bank or its subsidiary may, without the Board's approval under this subpart, acquire or retain securities on the basis of section 4(c)(5) of the BHC Act in accordance with the regulations of the Comptroller of the Currency.

(2) *State bank.* A state-chartered bank or its subsidiary may, insofar as federal law is concerned, and without the Board's prior approval under this subpart:

(i) Acquire or retain securities, on the basis of section 4(c)(5) of the BHC Act, of the kinds and amounts explicitly eligible by federal statute for investment by a national bank; or

(ii) Acquire or retain all (but, except for directors' qualifying shares, not less than all) of the securities of a company that engages solely in activities in which the parent bank may engage, at locations at which the bank may engage in the activity, and subject to the same limitations as if the bank were engaging in the activity directly.

(f) *Activities and securities of new bank holding companies.* A company that becomes a bank holding company may, for a period of two years, engage in nonbanking activities and control voting securities or assets of a nonbank subsidiary, if the bank holding company engaged in such activities or controlled such voting securities or assets on the date it became a bank holding company. The Board may grant requests for up to three one-year extensions of the two-year period.

(g) *Grandfathered activities and securities.* Unless the Board orders divestiture or termination under section 4(a)(2) of the BHC Act, a "company covered in 1970," as defined in section 2(b) of the BHC Act, may:

(1) Retain voting securities or assets and engage in activities that it has lawfully held or engaged in continuously since June 30, 1968; and

(2) Acquire voting securities of any newly formed company to engage in such activities.

(h) *Securities or activities exempt under Regulation K.* A bank holding company may acquire voting securities or assets and engage in activities as authorized in Regulation K (12 CFR part 211).

§ 225.23 Expedited action for certain nonbanking proposals by well-run bank holding companies.

(a) *Filing of notice*—(1) *Information required.* A bank holding company that meets the requirements of paragraph (c) of this section may satisfy the notice requirement of this subpart in connection with the acquisition of voting securities or assets of a company engaged in nonbanking activities that the Board has permitted by order or regulation (other than an insured depository institution),[1] or a proposal to engage *de novo*, either directly or indirectly, in a nonbanking activity that the Board has permitted by order or by regulation, by providing the appropriate Reserve Bank with a written notice containing the following:

(i) A certification that all of the criteria in paragraph (c) of this section are met;

(ii) A description of the transaction that includes identification of the companies involved in the transaction, the activities to be conducted, and a commitment to conduct the proposed activities in conformity with the Board's regulations and orders governing the conduct of the proposed activity;

(iii) If the proposal involves an acquisition of a going concern:

(A) If the bank holding company has consolidated assets of $500 million or more, an abbreviated consolidated *pro forma* balance sheet for the acquiring bank holding company as of the most recent quarter showing credit and debit adjustments that reflect the proposed transaction, consolidated *pro forma* risk-based capital ratios for the acquiring bank holding company as of the most recent quarter, a description of

[1] A bank holding company may acquire voting securities or assets of a savings association or other insured depository institution that is not a bank by using the procedures in § 225.14 of subpart B if the bank holding company and the proposal qualify under that section as if the savings association or other institution were a bank for purposes of that section.

the purchase price and the terms and sources of funding for the transaction, and the total revenue and net income of the company to be acquired;

(B) If the bank holding company has consolidated assets of less than $500 million, a *pro forma* parent-only balance sheet as of the most recent quarter showing credit and debit adjustments that reflect the proposed transaction, a description of the purchase price and the terms and sources of funding for the transaction and the sources and schedule for retiring any debt incurred in the transaction, and the total assets, off-balance sheet items, revenue and net income of the company to be acquired;

(C) For each insured depository institution whose Tier 1 capital, total capital, total assets or risk-weighted assets change as a result of the transaction, the total risk-weighted assets, total assets, Tier 1 capital and total capital of the institution on a *pro forma* basis;

(iv) Identification of the geographic markets in which competition would be affected by the proposal, a description of the effect of the proposal on competition in the relevant markets, a list of the major competitors in that market in the proposed activity if the affected market is local in nature, and, if requested, the market indexes for the relevant market; and

(v) A description of the public benefits that can reasonably be expected to result from the transaction.

(2) *Waiver of unnecessary information.* The Reserve Bank may reduce the information requirements in paragraphs (a)(1) (iii) and (iv) of this section as appropriate.

(b)(1) *Action on proposals under this section.* The Board or the appropriate Reserve Bank shall act on a proposal submitted under this section, or notify the bank holding company that the transaction is subject to the procedure in §225.24, within 12 business days following the filing of all of the information required in paragraph (a) of this section.

(2) *Acceptance of notice if expedited procedure not available.* If the Board or the Reserve Bank determines, after the filing of a notice under this section, that a bank holding company may not use the procedure in this section and must file a notice under §225.24, the notice shall be deemed accepted for purposes of §225.24 as of the date that the notice was filed under this section.

(c) *Criteria for use of expedited procedure.* The procedure in this section is available only if:

(1) *Well-capitalized organization*—(i) *Bank holding company.* Both at the time of and immediately after the proposed transaction, the acquiring bank holding company is well-capitalized;

(ii) *Insured depository institutions.* Both at the time of and immediately after the transaction:

(A) The lead insured depository institution of the acquiring bank holding company is well-capitalized;

(B) Well-capitalized insured depository institutions control at least 80 percent of the total risk-weighted assets of insured depository institutions controlled by the acquiring bank holding company; and

(C) No insured depository institution controlled by the acquiring bank holding company is undercapitalized;

(2) *Well managed organization*—(i) *Satisfactory examination ratings.* At the time of the transaction, the acquiring bank holding company, its lead insured depository institution, and insured depository institutions that control at least 80 percent of the total risk-weighted assets of insured depository institutions controlled by the holding company are well managed and have received at least a satisfactory rating for compliance at their most recent examination if such rating was given;

(ii) *No poorly managed institutions.* No insured depository institution controlled by the acquiring bank holding company has received 1 of the 2 lowest composite ratings at the later of the institution's most recent examination or subsequent review by the appropriate federal banking agency for the institution.

(iii) *Recently acquired institutions excluded.* Any insured depository institution that has been acquired by the bank holding company during the 12-month period preceding the date on which written notice is filed under paragraph (a) of this section may be excluded for purposes of paragraph (c)(2)(ii) of this section if:

(A) The bank holding company has developed a plan acceptable to the appropriate federal banking agency for the institution to restore the capital and management of the institution; and

(B) All insured depository institutions excluded under this paragraph represent, in the aggregate, less than 10 percent of the aggregate total risk-weighted assets of all insured depository institutions controlled by the bank holding company;

(3) *Permissible activity.* (i) The Board has determined by regulation or order that each activity proposed to be conducted is so closely related to banking, or managing or controlling banks, as to be a proper incident thereto; and

(ii) The Board has not indicated that proposals to engage in the activity are subject to the notice procedure provided in § 225.24;

(4) *Competitive criteria*—(i) *Competitive screen.* In the case of the acquisition of a going concern, the acquisition, without regard to any divestitures proposed by the acquiring bank holding company, does not cause:

(A) The acquiring bank holding company to control in excess of 35 percent of the market share in any relevant market; or

(B) The Herfindahl-Hirschman index to increase by more than 200 points in any relevant market with a post-acquisition index of at least 1800; and

(ii) *Other competitive factors.* The Board has not indicated that the transaction is subject to close scrutiny on competitive grounds;

(5) *Size of acquisition*—(i) *In general*—(A) *Limited growth.* Except as provided in paragraph (c)(5)(ii) of this section, the sum of aggregate risk-weighted assets to be acquired in the proposal and the aggregate risk-weighted assets acquired by the acquiring bank holding company in all other qualifying transactions does not exceed 35 percent of the consolidated risk-weighted assets of the acquiring bank holding company. For purposes of this paragraph, ''other qualifying transactions'' means any transaction approved under this section or § 225.14 during the 12 months prior to filing the notice under this section;

(B) *Consideration paid.* The gross consideration to be paid by the acquiring bank holding company in the proposal does not exceed 15 percent of the consolidated Tier 1 capital of the acquiring bank holding company; and

(C) *Individual size limitation.* The total risk-weighted assets to be acquired do not exceed $7.5 billion;

(ii) *Small bank holding companies.* Paragraph (c)(5)(i)(A) of this section shall not apply if, immediately following consummation of the proposed transaction, the consolidated risk-weighted assets of the acquiring bank holding company are less than $300 million;

(6) *Supervisory actions.* During the 12-month period ending on the date on which the bank holding company proposes to consummate the proposed transaction, no formal administrative order, including a written agreement, cease and desist order, capital directive, prompt corrective action directive, asset maintenance agreement, or other formal enforcement order is or was outstanding against the bank holding company or any insured depository institution subsidiary of the holding company, and no formal administrative enforcement proceeding involving any such enforcement action, order, or directive is or was pending; and

(7) *Notification.* The bank holding company has not been notified by the Board, in its discretion, prior to the expiration of the period in paragraph (b) of this section that a notice under § 225.24 is required in order to permit closer review of any potential adverse effect or other matter related to the factors that must be considered under this part.

(d) *Branches and agencies of foreign banking organizations.* For purposes of this section, a U.S. branch or agency of a foreign banking organization shall be considered to be an insured depository institution.

[Reg. Y, 62 FR 9329, Feb. 28, 1997, as amended at 66 FR 415, Jan. 3, 2001; 71 FR 9902, Feb. 28, 2006]

§ 225.24 Procedures for other nonbanking proposals.

(a) *Notice required for nonbanking activities.* Except as provided in § 225.22 and § 225.23, a notice for the Board's prior approval under § 225.21(a) to engage in or acquire a company engaged in a nonbanking activity shall be filed by a bank holding company (including a company seeking to become a bank holding company) with the appropriate Reserve Bank in accordance with this section and the Board's Rules of Procedure (12 CFR 262.3).

(1) *Engaging de novo in listed activities.* A bank holding company seeking to commence or to engage *de novo,* either directly or through a subsidiary, in a nonbanking activity listed in § 225.28 shall file a notice containing a description of the activities to be conducted and the identity of the company that will conduct the activity.

(2) *Acquiring company engaged in listed activities.* A bank holding company seeking to acquire or control voting securities or assets of a company engaged in a nonbanking activity listed in § 225.28 shall file a notice containing the following:

(i) A description of the proposal, including a description of each proposed activity, and the effect of the proposal on competition among entities engaging in each proposed activity in each relevant market with relevant market indexes;

(ii) The identity of any entity involved in the proposal, and, if the notificant proposes to conduct the activity through an existing subsidiary, a description of the existing activities of the subsidiary;

(iii) A statement of the public benefits that can reasonably be expected to result from the proposal;

(iv) If the bank holding company has consolidated assets of $150 million or more:

(A) Parent company and consolidated *pro forma* balance sheets for the acquiring bank holding company as of the most recent quarter showing credit and debit adjustments that reflect the proposed transaction;

(B) Consolidated *pro forma* risk-based capital and leverage ratio calculations for the acquiring bank holding company as of the most recent quarter; and

(C) A description of the purchase price and the terms and sources of funding for the transaction;

(v) If the bank holding company has consolidated assets of less than $150 million:

(A) A *pro forma* parent-only balance sheet as of the most recent quarter showing credit and debit adjustments that reflect the proposed transaction; and

(B) A description of the purchase price and the terms and sources of funding for the transaction and, if the transaction is debt funded, one-year income statement and cash flow projections for the parent company, and the sources and schedule for retiring any debt incurred in the transaction;

(vi) For each insured depository institution whose Tier 1 capital, total capital, total assets or risk-weighted assets change as a result of the transaction, the total risk-weighted assets, total assets, Tier 1 capital and total capital of the institution on a *pro forma* basis; and

(vii) A description of the management expertise, internal controls and risk management systems that will be utilized in the conduct of the proposed activities; and

(viii) A copy of the purchase agreements, and balance sheet and income statements for the most recent quarter and year-end for any company to be acquired.

(b) *Notice provided to Board.* The Reserve Bank shall immediately send to the Board a copy of any notice received under paragraphs (a)(2) or (a)(3) of this section.

(c) *Notice to public*—(1) *Listed activities and activities approved by order*—(i) In a case involving an activity listed in § 225.28 or previously approved by the Board by order, the Reserve Bank shall notify the Board for publication in the FEDERAL REGISTER immediately upon receipt by the Reserve Bank of:

(A) A notice under this section; or

(B) A written request that notice of a proposal under this section or § 225.23 be published in the FEDERAL REGISTER. Such a request may request that FEDERAL REGISTER publication occur up to 15 calendar days prior to submission of a notice under this subpart.

(ii) The FEDERAL REGISTER notice published under this paragraph shall invite public comment on the proposal, generally for a period of 15 days.

(2) *New activities*—(i) *In general.* In the case of a notice under this subpart involving an activity that is not listed in § 225.28 and that has not been previously approved by the Board by order, the Board shall send notice of the proposal to the FEDERAL REGISTER for publication, unless the Board determines that the notificant has not demonstrated that the activity is so closely related to banking or to managing or controlling banks as to be a proper incident thereto. The FEDERAL REGISTER notice shall invite public comment on the proposal for a reasonable period of time, generally for 30 days.

(ii) *Time for publication.* The Board shall send the notice required under this paragraph to the FEDERAL REGISTER within 10 business days of acceptance by the Reserve Bank. The Board may extend the 10-day period for an additional 30 calendar days upon notice to the notificant. In the event notice of a proposal is not published for comment, the Board shall inform the notificant of the reasons for the decision.

(d) *Action on notices*—(1) *Reserve Bank action*—(i) *In general.* Within 30 calendar days after receipt by the Reserve Bank of a notice filed pursuant to paragraphs (a)(1) or (a)(2) of this section, the Reserve Banks shall:

(A) Approve the notice; or

(B) Refer the notice to the Board for decision because action under delegated authority is not appropriate.

(ii) *Return of incomplete notice.* Within 7 calendar days of receipt, the Reserve Bank may return any notice as informationally incomplete that does not contain all of the information required by this subpart. The return of such a notice shall be deemed action on the notice.

(iii) *Notice of action.* The Reserve Bank shall promptly notify the bank holding company of any action or referral under this paragraph.

(iv) *Close of public comment period.* The Reserve Bank shall not approve any notice under this paragraph (d)(1) of this section prior to the third business day after the close of the public comment period, unless an emergency exists that requires expedited or immediate action.

(2) *Board action; internal schedule.* The Board seeks to act on every notice referred to it for decision within 60 days of the date that the notice is filed with the Reserve Bank. If the Board is unable to act within this period, the Board shall notify the notificant and explain the reasons and the date by which the Board expects to act.

(3)(i) *Required time limit for System action.* The Board or the Reserve Bank shall act on any notice under this section within 60 days after the submission of a complete notice.

(ii) *Extension of required period for action* (A) *In general.* The Board may extend the 60-day period required for Board action under paragraph (d)(3)(i) of this section for an additional 30 days upon notice to the notificant.

(B) *Unlisted activities.* If a notice involves a proposal to engage in an activity that is not listed in § 225.28, the Board may extend the period required for Board action under paragraph (d)(3)(i) of this section for an additional 90 days. This 90-day extension is in addition to the 30-day extension period provided in paragraph (d)(3)(ii)(A) of this section. The Board shall notify the notificant that the notice period has been extended and explain the reasons for the extension.

(4) *Requests for additional information.* The Board or the Reserve Bank may modify the information requirements under this section or at any time request any additional information that either believes is needed for a decision on any notice under this section.

(5) *Tolling of period.* The Board or the Reserve Bank may at any time extend or toll the time period for action on a notice for any period with the consent of the notificant.

[Reg. Y, 62 FR 9332, Feb. 28, 1997, as amended at 62 FR 60640, Nov. 12, 1997; 65 FR 14438, Mar. 17, 2000]

§ 225.25 Hearings, alteration of activities, and other matters.

(a) *Hearings*—(1) *Procedure to request hearing.* Any request for a hearing on a notice under this subpart shall comply with the provisions of 12 CFR 262.3(e).

(2) *Determination to hold hearing.* The Board may order a formal or informal hearing or other proceeding on a notice as provided in 12 CFR 262.3(i)(2). The

Board shall order a hearing only if there are disputed issues of material fact that cannot be resolved in some other manner.

(3) *Extension of period for hearing.* The Board may extend the time for action on any notice for such time as is reasonably necessary to conduct a hearing and evaluate the hearing record. Such extension shall not exceed 91 calendar days after the date of submission to the Board of the complete record on the notice. The procedures for computation of the 91-day rule as set forth in § 225.16(f) apply to notices under this subpart that involve hearings.

(b) *Approval through failure to act.* (1) Except as provided in paragraph (a) of this section or § 225.24(d)(5), a notice under this subpart shall be deemed to be approved at the conclusion of the period that begins on the date the complete notice is received by the Reserve Bank or the Board and that ends 60 calendar days plus any applicable extension and tolling period thereafter.

(2) *Complete notice.* For purposes of paragraph (b)(1) of this section, a notice shall be deemed complete at such time as it contains all information required by this subpart and all other information requested by the Board or the Reserve Bank.

(c) *Notice to expand or alter nonbanking activities*—(1) *De novo expansion.* A notice under this subpart is required to open a new office or to form a subsidiary to engage in, or to relocate an existing office engaged in, a nonbanking activity that the Board has previously approved for the bank holding company under this regulation, only if:

(i) The Board's prior approval was limited geographically;

(ii) The activity is to be conducted in a country outside of the United States and the bank holding company has not previously received prior Board approval under this regulation to engage in the activity in that country; or

(iii) The Board or appropriate Reserve Bank has notified the company that a notice under this subpart is required.

(2) *Activities outside United States.* With respect to activities to be engaged in outside the United States that require approval under this subpart, the procedures of this section apply only to activities to be engaged in directly by a bank holding company that is not a qualifying foreign banking organization, or by a nonbank subsidiary of a bank holding company approved under this subpart. Regulation K (12 CFR part 211) governs other international operations of bank holding companies.

(3) *Alteration of nonbanking activity.* Unless otherwise permitted by the Board, a notice under this subpart is required to alter a nonbanking activity in any material respect from that considered by the Board in acting on the application or notice to engage in the activity.

(d) *Emergency savings association acquisitions.* In the case of a notice to acquire a savings association, the Board may modify or dispense with the public notice and hearing requirements of this subpart if the Board finds that an emergency exists that requires the Board to act immediately and the primary federal regulator of the institution concurs.

[Reg. Y, 62 FR 9333, Feb. 28, 1997, as amended by Reg. Y, 62 FR 60640, Nov. 12, 1997]

§ 225.26 Factors considered in acting on nonbanking proposals.

(a) *In general.* In evaluating a notice under § 225.23 or § 225.24, the Board shall consider whether the notificant's performance of the activities can reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, and gains in efficiency) that outweigh possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices).

(b) *Financial and managerial resources.* Consideration of the factors in paragraph (a) of this section includes an evaluation of the financial and managerial resources of the notificant, including its subsidiaries and any company to be acquired, the effect of the proposed transaction on those resources, and the management expertise, internal control and risk-management systems, and capital of the entity conducting the activity.

(c) *Competitive effect of de novo proposals.* Unless the record demonstrates otherwise, the commencement or expansion of a nonbanking activity *de novo* is presumed to result in benefits to the public through increased competition.

(d) *Denial for lack of information.* The Board may deny any notice submitted under this subpart if the notificant neglects, fails, or refuses to furnish all information required by the Board.

(e) *Conditional approvals.* The Board may impose conditions on any approval, including conditions to address permissibility, financial, managerial, safety and soundness, competitive, compliance, conflicts of interest, or other concerns to ensure that approval is consistent with the relevant statutory factors and other provisions of the BHC Act.

§ 225.27 Procedures for determining scope of nonbanking activities.

(a) *Advisory opinions regarding scope of previously approved nonbanking activities*—(1) *Request for advisory opinion.* Any person may submit a request to the Board for an advisory opinion regarding the scope of any permissible nonbanking activity. The request shall be submitted in writing to the Board and shall identify the proposed parameters of the activity, or describe the service or product that will be provided, and contain an explanation supporting an interpretation regarding the scope of the permissible nonbanking activity.

(2) *Response to request.* The Board shall provide an advisory opinion within 45 days of receiving a written request under this paragraph.

(b) *Procedure for consideration of new activities*—(1) *Initiation of proceeding.* The Board may, at any time, on its own initiative or in response to a written request from any person, initiate a proceeding to determine whether any activity is so closely related to banking or managing or controlling banks as to be a proper incident thereto.

(2) *Requests for determination.* Any request for a Board determination that an activity is so closely related to banking or managing or controlling banks as to be a proper incident thereto, shall be submitted to the Board in writing, and shall contain evidence that the proposed activity is so closely related to banking or managing or controlling banks as to be a proper incident thereto.

(3) *Publication.* The Board shall publish in the FEDERAL REGISTER notice that it is considering the permissibility of a new activity and invite public comment for a period of at least 30 calendar days. In the case of a request submitted under paragraph (b) of this section, the Board may determine not to publish notice of the request if the Board determines that the requester has provided no reasonable basis for a determination that the activity is so closely related to banking, or managing or controlling banks as to be a proper incident thereto, and notifies the requester of the determination.

(4) *Comments and hearing requests.* Any comment and any request for a hearing regarding a proposal under this section shall comply with the provisions of §262.3(e) of the Board's Rules of Procedure (12 CFR 262.3(e)).

§ 225.28 List of permissible nonbanking activities.

(a) *Closely related nonbanking activities.* The activities listed in paragraph (b) of this section are so closely related to banking or managing or controlling banks as to be a proper incident thereto, and may be engaged in by a bank holding company or its subsidiary in accordance with the requirements of this regulation.

(b) *Activities determined by regulation to be permissible*—(1) *Extending credit and servicing loans.* Making, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit and accepting drafts) for the company's account or for the account of others.

(2) *Activities related to extending credit.* Any activity usual in connection with making, acquiring, brokering or servicing loans or other extensions of credit, as determined by the Board. The Board has determined that the following activities are usual in connection with making, acquiring, brokering or servicing loans or other extensions of credit:

(i) *Real estate and personal property appraising.* Performing appraisals of real estate and tangible and intangible personal property, including securities.

(ii) *Arranging commercial real estate equity financing*. Acting as intermediary for the financing of commercial or industrial income-producing real estate by arranging for the transfer of the title, control, and risk of such a real estate project to one or more investors, if the bank holding company and its affiliates do not have an interest in, or participate in managing or developing, a real estate project for which it arranges equity financing, and do not promote or sponsor the development of the property.

(iii) *Check-guaranty services*. Authorizing a subscribing merchant to accept personal checks tendered by the merchant's customers in payment for goods and services, and purchasing from the merchant validly authorized checks that are subsequently dishonored.

(iv) *Collection agency services*. Collecting overdue accounts receivable, either retail or commercial.

(v) *Credit bureau services*. Maintaining information related to the credit history of consumers and providing the information to a credit grantor who is considering a borrower's application for credit or who has extended credit to the borrower.

(vi) *Asset management, servicing, and collection activities*. Engaging under contract with a third party in asset management, servicing, and collection[2] of assets of a type that an insured depository institution may originate and own, if the company does not engage in real property management or real estate brokerage services as part of these services.

(vii) *Acquiring debt in default*. Acquiring debt that is in default at the time of acquisition, if the company:

(A) Divests shares or assets securing debt in default that are not permissible investments for bank holding companies, within the time period required for divestiture of property acquired in satisfaction of a debt previously contracted under § 225.12(b);[3]

(B) Stands only in the position of a creditor and does not purchase equity of obligors of debt in default (other than equity that may be collateral for such debt); and

(C) Does not acquire debt in default secured by shares of a bank or bank holding company.

(viii) *Real estate settlement servicing*. Providing real estate settlement services.[4]

(3) *Leasing personal or real property*. Leasing personal or real property or acting as agent, broker, or adviser in leasing such property if:

(i) The lease is on a nonoperating basis;[5]

(ii) The initial term of the lease is at least 90 days;

(iii) In the case of leases involving real property:

(A) At the inception of the initial lease, the effect of the transaction will yield a return that will compensate the lessor for not less than the lessor's full investment in the property plus the estimated total cost of financing the property over the term of the lease from rental payments, estimated tax

[2] Asset management services include acting as agent in the liquidation or sale of loans and collateral for loans, including real estate and other assets acquired through foreclosure or in satisfaction of debts previously contracted.

[3] For this purpose, the divestiture period for property begins on the date that the debt is acquired, regardless of when legal title to the property is acquired.

[4] For purposes of this section, real estate settlement services do not include providing title insurance as principal, agent, or broker.

[5] The requirement that the lease be on a nonoperating basis means that the bank holding company may not, directly or indirectly, engage in operating, servicing, maintaining, or repairing leased property during the lease term. For purposes of the leasing of automobiles, the requirement that the lease be on a nonoperating basis means that the bank holding company may not, directly or indirectly: (1) Provide servicing, repair, or maintenance of the leased vehicle during the lease term; (2) purchase parts and accessories in bulk or for an individual vehicle after the lessee has taken delivery of the vehicle; (3) provide the loan of an automobile during servicing of the leased vehicle; (4) purchase insurance for the lessee; or (5) provide for the renewal of the vehicle's license merely as a service to the lessee where the lessee could renew the license without authorization from the lessor. The bank holding company may arrange for a third party to provide these services or products.

benefits, and the estimated residual value of the property at the expiration of the initial lease; and

(B) The estimated residual value of property for purposes of paragraph (b)(3)(iii)(A) of this section shall not exceed 25 percent of the acquisition cost of the property to the lessor.

(4) *Operating nonbank depository institutions*—(i) *Industrial banking.* Owning, controlling, or operating an industrial bank, Morris Plan bank, or industrial loan company, so long as the institution is not a bank.

(ii) *Operating savings association.* Owning, controlling, or operating a savings association, if the savings association engages only in deposit-taking activities, lending, and other activities that are permissible for bank holding companies under this subpart C.

(5) *Trust company functions.* Performing functions or activities that may be performed by a trust company (including activities of a fiduciary, agency, or custodial nature), in the manner authorized by federal or state law, so long as the company is not a bank for purposes of section 2(c) of the Bank Holding Company Act.

(6) *Financial and investment advisory activities.* Acting as investment or financial advisor to any person, including (without, in any way, limiting the foregoing):

(i) Serving as investment adviser (as defined in section 2(a)(20) of the Investment Company Act of 1940, 15 U.S.C. 80a–2(a)(20)), to an investment company registered under that act, including sponsoring, organizing, and managing a closed-end investment company;

(ii) Furnishing general economic information and advice, general economic statistical forecasting services, and industry studies;

(iii) Providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structurings, financing transactions and similar transactions, and conducting financial feasibility studies;[6]

(iv) Providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments;

(v) Providing educational courses, and instructional materials to consumers on individual financial management matters; and

(vi) Providing tax-planning and tax-preparation services to any person.

(7) *Agency transactional services for customer investments*—(i) *Securities brokerage.* Providing securities brokerage services (including securities clearing and/or securities execution services on an exchange), whether alone or in combination with investment advisory services, and incidental activities (including related securities credit activities and custodial services), if the securities brokerage services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting or dealing.

(ii) *Riskless principal transactions.* Buying and selling in the secondary market all types of securities on the order of customers as a ''riskless principal'' to the extent of engaging in a transaction in which the company, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer. This does not include:

(A) Selling bank-ineligible securities[7] at the order of a customer that is the issuer of the securities, or selling bank-ineligible securities in any transaction where the company has a contractual agreement to place the securities as agent of the issuer; or

(B) Acting as a riskless principal in any transaction involving a bank-ineligible security for which the company

[6] Feasibility studies do not include assisting management with the planning or marketing for a given project or providing general operational or management advice.

[7] A bank-ineligible security is any security that a State member bank is not permitted to underwrite or deal in under 12 U.S.C. 24 and 335.

or any of its affiliates acts as underwriter (during the period of the underwriting or for 30 days thereafter) or dealer.[8]

(iii) *Private placement services.* Acting as agent for the private placement of securities in accordance with the requirements of the Securities Act of 1933 (1933 Act) and the rules of the Securities and Exchange Commission, if the company engaged in the activity does not purchase or repurchase for its own account the securities being placed, or hold in inventory unsold portions of issues of these securities.

(iv) *Futures commission merchant.* Acting as a futures commission merchant (FCM) for unaffiliated persons in the execution, clearance, or execution and clearance of any futures contract and option on a futures contract traded on an exchange in the United States or abroad if:

(A) The activity is conducted through a separately incorporated subsidiary of the bank holding company, which may engage in activities other than FCM activities (including, but not limited to, permissible advisory and trading activities); and

(B) The parent bank holding company does not provide a guarantee or otherwise become liable to the exchange or clearing association other than for those trades conducted by the subsidiary for its own account or for the account of any affiliate.

(v) *Other transactional services.* Providing to customers as agent transactional services with respect to swaps and similar transactions, any transaction described in paragraph (b)(8) of this section, any transaction that is permissible for a state member bank, and any other transaction involving a forward contract, option, futures, option on a futures or similar contract (whether traded on an exchange or not) relating to a commodity that is traded on an exchange.

(8) *Investment transactions as principal*—(i) *Underwriting and dealing in government obligations and money market instruments.* Underwriting and dealing in obligations of the United States, general obligations of states and their political subdivisions, and other obligations that state member banks of the Federal Reserve System may be authorized to underwrite and deal in under 12 U.S.C. 24 and 335, including banker's acceptances and certificates of deposit, under the same limitations as would be applicable if the activity were performed by the bank holding company's subsidiary member banks or its subsidiary nonmember banks as if they were member banks.

(ii) *Investing and trading activities.* Engaging as principal in:

(A) Foreign exchange;

(B) Forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset (including gold, silver, platinum, palladium, copper, or any other metal approved by the Board), nonfinancial asset, or group of assets, other than a bank-ineligible security,[9] if:

(*1*) A state member bank is authorized to invest in the asset underlying the contract;

(*2*) The contract requires cash settlement;

(*3*) The contract allows for assignment, termination, or offset prior to delivery or expiration, and the company—

(*i*) Makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract; or

(*ii*) Receives and instantaneously transfers title to the underlying asset, by operation of contract and without taking or making physical delivery of the asset; or

(*4*) The contract does not allow for assignment, termination, or offset prior to delivery or expiration and is

[8] A company or its affiliates may not enter quotes for specific bank-ineligible securities in any dealer quotation system in connection with the company's riskless principal transactions; except that the company or its affiliates may enter "bid" or "ask" quotations, or publish "offering wanted" or "bid wanted" notices on trading systems other than NASDAQ or an exchange, if the company or its affiliate does not enter price quotations on different sides of the market for a particular security during any two-day period.

[9] A bank-ineligible security is any security that a state member bank is not permitted to underwrite or deal in under 12 U.S.C. 24 and 335.

based on an asset for which futures contracts or options on futures contracts have been approved for trading on a U.S. contract market by the Commodity Futures Trading Commission, and the company—

(*i*) Makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract; or

(*ii*) Receives and instantaneously transfers title to the underlying asset, by operation of contract and without taking or making physical delivery of the asset.

(C) Forward contracts, options,[10] futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on an index of a rate, a price, or the value of any financial asset, nonfinancial asset, or group of assets, if the contract requires cash settlement.

(iii) *Buying and selling bullion, and related activities.* Buying, selling and storing bars, rounds, bullion, and coins of gold, silver, platinum, palladium, copper, and any other metal approved by the Board, for the company's own account and the account of others, and providing incidental services such as arranging for storage, safe custody, assaying, and shipment.

(9) *Management consulting and counseling activities*—(i) *Management consulting.* (A) Providing management consulting advice:[11]

(*1*) On any matter to unaffiliated depository institutions, including commercial banks, savings and loan associations, savings banks, credit unions, industrial banks, Morris Plan banks, cooperative banks, industrial loan companies, trust companies, and branches or agencies of foreign banks;

(*2*) On any financial, economic, accounting, or audit matter to any other company.

(B) A company conducting management consulting activities under this subparagraph and any affiliate of such company may not:

(*1*) Own or control, directly or indirectly, more than 5 percent of the voting securities of the client institution; and

(*2*) Allow a management official, as defined in 12 CFR 212.2(h), of the company or any of its affiliates to serve as a management official of the client institution, except where such interlocking relationship is permitted pursuant to an exemption granted under 12 CFR 212.4(b) or otherwise permitted by the Board.

(C) A company conducting management consulting activities may provide management consulting services to customers not described in paragraph (b)(9)(i)(A)(*1*) of this section or regarding matters not described in paragraph (b)(9)(i)(A)(*2*) of this section, if the total annual revenue derived from those management consulting services does not exceed 30 percent of the company's total annual revenue derived from management consulting activities.

(ii) *Employee benefits consulting services.* Providing consulting services to employee benefit, compensation and insurance plans, including designing plans, assisting in the implementation of plans, providing administrative services to plans, and developing employee communication programs for plans.

(iii) *Career counseling services.* Providing career counseling services to:

(A) A financial organization[12] and individuals currently employed by, or recently displaced from, a financial organization;

[10] This reference does not include acting as a dealer in options based on indices of bank-ineligible securities when the options are traded on securities exchanges. These options are securities for purposes of the federal securities laws and bank-ineligible securities for purposes of section 20 of the Glass-Steagall Act, 12 U.S.C. 337. Similarly, this reference does not include acting as a dealer in any other instrument that is a bank-ineligible security for purposes of section 20. A bank holding company may deal in these instruments in accordance with the Board's orders on dealing in bank-ineligible securities.

[11] In performing this activity, bank holding companies are not authorized to perform tasks or operations or provide services to client institutions either on a daily or continuing basis, except as necessary to instruct the client institution on how to perform such services for itself. See also the Board's interpretation of bank management consulting advice (12 CFR 225.131).

[12] *Financial organization* refers to insured depository institution holding companies and their subsidiaries, other than nonbanking affiliates of diversified savings and loan holding companies that engage in activities not permissible under section 4(c)(8)

(B) Individuals who are seeking employment at a financial organization; and

(C) Individuals who are currently employed in or who seek positions in the finance, accounting, and audit departments of any company.

(10) *Support services*—(i) *Courier services*. Providing courier services for:

(A) Checks, commercial papers, documents, and written instruments (excluding currency or bearer-type negotiable instruments) that are exchanged among banks and financial institutions; and

(B) Audit and accounting media of a banking or financial nature and other business records and documents used in processing such media.[13]

(ii) *Printing and selling MICR-encoded items*. Printing and selling checks and related documents, including corporate image checks, cash tickets, voucher checks, deposit slips, savings withdrawal packages, and other forms that require Magnetic Ink Character Recognition (MICR) encoding.

(11) *Insurance agency and underwriting*—(i) *Credit insurance*. Acting as principal, agent, or broker for insurance (including home mortgage redemption insurance) that is:

(A) Directly related to an extension of credit by the bank holding company or any of its subsidiaries; and

(B) Limited to ensuring the repayment of the outstanding balance due on the extension of credit[14] in the event of the death, disability, or involuntary unemployment of the debtor.

(ii) *Finance company subsidiary*. Acting as agent or broker for insurance directly related to an extension of credit by a finance company[15] that is a subsidiary of a bank holding company, if:

(A) The insurance is limited to ensuring repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit; and

(B) The extension of credit is not more than $10,000, or $25,000 if it is to finance the purchase of a residential manufactured home[16] and the credit is secured by the home; and

(C) The applicant commits to notify borrowers in writing that:

(*1*) They are not required to purchase such insurance from the applicant;

(*2*) Such insurance does not insure any interest of the borrower in the collateral; and

(*3*) The applicant will accept more comprehensive property insurance in place of such single-interest insurance.

(iii) *Insurance in small towns*. Engaging in any insurance agency activity in a place where the bank holding company or a subsidiary of the bank holding company has a lending office and that:

(A) Has a population not exceeding 5,000 (as shown in the preceding decennial census); or

(B) Has inadequate insurance agency facilities, as determined by the Board, after notice and opportunity for hearing.

(iv) *Insurance-agency activities conducted on May 1, 1982*. Engaging in any specific insurance-agency activity[17] if the bank holding company, or subsidiary conducting the specific activity, conducted such activity on May 1,

of the Bank Holding Company Act (12 U.S.C. 1842(c)(8)).

[13] See also the Board's interpretation on courier activities (12 CFR 225.129), which sets forth conditions for bank holding company entry into the activity.

[14] *Extension of credit* includes direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases are nonoperating and full-payout leases that meet the requirements of paragraph (b)(3) of this section.

[15] *Finance company* includes all non-deposit-taking financial institutions that engage in a significant degree of consumer lending (excluding lending secured by first mortgages) and all financial institutions specifically defined by individual states as finance companies and that engage in a significant degree of consumer lending.

[16] These limitations increase at the end of each calendar year, beginning with 1982, by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

[17] Nothing contained in this provision shall preclude a bank holding company subsidiary that is authorized to engage in a specific insurance-agency activity under this clause from continuing to engage in the particular activity after merger with an affiliate, if the merger is for legitimate business purposes and prior notice has been provided to the Board.

1982, or received Board approval to conduct such activity on or before May 1, 1982.[18] A bank holding company or subsidiary engaging in a specific insurance agency activity under this clause may:

(A) Engage in such specific insurance agency activity only at locations:

(*1*) In the state in which the bank holding company has its principal place of business (as defined in 12 U.S.C. 1842(d));

(*2*) In any state or states immediately adjacent to such state; and

(*3*) In any state in which the specific insurance-agency activity was conducted (or was approved to be conducted) by such bank holding company or subsidiary thereof or by any other subsidiary of such bank holding company on May 1, 1982; and

(B) Provide other insurance coverages that may become available after May 1, 1982, so long as those coverages insure against the types of risks as (or are otherwise functionally equivalent to) coverages sold or approved to be sold on May 1, 1982, by the bank holding company or subsidiary.

(v) *Supervision of retail insurance agents.* Supervising on behalf of insurance underwriters the activities of retail insurance agents who sell:

(A) Fidelity insurance and property and casualty insurance on the real and personal property used in the operations of the bank holding company or its subsidiaries; and

(B) Group insurance that protects the employees of the bank holding company or its subsidiaries.

(vi) *Small bank holding companies.* Engaging in any insurance-agency activity if the bank holding company has total consolidated assets of $50 million or less. A bank holding company performing insurance-agency activities under this paragraph may not engage in the sale of life insurance or annuities except as provided in paragraphs (b)(11) (i) and (iii) of this section, and it may not continue to engage in insurance-agency activities pursuant to this provision more than 90 days after the end of the quarterly reporting period in which total assets of the holding company and its subsidiaries exceed $50 million.

(vii) *Insurance-agency activities conducted before 1971.* Engaging in any insurance-agency activity performed at any location in the United States directly or indirectly by a bank holding company that was engaged in insurance-agency activities prior to January 1, 1971, as a consequence of approval by the Board prior to January 1, 1971.

(12) *Community development activities*—(i) *Financing and investment activities.* Making equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas by providing housing, services, or jobs for residents.

(ii) *Advisory activities.* Providing advisory and related services for programs designed primarily to promote community welfare.

(13) *Money orders, savings bonds, and traveler's checks.* The issuance and sale at retail of money orders and similar consumer-type payment instruments; the sale of U.S. savings bonds; and the issuance and sale of traveler's checks.

(14) *Data processing.* (i) Providing data processing, data storage and data transmission services, facilities (including data processing, data storage and data transmission hardware, software, documentation, or operating personnel), databases, advice, and access to such services, facilities, or databases by any technological means, if:

(A) The data to be processed, stored or furnished are financial, banking or economic; and

(B) The hardware provided in connection therewith is offered only in conjunction with software designed and marketed for the processing, storage and transmission of financial, banking, or economic data, and where the general purpose hardware does not constitute more than 30 percent of the cost of any packaged offering.

[18] For the purposes of this paragraph, activities engaged in on May 1, 1982, include activities carried on subsequently as the result of an application to engage in such activities pending before the Board on May 1, 1982, and approved subsequently by the Board or as the result of the acquisition by such company pursuant to a binding written contract entered into on or before May 1, 1982, of another company engaged in such activities at the time of the acquisition.

(ii) A company conducting data processing, data storage, and data transmission activities may conduct data processing, data storage, and data transmission activities not described in paragraph (b)(14)(i) of this section if the total annual revenue derived from those activities does not exceed 49 percent of the company's total annual revenues derived from data processing, data storage and data transmission activities.

[Reg. Y, 62 FR 9329, Feb. 28, 1997, as amended at 68 FR 39810, July 3, 2003; 68 FR 41901, July 16, 2003; 68 FR 68499, Dec. 9, 2003]

Subpart D—Control and Divestiture Proceedings

§ 225.31 Control proceedings.

(a) *Preliminary determination of control.* (1) The Board may issue a preliminary determination of control under the procedures set forth in this section in any case in which:

(i) Any of the presumptions of control set forth in paragraph (d) of this section is present; or

(ii) It otherwise appears that a company has the power to exercise a controlling influence over the management or policies of a bank or other company.

(2) If the Board makes a preliminary determination of control under this section, the Board shall send notice to the controlling company containing a statement of the facts upon which the preliminary determination is based.

(b) *Response to preliminary determination of control.* Within 30 calendar days of issuance by the Board of a preliminary determination of control or such longer period permitted by the Board, the company against whom the determination has been made shall:

(1) Submit for the Board's approval a specific plan for the prompt termination of the control relationship;

(2) File an application under subpart B or C of this regulation to retain the control relationship; or

(3) Contest the preliminary determination by filing a response, setting forth the facts and circumstances in support of its position that no control exists, and, if desired, requesting a hearing or other proceeding.

(c) *Hearing and final determination.* (1) The Board shall order a formal hearing or other appropriate proceeding upon the request of a company that contests a preliminary determination that the company has the power to exercise a controlling influence over the management or policies of a bank or other company, if the Board finds that material facts are in dispute. The Board may also in its discretion order a formal hearing or other proceeding with respect to a preliminary determination that the company controls voting securities of the bank or other company under the presumptions in paragraph (d)(1) of this section.

(2) At a hearing or other proceeding, any applicable presumptions established by paragraph (d) of this section shall be considered in accordance with the Federal Rules of Evidence and the Board's Rules of Practice for Formal Hearings (12 CFR part 263).

(3) After considering the submissions of the company and other evidence, including the record of any hearing or other proceeding, the Board shall issue a final order determining whether the company controls voting securities, or has the power to exercise a controlling influence over the management or policies, of the bank or other company. If a control relationship is found, the Board may direct the company to terminate the control relationship or to file an application for the Board's approval to retain the control relationship under subpart B or C of this regulation.

(d) *Rebuttable presumptions of control.* The following rebuttable presumptions shall be used in any proceeding under this section:

(1) *Control of voting securities*—(i) *Securities convertible into voting securities.* A company that owns, controls, or holds securities that are immediately convertible, at the option of the holder or owner, into voting securities of a bank or other company, controls the voting securities.

(ii) *Option or restriction on voting securities.* A company that enters into an agreement or understanding under which the rights of a holder of voting securities of a bank or other company are restricted in any manner controls the securities. This presumption does not apply where the agreement or understanding:

(A) Is a mutual agreement among shareholders granting to each other a right of first refusal with respect to their shares;

(B) Is incident to a *bona fide* loan transaction; or

(C) Relates to restrictions on transferability and continues only for the time necessary to obtain approval from the appropriate Federal supervisory authority with respect to acquisition by the company of the securities.

(2) *Control over company*—(i) *Management agreement*. A company that enters into any agreement or understanding with a bank or other company (other than an investment advisory agreement), such as a management contract, under which the first company or any of its subsidiaries directs or exercises significant influence over the general management or overall operations of the bank or other company controls the bank or other company.

(ii) *Shares controlled by company and associated individuals*. A company that, together with its management officials or controlling shareholders (including members of the immediate families of either), owns, controls, or holds with power to vote 25 percent or more of the outstanding shares of any class of voting securities of a bank or other company controls the bank or other company, if the first company owns, controls, or holds with power to vote more than 5 percent of the outstanding shares of any class of voting securities of the bank or other company.

(iii) *Common management officials*. A company that has one or more management officials in common with a bank or other company controls the bank or other company, if the first company owns, controls or holds with power to vote more than 5 percent of the outstanding shares of any class of voting securities of the bank or other company, and no other person controls as much as 5 percent of the outstanding shares of any class of voting securities of the bank or other company.

(iv) *Shares held as fiduciary*. The presumptions in paragraphs (d)(2) (ii) and (iii) of this section do not apply if the securities are held by the company in a fiduciary capacity without sole discretionary authority to exercise the voting rights.

(e) *Presumption of non-control*—(1) In any proceeding under this section, there is a presumption that any company that directly or indirectly owns, controls, or has power to vote less than 5 percent of the outstanding shares of any class of voting securities of a bank or other company does not have control over that bank or other company.

(2) In any proceeding under this section, or judicial proceeding under the BHC Act, other than a proceeding in which the Board has made a preliminary determination that a company has the power to exercise a controlling influence over the management or policies of the bank or other company, a company may not be held to have had control over the bank or other company at any given time, unless that company, at the time in question, directly or indirectly owned, controlled, or had power to vote 5 percent or more of the outstanding shares of any class of voting securities of the bank or other company, or had already been found to have control on the basis of the existence of a controlling influence relationship.

[Reg. Y, 49 FR 818, Jan. 5, 1984, as amended at 58 FR 474, Jan. 6, 1993; Reg. Y, 62 FR 9338, Feb. 28, 1997]

Subpart E—Change in Bank Control

SOURCE: Reg. Y, 62 FR 9338, Feb. 28, 1997, unless otherwise noted.

§ 225.41 Transactions requiring prior notice.

(a) *Prior notice requirement*. Any person acting directly or indirectly, or through or in concert with one or more persons, shall give the Board 60 days' written notice, as specified in § 225.43 of this subpart, before acquiring control of a state member bank or bank holding company, unless the acquisition is exempt under § 225.42.

(b) *Definitions*. For purposes of this subpart:

(1) *Acquisition* includes a purchase, assignment, transfer, or pledge of voting securities, or an increase in percentage ownership of a state member

bank or a bank holding company resulting from a redemption of voting securities.

(2) *Acting in concert* includes knowing participation in a joint activity or parallel action towards a common goal of acquiring control of a state member bank or bank holding company whether or not pursuant to an express agreement.

(3) *Immediate family* includes a person's father, mother, stepfather, stepmother, brother, sister, stepbrother, stepsister, son, daughter, stepson, stepdaughter, grandparent, grandson, granddaughter, father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law, the spouse of any of the foregoing, and the person's spouse.

(c) *Acquisitions requiring prior notice*—(1) *Acquisition of control.* The acquisition of voting securities of a state member bank or bank holding company constitutes the acquisition of control under the Bank Control Act, requiring prior notice to the Board, if, immediately after the transaction, the acquiring person (or persons acting in concert) will own, control, or hold with power to vote 25 percent or more of any class of voting securities of the institution.

(2) *Rebuttable presumption of control.* The Board presumes that an acquisition of voting securities of a state member bank or bank holding company constitutes the acquisition of control under the Bank Control Act, requiring prior notice to the Board, if, immediately after the transaction, the acquiring person (or persons acting in concert) will own, control, or hold with power to vote 10 percent or more of any class of voting securities of the institution, and if:

(i) The institution has registered securities under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l); or

(ii) No other person will own, control, or hold the power to vote a greater percentage of that class of voting securities immediately after the transaction.[1]

(d) *Rebuttable presumption of concerted action.* The following persons shall be presumed to be acting in concert for purposes of this subpart:

(1) A company and any controlling shareholder, partner, trustee, or management official of the company, if both the company and the person own voting securities of the state member bank or bank holding company;

(2) An individual and the individual's immediate family;

(3) Companies under common control;

(4) Persons that are parties to any agreement, contract, understanding, relationship, or other arrangement, whether written or otherwise, regarding the acquisition, voting, or transfer of control of voting securities of a state member bank or bank holding company, other than through a revocable proxy as described in § 225.42(a)(5) of this subpart;

(5) Persons that have made, or propose to make, a joint filing under sections 13 or 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78n), and the rules promulgated thereunder by the Securities and Exchange Commission; and

(6) A person and any trust for which the person serves as trustee.

(e) *Acquisitions of loans in default.* The Board presumes an acquisition of a loan in default that is secured by voting securities of a state member bank or bank holding company to be an acquisition of the underlying securities for purposes of this section.

(f) *Other transactions.* Transactions other than those set forth in paragraph (c) of this section resulting in a person's control of less than 25 percent of a class of voting securities of a state member bank or bank holding company are not deemed by the Board to constitute control for purposes of the Bank Control Act.

(g) *Rebuttal of presumptions.* Prior notice to the Board is not required for any acquisition of voting securities under the presumption of control set forth in this section, if the Board finds that the acquisition will not result in control. The Board shall afford any

[1] If two or more persons, not acting in concert, each propose to acquire simultaneously equal percentages of 10 percent or more of a class of voting securities of the state member bank or bank holding company, each person must file prior notice to the Board.

person seeking to rebut a presumption in this section an opportunity to present views in writing or, if appropriate, orally before its designated representatives at an informal conference.

§ 225.42 Transactions not requiring prior notice.

(a) *Exempt transactions.* The following transactions do not require notice to the Board under this subpart:

(1) *Existing control relationships.* The acquisition of additional voting securities of a state member bank or bank holding company by a person who:

(i) Continuously since March 9, 1979 (or since the institution commenced business, if later), held power to vote 25 percent or more of any class of voting securities of the institution; or

(ii) Is presumed, under § 225.41(c)(2) of this subpart, to have controlled the institution continuously since March 9, 1979, if the aggregate amount of voting securities held does not exceed 25 percent or more of any class of voting securities of the institution or, in other cases, where the Board determines that the person has controlled the bank continuously since March 9, 1979;

(2) *Increase of previously authorized acquisitions.* Unless the Board or the Reserve Bank otherwise provides in writing, the acquisition of additional shares of a class of voting securities of a state member bank or bank holding company by any person (or persons acting in concert) who has lawfully acquired and maintained control of the institution (for purposes of § 225.41(c) of this subpart), after complying with the procedures and receiving approval to acquire voting securities of the institution under this subpart, or in connection with an application approved under section 3 of the BHC Act (12 U.S.C. 1842; § 225.11 of subpart B of this part) or section 18(c) of the Federal Deposit Insurance Act (Bank Merger Act, 12 U.S.C. 1828(c));

(3) *Acquisitions subject to approval under BHC Act or Bank Merger Act.* Any acquisition of voting securities subject to approval under section 3 of the BHC Act (12 U.S.C. 1842; § 225.11 of subpart B of this part), or section 18(c) of the Federal Deposit Insurance Act (Bank Merger Act, 12 U.S.C. 1828(c));

(4) *Transactions exempt under BHC Act.* Any transaction described in sections 2(a)(5), 3(a)(A), or 3(a)(B) of the BHC Act (12 U.S.C. 1841(a)(5), 1842(a)(A), and 1842(a)(B)), by a person described in those provisions;

(5) *Proxy solicitation.* The acquisition of the power to vote securities of a state member bank or bank holding company through receipt of a revocable proxy in connection with a proxy solicitation for the purposes of conducting business at a regular or special meeting of the institution, if the proxy terminates within a reasonable period after the meeting;

(6) *Stock dividends.* The receipt of voting securities of a state member bank or bank holding company through a stock dividend or stock split if the proportional interest of the recipient in the institution remains substantially the same; and

(7) *Acquisition of foreign banking organization.* The acquisition of voting securities of a qualifying foreign banking organization. (This exemption does not extend to the reports and information required under paragraphs 9, 10, and 12 of the Bank Control Act (12 U.S.C. 1817(j) (9), (10), and (12)) and § 225.44 of this subpart.)

(b) *Prior notice exemption.* (1) The following acquisitions of voting securities of a state member bank or bank holding company, which would otherwise require prior notice under this subpart, are not subject to the prior notice requirements if the acquiring person notifies the appropriate Reserve Bank within 90 calendar days after the acquisition and provides any relevant information requested by the Reserve Bank:

(i) Acquisition of voting securities through inheritance;

(ii) Acquisition of voting securities as a *bona fide* gift; and

(iii) Acquisition of voting securities in satisfaction of a debt previously contracted (DPC) in good faith.

(2) The following acquisitions of voting securities of a state member bank or bank holding company, which would otherwise require prior notice under this subpart, are not subject to the prior notice requirements if the acquiring person does not reasonably have advance knowledge of the transaction,

and provides the written notice required under section 225.43 to the appropriate Reserve Bank within 90 calendar days after the transaction occurs:

(i) Acquisition of voting securities resulting from a redemption of voting securities by the issuing bank or bank holding company; and

(ii) Acquisition of voting securities as a result of actions (including the sale of securities) by any third party that is not within the control of the acquiror.

(3) Nothing in paragraphs (b)(1) or (b)(2) of this section limits the authority of the Board to disapprove a notice pursuant to § 225.43(h) of this subpart.

§ 225.43 Procedures for filing, processing, publishing, and acting on notices.

(a) *Filing notice.* (1) A notice required under this subpart shall be filed with the appropriate Reserve Bank and shall contain all the information required by paragraph 6 of the Bank Control Act (12 U.S.C. 1817(j)(6)), or prescribed in the designated Board form.

(2) The Board may waive any of the informational requirements of the notice if the Board determines that it is in the public interest.

(3) A notificant shall notify the appropriate Reserve Bank or the Board immediately of any material changes in a notice submitted to the Reserve Bank, including changes in financial or other conditions.

(4) When the acquiring person is an individual, or group of individuals acting in concert, the requirement to provide personal financial data may be satisfied by a current statement of assets and liabilities and an income summary, as required in the designated Board form, together with a statement of any material changes since the date of the statement or summary. The Reserve Bank or the Board, nevertheless, may request additional information, if appropriate.

(b) *Acceptance of notice.* The 60-day notice period specified in § 225.41 of this subpart begins on the date of receipt of a complete notice. The Reserve Bank shall notify the person or persons submitting a notice under this subpart in writing of the date the notice is or was complete and thereby accepted for processing. The Reserve Bank or the Board may request additional relevant information at any time after the date of acceptance.

(c) *Publication*—(1) *Newspaper Announcement.* Any person(s) filing a notice under this subpart shall publish, in a form prescribed by the Board, an announcement soliciting public comment on the proposed acquisition. The announcement shall be published in a newspaper of general circulation in the community in which the head office of the state member bank to be acquired is located or, in the case of a proposed acquisition of a bank holding company, in the community in which its head office is located and in the community in which the head office of each of its subsidiary banks is located. The announcement shall be published no earlier than 15 calendar days before the filing of the notice with the appropriate Reserve Bank and no later than 10 calendar days after the filing date; and the publisher's affidavit of a publication shall be provided to the appropriate Reserve Bank.

(2) *Contents of newspaper announcement.* The newspaper announcement shall state:

(i) The name of each person identified in the notice as a proposed acquiror of the bank or bank holding company;

(ii) The name of the bank or bank holding company to be acquired, including the name of each of the bank holding company's subsidiary banks; and

(iii) A statement that interested persons may submit comments on the notice to the Board or the appropriate Reserve Bank for a period of 20 days, or such shorter period as may be provided, pursuant to paragraph (c)(5) of this section.

(3) FEDERAL REGISTER *announcement.* The Board shall, upon filing of a notice under this subpart, publish announcement in the FEDERAL REGISTER of receipt of the notice. The FEDERAL REGISTER announcement shall contain the information required under paragraphs (c)(2)(i) and (c)(2)(ii) of this section and a statement that interested persons may submit comments on the proposed acquisition for a period of 15 calendar

days, or such shorter period as may be provided, pursuant to paragraph (c)(5) of this section. The Board may waive publication in the FEDERAL REGISTER, if the Board determines that such action is appropriate.

(4) *Delay of publication.* The Board may permit delay in the publication required under paragraphs (c)(1) and (c)(3) of this section if the Board determines, for good cause shown, that it is in the public interest to grant such delay. Requests for delay of publication may be submitted to the appropriate Reserve Bank.

(5) *Shortening or waiving notice.* The Board may shorten or waive the public comment or newspaper publication requirements of this paragraph, or act on a notice before the expiration of a public comment period, if it determines in writing that an emergency exists, or that disclosure of the notice, solicitation of public comment, or delay until expiration of the public comment period would seriously threaten the safety or soundness of the bank or bank holding company to be acquired.

(6) *Consideration of public comments.* In acting upon a notice filed under this subpart, the Board shall consider all public comments received in writing within the period specified in the newspaper or FEDERAL REGISTER announcement, whichever is later. At the Board's option, comments received after this period may, but need not, be considered.

(7) *Standing.* No person (other than the acquiring person) who submits comments or information on a notice filed under this subpart shall thereby become a party to the proceeding or acquire any standing or right to participate in the Board's consideration of the notice or to appeal or otherwise contest the notice or the Board's action regarding the notice.

(d) *Time period for Board action*—(1) *Consummation of acquisition*—(i) The notificant(s) may consummate the proposed acquisition 60 days after submission to the Reserve Bank of a complete notice under paragraph (a) of this section, unless within that period the Board disapproves the proposed acquisition or extends the 60-day period, as provided under paragraph (d)(2) of this section.

(ii) The notificant(s) may consummate the proposed transaction before the expiration of the 60-day period if the Board notifies the notificant(s) in writing of the Board's intention not to disapprove the acquisition.

(2) *Extensions of time period.* (i) The Board may extend the 60-day period in paragraph (d)(1) of this section for an additional 30 days by notifying the acquiring person(s).

(ii) The Board may further extend the period during which it may disapprove a notice for two additional periods of not more than 45 days each, if the Board determines that:

(A) Any acquiring person has not furnished all the information required under paragraph (a) of this section;

(B) Any material information submitted is substantially inaccurate;

(C) The Board is unable to complete the investigation of an acquiring person because of inadequate cooperation or delay by that person; or

(D) Additional time is needed to investigate and determine that no acquiring person has a record of failing to comply with the requirements of the Bank Secrecy Act, subchapter II of Chapter 53 of Title 31, United States Code.

(iii) If the Board extends the time period under this paragraph, it shall notify the acquiring person(s) of the reasons therefor and shall include a statement of the information, if any, deemed incomplete or inaccurate.

(e) *Advice to bank supervisory agencies.* (1) Upon accepting a notice relating to acquisition of securities of a state member bank, the Reserve Bank shall send a copy of the notice to the appropriate state bank supervisor, which shall have 30 calendar days from the date the notice is sent in which to submit its views and recommendations to the Board. The Reserve Bank also shall send a copy of any notice to the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

(2) If the Board finds that it must act immediately in order to prevent the probable failure of the bank or bank holding company involved, the Board may dispense with or modify the requirements for notice to the state supervisor.

(f) *Investigation and report.* (1) After receiving a notice under this subpart, the Board or the appropriate Reserve Bank shall conduct an investigation of the competence, experience, integrity, and financial ability of each person by and for whom an acquisition is to be made. The Board shall also make an independent determination of the accuracy and completeness of any information required to be contained in a notice under paragraph (a) of this section. In investigating any notice accepted under this subpart, the Board or Reserve Bank may solicit information or views from any person, including any bank or bank holding company involved in the notice, and any appropriate state, federal, or foreign governmental authority.

(2) The Board or the appropriate Reserve Bank shall prepare a written report of its investigation, which shall contain, at a minimum, a summary of the results of the investigation.

(g) *Factors considered in acting on notices.* In reviewing a notice filed under this subpart, the Board shall consider the information in the record, the views and recommendations of the appropriate bank supervisor, and any other relevant information obtained during any investigation of the notice.

(h) *Disapproval and hearing*—(1) *Disapproval of notice.* The Board may disapprove an acquisition if it finds adverse effects with respect to any of the factors set forth in paragraph 7 of the Bank Control Act (12 U.S.C. 1817(j)(7)) (*i.e.*, competitive, financial, managerial, banking, or incompleteness of information).

(2) *Disapproval notification.* Within three days after its decision to issue a notice of intent to disapprove any proposed acquisition, the Board shall notify the acquiring person in writing of the reasons for the action.

(3) *Hearing.* Within 10 calendar days of receipt of the notice of the Board's intent to disapprove, the acquiring person may submit a written request for a hearing. Any hearing conducted under this paragraph shall be in accordance with the Rules of Practice for Formal Hearings (12 CFR part 263). At the conclusion of the hearing, the Board shall, by order, approve or disapprove the proposed acquisition on the basis of the record of the hearing. If the acquiring person does not request a hearing, the notice of intent to disapprove becomes final and unappealable.

§ 225.44 Reporting of stock loans.

(a) *Requirements.* (1) Any foreign bank or affiliate of a foreign bank that has credit outstanding to any person or group of persons, in the aggregate, which is secured, directly or indirectly, by 25 percent or more of any class of voting securities of a state member bank, shall file a consolidated report with the appropriate Reserve Bank for the state member bank.

(2) The foreign bank or its affiliate also shall file a copy of the report with its appropriate Federal banking agency.

(3) Any shares of the state member bank held by the foreign bank or any affiliate of the foreign bank as principal must be included in the calculation of the number of shares in which the foreign bank or its affiliate has a security interest for purposes of paragraph (a) of this section.

(b) *Definitions.* For purposes of paragraph (a) of this section:

(1) *Foreign bank* shall have the same meaning as in section 1(b) of the International Banking Act of 1978 (12 U.S.C. 3101).

(2) *Credit outstanding* includes any loan or extension of credit; the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit; and any other type of transaction that extends credit or financing to the person or group of persons.

(3) *Group of persons* includes any number of persons that the foreign bank or any affiliate of a foreign bank has reason to believe:

(i) Are acting together, in concert, or with one another to acquire or control shares of the same insured depository institution, including an acquisition of shares of the same depository institution at approximately the same time under substantially the same terms; or

(ii) Have made, or propose to make, a joint filing under section 13 or 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78n), and the rules promulgated thereunder by the Securities and Exchange Commission regarding ownership of the shares of the same insured depository institution.

(c) *Exceptions.* Compliance with paragraph (a) of this section is not required if:

(1) The person or group of persons referred to in that paragraph has disclosed the amount borrowed and the security interest therein to the Board or appropriate Reserve Bank in connection with a notice filed under § 225.41 of this subpart, or another application filed with the Board or Reserve Bank as a substitute for a notice under § 225.41 of this subpart, including an application filed under section 3 of the BHC Act (12 U.S.C. 1842) or section 18(c) of the Federal Deposit Insurance Act (Bank Merger Act, 12 U.S.C. 1828(c)), or an application for membership in the Federal Reserve System; or

(2) The transaction involves a person or group of persons that has been the owner or owners of record of the stock for a period of one year or more; or, if the transaction involves stock issued by a newly chartered bank, before the bank is opened for business.

(d) *Report requirements.* (1) The consolidated report shall indicate the number and percentage of shares securing each applicable extension of credit, the identity of the borrower, and the number of shares held as principal by the foreign bank and any affiliate thereof.

(2) A foreign bank, or any affiliate of a foreign bank, shall file the consolidated report in writing within 30 days of the date on which the foreign bank or affiliate first believes that the security for any outstanding credit consists of 25 percent or more of any class of voting securities of a state member bank.

(e) *Other reporting requirements.* A foreign bank, or any affiliate thereof, that is supervised by the System and is required to report credit outstanding that is secured by the shares of an insured depository institution to another Federal banking agency also shall file a copy of the report with the appropriate Reserve Bank.

Subpart F—Limitations on Nonbank Banks

§ 225.52 Limitation on overdrafts.

(a) *Definitions.* For purposes of this section—

(1) *Account* means a reserve account, clearing account, or deposit account as defined in the Board's Regulation D (12 CFR 204.2(a)(1)(i)), that is maintained at a Federal Reserve Bank or nonbank bank.

(2) *Cash item* means (i) a check other than a check classified as a noncash item; or (ii) any other item payable on demand and collectible at par that the Federal Reserve Bank of the district in which the item is payable is willing to accept as a cash item.

(3) *Discount window loan* means any credit extended by a Federal Reserve Bank to a nonbank bank or industrial bank pursuant to the provisions of the Board's Regulation A (12 CFR part 201).

(4) *Industrial bank* means an institution as defined in section 2(c)(2)(H) of the BHC Act (12 U.S.C. 1841(c)(2)(H)).

(5) *Noncash item* means an item handled by a Reserve Bank as a noncash item under the Reserve Bank's ''Collection of Noncash Items Operating Circular'' (*e.g.*, a maturing bankers' acceptance or a maturing security, or a demand item, such as a check, with special instructions or an item that has not been preprinted or post-encoded).

(6) *Other nonelectronic transactions* include all other transactions not included as funds transfers, book-entry securities transfers, cash items, noncash items, automated clearing house transactions, net settlement entries, and discount window loans (*e.g.*, original issue of securities or redemption of securities).

(7) An *overdraft* in an account occurs whenever the Federal Reserve Bank, nonbank bank, or industrial bank holding an account posts a transaction to the account of the nonbank bank, industrial bank, or affiliate that exceeds the aggregate balance of the accounts of the nonbank bank, industrial bank, or affiliate, as determined by the posting rules set forth in paragraphs (d) and (e) of this section and continues until the aggregate balance of the account is zero or greater.

(8) *Transfer item* means an item as defined in subpart B of Regulation J (12 CFR 210.25 *et seq*).

(b) *Restriction on overdrafts*—(1) *Affiliates*. Neither a nonbank bank nor an industrial bank shall permit any affiliate to incur any overdraft in its account with the nonbank bank or industrial bank.

(2) *Nonbank banks or industrial banks*. (i) No nonbank bank or industrial bank shall incur any overdraft in its account at a Federal Reserve Bank on behalf of an affiliate.

(ii) An overdraft by a nonbank bank or industrial bank in its account at a Federal Reserve Bank shall be deemed to be on behalf of an affiliate whenever:

(A) A nonbank bank or industrial bank holds an account for an affiliate from which third-party payments can be made; and

(B) When the posting of an affiliate's transaction to the nonbank bank's or industrial bank's account at a Reserve Bank creates an overdraft in its account at a Federal Reserve Bank or increases the amount of an existing overdraft in its account at a Federal Reserve Bank.

(c) *Permissible overdrafts*. The following are permissible overdrafts not subject to paragraph (b) of this section:

(1) *Inadvertent error*. An overdraft in its account by a nonbank bank or its affiliate, or an industrial bank or its affiliate, that results from an inadvertent computer error or inadvertent accounting error, that was not reasonably forseeable or could not have been prevented through the maintenance of procedures reasonably adopted by the nonbank bank or affiliate to avoid such overdraft; and

(2) *Fully secured primary dealer affiliate overdrafts*. (i) An overdraft incurred by an affiliate of a nonbank bank, which affiliate is recognized as a primary dealer by the Federal Reserve Bank of New York, in the affiliate's account at the nonbank bank, or an overdraft incurred by a nonbank bank on behalf of its primary dealer affiliate in the nonbank bank's account at a Federal Reserve Bank; *provided:* the overdraft is fully secured by bonds, notes, or other obligations which are direct obligations of the United States or on which the principal and interest are fully guaranteed by the United States or by securities and obligations eligible for settlement on the Federal Reserve book-entry system.

(ii) An overdraft by a nonbank bank in its account at a Federal Reserve Bank that is on behalf of a primary dealer affiliate is fully secured when that portion of its overdraft at the Federal Reserve Bank that corresponds to the transaction posted for an affiliate that caused or increased the nonbank bank's overdraft is fully secured in accordance with paragraph (c)(2)(iii) of this section.

(iii) An overdraft is fully secured under paragraph (c)(2)(i) when the nonbank bank can demonstrate that the overdraft is secured, at all times, by a perfected security interest in specific, identified obligations described in paragraph (c)(2)(i) with a market value that, in the judgment of the Reserve Bank holding the nonbank bank's account, is sufficiently in excess of the amount of the overdraft to provide a margin of protection in a volatile market or in the event the securities need to be liquidated quickly.

(d) *Posting by Federal Reserve Banks*. For purposes of determining the balance of an account under this section, payments and transfers by nonbank banks and industrial banks processed by the Federal Reserve Banks shall be considered posted to their accounts at Federal Reserve Banks as follows:

(1) *Funds transfers*. Transfer items shall be posted:

(i) To the transferor's account at the time the transfer is actually made by the transferor's Federal Reserve Bank; and

(ii) To the transferee's account at the time the transferee's Reserve Bank sends the transfer item or sends or telephones the advice of credit for the item to the transferee, whichever occurs first.

(2) *Book-entry securities transfers against payment*. A book-entry securities transfer against payment shall be posted: (i) to the transferor's account at the time the entry is made by the transferor's Reserve Bank; and (ii) to the transferee's account at the time the entry is made by the transferee's Reserve Bank.

(3) *Discount window loans.* Credit for a discount window loan shall be posted to the account of a nonbank bank or industrial bank at the close of business on the day that it is made or such earlier time as may be specifically agreed to by the Federal Reserve Bank and the nonbank bank under the terms of the loan. Debit for repayment of a discount window loan shall be posted to the account of the nonbank bank or industrial bank as of the close of business on the day of maturity of the loan or such earlier time as may be agreed to by the Federal Reserve Bank and the nonbank bank or required by the Federal Reserve Bank under the terms of the loan.

(4) *Other transactions.* Total aggregate credits for automated clearing house transfers, cash items, noncash items, net settlement entries, and other nonelectronic transactions shall be posted to the account of a nonbank bank or industrial bank as of the opening of business on settlement day. Total aggregate debits for these transactions and entries shall be posted to the account of a nonbank bank or industrial bank as of the close of business on settlement day.

(e) *Posting by nonbank banks and industrial banks.* For purposes of determining the balance of an affiliate's account under this section, payments and transfers through an affiliate's account at a nonbank bank or industrial bank shall be posted as follows:

(1) *Funds transfers.* (i) Fedwire transfer items shall be posted:

(A) To the transferor affiliate's account no later than the time the transfer is actually made by the transferor's Federal Reserve Bank; and

(B) To the transferee affiliate's account no earlier than the time the transferee's Reserve Bank sends the transfer item, or sends or telephones the advice of credit for the item to the transferee, whichever occurs first.

(ii) For funds transfers not sent or received through Federal Reserve Banks, debits shall be posted to the transferor affiliate's account not later than the time the nonbank bank or industrial bank becomes obligated on the transfer. Credits shall not be posted to the transferee affiliate's account before the nonbank bank or industrial bank has received actually and finally collected funds for the transfer.

(2) *Book-entry securities transfers against payment.* (i) A book-entry securities transfer against payment shall be posted:

(A) To the transferor affiliate's account not earlier than the time the entry is made by the transferor's Reserve Bank; and

(B) To the transferee affiliate's account not later than the time the entry is made by the transferee's Reserve Bank.

(ii) For book-entry securities transfers against payment that are not sent or received through Federal Reserve Banks, entries shall be posted:

(A) To the buyer-affiliate's account not later than the time the nonbank bank or industrial bank becomes obligated on the transfer; and

(B) To the seller-affiliate's account not before the nonbank bank or industrial bank has received actually and finally collected funds for the transfer.

(3) *Other transactions*—(i) *Credits.* Except as otherwise provided in this paragraph, credits for cash items, noncash items, ACH transfers, net settlement entries, and all other nonelectronic transactions shall be posted to an affiliate's account on the day of the transaction (*i.e.*, settlement day for ACH transactions or the day of credit for check transactions), but no earlier than the Federal Reserve Bank's opening of business on that day. Credit for cash items that are required by federal or state statute or regulation to be made available to the depositor for withdrawal prior to the posting time set forth in the preceding paragraph shall be posted as of the required availability time.

(ii) *Debits.* Debits for cash items, noncash items, ACH transfers, net settlement entries, and all other nonelectronic transactions shall be posted to an affiliate's account on the day of the transaction (*e.g.*, settlement day for ACH transactions or the day of presentment for check transactions), but no later than the Federal Reserve Bank's close of business on that day. If a check drawn on an affiliate's account or an ACH debit transfer received by an affiliate is returned timely by the nonbank bank or industrial bank in accordance with applicable law and agreements, no entry need to be posted to the affiliate's account for such item.

[Reg. Y, 53 FR 37744, Sept. 28, 1988]

Subpart G—Appraisal Standards for Federally Related Transactions

SOURCE: Reg. Y, 55 FR 27771, July 5, 1990, unless otherwise noted.

§ 225.61 Authority, purpose, and scope.

(a) *Authority*. This subpart is issued by the Board of Governors of the Federal Reserve System (the *Board*) under title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (*FIRREA*) (Pub. L. No. 101–73, 103 Stat. 183 (1989)), 12 U.S.C. 3310, 3331–3351, and section 5(b) of the Bank Holding Company Act, 12 U.S.C. 1844(b).

(b) *Purpose and scope*. (1) Title XI provides protection for federal financial and public policy interests in real estate related transactions by requiring real estate appraisals used in connection with federally related transactions to be performed in writing, in accordance with uniform standards, by appraisers whose competency has been demonstrated and whose professional conduct will be subject to effective supervision. This subpart implements the requirements of title XI, and applies to all federally related transactions entered into by the Board or by institutions regulated by the Board (*regulated institutions*).

(2) This subpart:

(i) Identifies which real estate-related financial transactions require the services of an appraiser;

(ii) Prescribes which categories of federally related transactions shall be appraised by a State certified appraiser and which by a State licensed appraiser; and

(iii) Prescribes minimum standards for the performance of real estate appraisals in connection with federally related transactions under the jurisdiction of the Board.

§ 225.62 Definitions.

(a) *Appraisal* means a written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.

(b) *Appraisal Foundation* means the Appraisal Foundation established on November 30, 1987, as a not-for-profit corporation under the laws of Illinois.

(c) *Appraisal Subcommittee* means the Appraisal Subcommittee of the Federal Financial Institutions Examination Council.

(d) *Business loan* means a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, pool, syndicate, sole proprietorship, or other business entity.

(e) *Complex 1-to-4 family residential property appraisal* means one in which the property to be appraised, the form of ownership, or market conditions are atypical.

(f) *Federally related transaction* means any real estate-related financial transaction entered into on or after August 9, 1990, that:

(1) The Board or any regulated institution engages in or contracts for; and

(2) Requires the services of an appraiser.

(g) *Market value* means the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

(1) Buyer and seller are typically motivated;

(2) Both parties are well informed or well advised, and acting in what they consider their own best interests;

(3) A reasonable time is allowed for exposure in the open market;

(4) Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and

(5) The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

(h) *Real estate* or *real property* means an identified parcel or tract of land, with improvements, and includes easements, rights of way, undivided or future interests, or similar rights in a tract of land, but does not include mineral rights, timber rights, growing crops, water rights, or similar interests severable from the land when the transaction does not involve the associated parcel or tract of land.

(i) *Real estate-related financial transaction* means any transaction involving:

(1) The sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof; or

(2) The refinancing of real property or interests in real property; or

(3) The use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

(j) *State certified appraiser* means any individual who has satisfied the requirements for certification in a State or territory whose criteria for certification as a real estate appraiser currently meet or exceed the minimum criteria for certification issued by the Appraiser Qualifications Board of the Appraisal Foundation. No individual shall be a State certified appraiser unless such individual has achieved a passing grade upon a suitable examination administered by a State or territory that is consistent with and equivalent to the Uniform State Certification Examination issued or endorsed by the Appraiser Qualifications Board of the Appraisal Foundation. In addition, the Appraisal Subcommittee must not have issued a finding that the policies, practices, or procedures of the State or territory are inconsistent with title XI of FIRREA. The Board may, from time to time, impose additional qualification criteria for certified appraisers performing appraisals in connection with federally related transactions within its jurisdiction.

(k) *State licensed appraiser* means any individual who has satisfied the requirements for licensing in a State or territory where the licensing procedures comply with title XI of FIRREA and where the Appraisal Subcommittee has not issued a finding that the policies, practices, or procedures of the State or territory are inconsistent with title XI. The Board may, from time to time, impose additional qualification criteria for licensed appraisers performing appraisals in connection with federally related transactions within the Board's jurisdiction.

(l) *Tract development* means a project of five units or more that is constructed or is to be constructed as a single development.

(m) *Transaction value* means:

(1) For loans or other extensions of credit, the amount of the loan or extension of credit;

(2) For sales, leases, purchases, and investments in or exchanges of real property, the market value of the real property interest involved; and

(3) For the pooling of loans or interests in real property for resale or purchase, the amount of the loan or the market value of the real property calculated with respect to each such loan or interest in real property.

[Reg. Y, 55 FR 27771, July 5, 1990, as amended at 59 FR 29500, June 7, 1994]

§ 225.63 Appraisals required; transactions requiring a State certified or licensed appraiser.

(a) *Appraisals required*. An appraisal performed by a State certified or licensed appraiser is required for all real estate-related financial transactions except those in which:

(1) The transaction value is $250,000 or less;

(2) A lien on real estate has been taken as collateral in an abundance of caution;

(3) The transaction is not secured by real estate;

(4) A lien on real estate has been taken for purposes other than the real estate's value;

(5) The transaction is a business loan that:

(i) Has a transaction value of $1 million or less; and

(ii) Is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;

(6) A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;

(7) The transaction involves an existing extension of credit at the lending institution, provided that:

(i) There has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or

(ii) There is no advancement of new monies, other than funds necessary to cover reasonable closing costs;

(8) The transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by, a loan or interest in a loan, pooled loans, or interests in real property, including mortgaged-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met Board regulatory requirements for appraisals at the time of origination;

(9) The transaction is wholly or partially insured or guaranteed by a United States government agency or United States government sponsored agency;

(10) The transaction either:

(i) Qualifies for sale to a United States government agency or United States government sponsored agency; or

(ii) Involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;

(11) The regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law;

(12) The transaction involves underwriting or dealing in mortgage-backed securities; or

(13) The Board determines that the services of an appraiser are not necessary in order to protect Federal financial and public policy interests in real estate-related financial transactions or to protect the safety and soundness of the institution.

(b) *Evaluations required.* For a transaction that does not require the services of a State certified or licensed appraiser under paragraph (a)(1), (a)(5) or (a)(7) of this section, the institution shall obtain an appropriate evaluation of real property collateral that is consistent with safe and sound banking practices.

(c) *Appraisals to address safety and soundness concerns.* The Board reserves the right to require an appraisal under this subpart whenever the agency believes it is necessary to address safety and soundness concerns.

(d) *Transactions requiring a State certified appraiser*—(1) *All transactions of $1,000,000 or more.* All federally related transactions having a transaction value of $1,000,000 or more shall require an appraisal prepared by a State certified appraiser.

(2) *Nonresidential transactions of $250,000 or more.* All federally related transactions having a transaction value of $250,000 or more, other than those involving appraisals of 1-to-4 family residential properties, shall require an appraisal prepared by a State certified appraiser.

(3) *Complex residential transactions of $250,000 or more.* All complex 1-to-4 family residential property appraisals rendered in connection with federally related transactions shall require a State certified appraiser if the transaction value is $250,000 or more. A regulated institution may presume that appraisals of 1-to-4 family residential properties are not complex, unless the institution has readily available information that a given appraisal will be complex. The regulated institution shall be responsible for making the final determination of whether the appraisal is complex. If during the course of the appraisal a licensed appraiser identifies factors that would result in the property, form of ownership, or market conditions being considered atypical, then either:

(i) The regulated institution may ask the licensed appraiser to complete the appraisal and have a certified appraiser approve and co-sign the appraisal; or

(ii) The institution may engage a certified appraiser to complete the appraisal.

(e) *Transactions requiring either a State certified or licensed appraiser.* All appraisals for federally related transactions not requiring the services of a

State certified appraiser shall be prepared by either a State certified appraiser or a State licensed appraiser.

[Reg. Y, 55 FR 27771, July 5, 1990, as amended at 58 FR 15077, Mar. 19, 1993; 59 FR 29500, June 7, 1994; 63 FR 65532, Nov. 27, 1998]

§ 225.64 Minimum appraisal standards.

For federally related transactions, all appraisals shall, at a minimum:

(a) Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board of the Appraisal Foundation, 1029 Vermont Ave., NW., Washington, DC 20005, unless principles of safe and sound banking require compliance with stricter standards;

(b) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

(c) Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;

(d) Be based upon the definition of market value as set forth in this subpart; and

(e) Be performed by State licensed or certified appraisers in accordance with requirements set forth in this subpart.

[Reg. Y, 59 FR 29501, June 7, 1994]

§ 225.65 Appraiser independence.

(a) *Staff appraisers.* If an appraisal is prepared by a staff appraiser, that appraiser must be independent of the lending, investment, and collection functions and not involved, except as an appraiser, in the federally related transaction, and have no direct or indirect interest, financial or otherwise, in the property. If the only qualified persons available to perform an appraisal are involved in the lending, investment, or collection functions of the regulated institution, the regulated institution shall take appropriate steps to ensure that the appraisers exercise independent judgment and that the appraisal is adequate. Such steps include, but are not limited to, prohibiting an individual from performing appraisals in connection with federally related transactions in which the appraiser is otherwise involved and prohibiting directors and officers from participating in any vote or approval involving assets on which they performed an appraisal.

(b) *Fee appraisers.* (1) If an appraisal is prepared by a fee appraiser, the appraiser shall be engaged directly by the regulated institution or its agent, and have no direct or indirect interest, financial or otherwise, in the property or the transaction.

(2) A regulated institution also may accept an appraisal that was prepared by an appraiser engaged directly by another financial services institution, if:

(i) The appraiser has no direct or indirect interest, financial or otherwise, in the property or the transaction; and

(ii) The regulated institution determines that the appraisal conforms to the requirements of this subpart and is otherwise acceptable.

[Reg. Y, 55 FR 27771, July 5, 1990, as amended at 59 FR 29501, June 7, 1994]

§ 225.66 Professional association membership; competency.

(a) *Membership in appraisal organizations.* A State certified appraiser or a State licensed appraiser may not be excluded from consideration for an assignment for a federally related transaction solely by virtue of membership or lack of membership in any particular appraisal organization.

(b) *Competency.* All staff and fee appraisers performing appraisals in connection with federally related transactions must be State certified or licensed, as appropriate. However, a State certified or licensed appraiser may not be considered competent solely by virtue of being certified or licensed. Any determination of competency shall be based upon the individual's experience and educational background as they relate to the particular appraisal assignment for which he or she is being considered.

§ 225.67 Enforcement.

Institutions and institution-affiliated parties, including staff appraisers and fee appraisers, may be subject to removal and/or prohibition orders, cease and desist orders, and the imposition of civil money penalties pursuant to the Federal Deposit Insurance Act, 12 U.S.C 1811 *et seq.*, as amended, or other applicable law.

Subpart H—Notice of Addition or Change of Directors and Senior Executive Officers

SOURCE: Reg. Y, 62 FR 9341, Feb. 28, 1997, unless otherwise noted.

§ 225.71 Definitions.

(a) *Director* means a person who serves on the board of directors of a regulated institution, except that this term does not include an advisory director who:

(1) Is not elected by the shareholders of the regulated institution;

(2) Is not authorized to vote on any matters before the board of directors or any committee thereof;

(3) Solely provides general policy advice to the board of directors and any committee thereof; and

(4) Has not been identified by the Board or Reserve Bank as a person who performs the functions of a director for purposes of this subpart.

(b) *Regulated institution* means a state member bank or a bank holding company.

(c) *Senior executive officer* means a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer, chief operating officer, chief financial officer, chief lending officer, or chief investment officer. *Senior executive officer* also includes any other person identified by the Board or Reserve Bank, whether or not hired as an employee, with significant influence over, or who participates in, major policymaking decisions of the regulated institution.

(d) *Troubled condition* for a regulated institution means an institution that:

(1) Has a composite rating, as determined in its most recent report of examination or inspection, of 4 or 5 under the Uniform Financial Institutions Rating System or under the Federal Reserve Bank Holding Company Rating System;

(2) Is subject to a cease-and-desist order or formal written agreement that requires action to improve the financial condition of the institution, unless otherwise informed in writing by the Board or Reserve Bank; or

(3) Is informed in writing by the Board or Reserve Bank that it is in troubled condition for purposes of the requirements of this subpart on the basis of the institution's most recent report of condition or report of examination or inspection, or other information available to the Board or Reserve Bank.

§ 225.72 Director and officer appointments; prior notice requirement.

(a) *Prior notice by regulated institution.* A regulated institution shall give the Board 30 days' written notice, as specified in § 225.73, before adding or replacing any member of its board of directors, employing any person as a senior executive officer of the institution, or changing the responsibilities of any senior executive officer so that the person would assume a different senior executive officer position, if:

(1) The regulated institution is not in compliance with all minimum capital requirements applicable to the institution as determined on the basis of the institution's most recent report of condition or report of examination or inspection;

(2) The regulated institution is in troubled condition; or

(3) The Board determines, in connection with its review of a capital restoration plan required under section 38 of the Federal Deposit Insurance Act or subpart B of the Board's Regulation H, or otherwise, that such notice is appropriate.

(b) *Prior notice by individual.* The prior notice required by paragraph (a) of this section may be provided by an individual seeking election to the board of directors of a regulated institution.

§ 225.73 Procedures for filing, processing, and acting on notices; standards for disapproval; waiver of notice.

(a) *Filing notice*—(1) *Content.* The notice required in § 225.72 shall be filed with the appropriate Reserve Bank and shall contain:

(i) The information required by paragraph 6(A) of the Change in Bank Control Act (12 U.S.C. 1817(j)(6)(A)) as may be prescribed in the designated Board form;

(ii) Additional information consistent with the Federal Financial Institutions Examination Council's Joint Statement of Guidelines on Conducting Background Checks and Change in Control Investigations, as set forth in the designated Board form; and

(iii) Such other information as may be required by the Board or Reserve Bank.

(2) *Modification.* The Reserve Bank may modify or accept other information in place of the requirements of § 225.73(a)(1) for a notice filed under this subpart.

(3) *Acceptance and processing of notice.* The 30-day notice period specified in § 225.72 shall begin on the date all information required to be submitted by the notificant pursuant to § 225.73(a)(1) is received by the appropriate Reserve Bank. The Reserve Bank shall notify the regulated institution or individual submitting the notice of the date on which all required information is received and the notice is accepted for processing, and of the date on which the 30-day notice period will expire. The Board or Reserve Bank may extend the 30-day notice period for an additional period of not more than 60 days by notifying the regulated institution or individual filing the notice that the period has been extended and stating the reason for not processing the notice within the 30-day notice period.

(b) *Commencement of service*—(1) *At expiration of period.* A proposed director or senior executive officer may begin service after the end of the 30-day period and any extension as provided under paragraph (a)(3) of this section, unless the Board or Reserve Bank disapproves the notice before the end of the period.

(2) *Prior to expiration of period.* A proposed director or senior executive officer may begin service before the end of the 30-day period and any extension as provided under paragraph (a)(3) of this section, if the Board or the Reserve Bank notifies in writing the regulated institution or individual submitting the notice of the Board's or Reserve Bank's intention not to disapprove the notice.

(c) *Notice of disapproval.* The Board or Reserve Bank shall disapprove a notice under § 225.72 if the Board or Reserve Bank finds that the competence, experience, character, or integrity of the individual with respect to whom the notice is submitted indicates that it would not be in the best interests of the depositors of the regulated institution or in the best interests of the public to permit the individual to be employed by, or associated with, the regulated institution. The notice of disapproval shall contain a statement of the basis for disapproval and shall be sent to the regulated institution and the disapproved individual.

(d) *Appeal of a notice of disapproval.* (1) A disapproved individual or a regulated institution that has submitted a notice that is disapproved under this section may appeal the disapproval to the Board within 15 days of the effective date of the notice of disapproval. An appeal shall be in writing and explain the reasons for the appeal and include all facts, documents, and arguments that the appealing party wishes to be considered in the appeal, and state whether the appealing party is requesting an informal hearing.

(2) Written notice of the final decision of the Board shall be sent to the appealing party within 60 days of the receipt of an appeal, unless the appealing party's request for an informal hearing is granted.

(3) The disapproved individual may not serve as a director or senior executive officer of the state member bank or bank holding company while the appeal is pending.

(e) *Informal hearing.* (1) An individual or regulated institution whose notice under this section has been disapproved may request an informal hearing on the notice. A request for an informal hearing shall be in writing and shall be submitted within 15 days of a notice of disapproval. The Board may, in its sole discretion, order an informal hearing if the Board finds that oral argument is appropriate or necessary to resolve disputes regarding material issues of fact.

(2) An informal hearing shall be held within 30 days of a request, if granted,

unless the requesting party agrees to a later date.

(3) Written notice of the final decision of the Board shall be given to the individual and the regulated institution within 60 days of the conclusion of any informal hearing ordered by the Board, unless the requesting party agrees to a later date.

(f) *Waiver of notice*—(1) *Waiver requests.* The Board or Reserve Bank may permit an individual to serve as a senior executive officer or director before the notice required under this subpart is provided, if the Board or Reserve Bank finds that:

(i) Delay would threaten the safety or soundness of the regulated institution or a bank controlled by a bank holding company;

(ii) Delay would not be in the public interest; or

(iii) Other extraordinary circumstances exist that justify waiver of prior notice.

(2) *Automatic waiver.* An individual may serve as a director upon election to the board of directors of a regulated institution before the notice required under this subpart is provided if the individual:

(i) Is not proposed by the management of the regulated institution;

(ii) Is elected as a new member of the board of directors at a meeting of the regulated institution; and

(iii) Provides to the appropriate Reserve Bank all the information required in § 225.73(a) within two (2) business days after the individual's election.

(3) *Effect on disapproval authority.* A waiver shall not affect the authority of the Board or Reserve Bank to disapprove a notice within 30 days after a waiver is granted under paragraph (f)(1) of this section or the election of an individual who has filed a notice and is serving pursuant to an automatic waiver under paragraph (f)(2) of this section.

Subpart I—Financial Holding Companies

SOURCE: Reg. Y, 66 FR 415, Jan. 3, 2001, unless otherwise noted.

§ 225.81 What is a financial holding company?

(a) *Definition.* A financial holding company is a bank holding company that meets the requirements of this section.

(b) *Requirements to be a financial holding company.* In order to be a financial holding company:

(1) All depository institutions controlled by the bank holding company must be and remain well capitalized;

(2) All depository institutions controlled by the bank holding company must be and remain well managed; and

(3) The bank holding company must have made an effective election to become a financial holding company.

(c) *Requirements for foreign banks that are or are owned by bank holding companies*—(1) *Foreign banks with U.S. branches or agencies that also own U.S. banks.* A foreign bank that is a bank holding company and that operates a branch or agency or owns or controls a commercial lending company in the United States must comply with the requirements of this section, § 225.82, and §§ 225.90 through 225.92 in order to be a financial holding company. After it becomes a financial holding company, a foreign bank described in this paragraph will be subject to the provisions of §§ 225.83, 225.84, 225.93, and 225.94.

(2) *Bank holding companies that own foreign banks with U.S. branches or agencies.* A bank holding company that owns a foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States must comply with the requirements of this section, § 225.82, and §§ 225.90 through 225.92 in order to be a financial holding company. After it becomes a financial holding company, a bank holding company described in this paragraph will be subject to the provisions of §§ 225.83, 225.84, 225.93, and 225.94.

§ 225.82 How does a bank holding company elect to become a financial holding company?

(a) *Filing requirement.* A bank holding company may elect to become a financial holding company by filing a written declaration with the appropriate Reserve Bank. A declaration by a bank holding company is considered to be filed on the date that all information required by paragraph (b) of this section is received by the appropriate Reserve Bank.

(b) *Contents of declaration.* To be deemed complete, a declaration must:

(1) State that the bank holding company elects to be a financial holding company;

(2) Provide the name and head office address of the bank holding company and of each depository institution controlled by the bank holding company;

(3) Certify that each depository institution controlled by the bank holding company is well capitalized as of the date the bank holding company submits its declaration;

(4) Provide the capital ratios as of the close of the previous quarter for all relevant capital measures, as defined in section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o), for each depository institution controlled by the company on the date the company submits its declaration; and

(5) Certify that each depository institution controlled by the company is well managed as of the date the company submits its declaration.

(c) *Effectiveness of election.* An election by a bank holding company to become a financial holding company shall not be effective if, during the period provided in paragraph (e) of this section, the Board finds that, as of the date the declaration was filed with the appropriate Reserve Bank:

(1) Any insured depository institution controlled by the bank holding company (except an institution excluded under paragraph (d) of this section) has not achieved at least a rating of ''satisfactory record of meeting community credit needs'' under the Community Reinvestment Act at the institution's most recent examination; or

(2) Any depository institution controlled by the bank holding company is not both well capitalized and well managed.

(d) *Consideration of the CRA performance of a recently acquired insured depository institution.* Except as provided in paragraph (f) of this section, an insured depository institution will be excluded for purposes of the review of the Community Reinvestment Act rating provisions of paragraph (c)(1) of this section if:

(1) The bank holding company acquired the insured depository institution during the 12-month period preceding the filing of an election under paragraph (a) of this section;

(2) The bank holding company has submitted an affirmative plan to the appropriate Federal banking agency for the institution to take actions necessary for the institution to achieve at least a rating of ''satisfactory record of meeting community credit needs'' under the Community Reinvestment Act at the next examination of the institution; and

(3) The appropriate Federal banking agency for the institution has accepted the plan described in paragraph (d)(2) of this section.

(e) *Effective date of election*—(1) *In general.* An election filed by a bank holding company under paragraph (a) of this section is effective on the 31st calendar day after the date that a complete declaration was filed with the appropriate Reserve Bank, unless the Board notifies the bank holding company prior to that time that the election is ineffective.

(2) *Earlier notification that an election is effective.* The Board or the appropriate Reserve Bank may notify a bank holding company that its election to become a financial holding company is effective prior to the 31st day after the date that a complete declaration was filed with the appropriate Reserve Bank. Such a notification must be in writing.

(f) *Requests to become a financial holding company submitted as part of an application to become a bank holding company*—(1) *In general.* A company that is not a bank holding company and has applied for the Board's approval to become a bank holding company under section 3(a)(1) of the BHC Act (12 U.S.C. 1842(a)(1)) may as part of that application submit a request to become a financial holding company.

(2) *Contents of request.* A request to become a financial holding company submitted as part of an application to become a bank holding company must:

(i) State that the company seeks to become a financial holding company on consummation of its proposal to become a bank holding company; and

(ii) Certify that each depository institution that would be controlled by the company on consummation of its proposal to become a bank holding company will be both well capitalized and well managed as of the date the company consummates the proposal.

(3) *Request becomes a declaration and an effective election on date of consummation of bank holding company proposal.* A complete request submitted by a company under this paragraph (f) becomes a complete declaration by a bank holding company for purposes of section 4(l) of the BHC Act (12 U.S.C. 1843(l)) and becomes an effective election for purposes of § 225.81(b) on the date that the company lawfully consummates its proposal under section 3 of the BHC Act (12 U.S.C. 1842), unless the Board notifies the company at any time prior to consummation of the proposal and that:

(i) Any depository institution that would be controlled by the company on consummation of the proposal will not be both well capitalized and well managed on the date of consummation; or

(ii) Any insured depository institution that would be controlled by the company on consummation of the proposal has not achieved at least a rating of "satisfactory record of meeting community credit needs" under the Community Reinvestment Act at the institution's most recent examination.

(4) *Limited exclusion for recently acquired institutions not available.* Unless the Board determines otherwise, an insured depository institution that is controlled or would be controlled by the company as part of its proposal to become a bank holding company may not be excluded for purposes of evaluating the Community Reinvestment Act criterion described in this paragraph or in paragraph (d) of this section.

(g) *Board's authority to exercise supervisory authority over a financial holding company.* An effective election to become a financial holding company does not in any way limit the Board's statutory authority under the BHC Act, the Federal Deposit Insurance Act, or any other relevant Federal statute to take appropriate action, including imposing supervisory limitations, restrictions, or prohibitions on the activities and acquisitions of a bank holding company that has elected to become a financial holding company, or enforcing compliance with applicable law.

§ 225.83 What are the consequences of failing to continue to meet applicable capital and management requirements?

(a) *Notice by the Board.* If the Board finds that a financial holding company controls any depository institution that is not well capitalized or well managed, the Board will notify the company in writing that it is not in compliance with the applicable requirement(s) for a financial holding company and identify the area(s) of noncompliance. The Board may provide this notice at any time before or after receiving notice from the financial holding company under paragraph (b) of this section.

(b) *Notification by a financial holding company required*—(1) *Notice to Board.* A financial holding company must notify the Board in writing within 15 calendar days of becoming aware that any depository institution controlled by the company has ceased to be well capitalized or well managed. This notification must identify the depository institution involved and the area(s) of noncompliance.

(2) *Triggering events for notice to the Board*—(i) *Well capitalized.* A company becomes aware that a depository institution it controls is no longer well capitalized upon the occurrence of any material event that would change the category assigned to the institution for purposes of section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o). *See* 12 CFR 6.3(b)–(c), 208.42(b)–(c), and 325.102(b)–(c).

(ii) *Well managed.* A company becomes aware that a depository institution it controls is no longer well managed at the time the depository institution receives written notice from the appropriate Federal or state banking agency that either its composite rating or its rating for management is not at least satisfactory.

(c) *Execution of agreement acceptable to the Board*—(1) *Agreement required; time period.* Within 45 days after receiving a notice from the Board under paragraph (a) of this section, the company must execute an agreement acceptable to the Board to comply with all applicable capital and management requirements.

(2) *Extension of time for executing agreement.* Upon request by a company, the Board may extend the 45-day period under paragraph (c)(1) of this section if the Board determines that granting additional time is appropriate under the circumstances. A request by a company for additional time must include an explanation of why an extension is necessary.

(3) *Agreement requirements.* An agreement required by paragraph (c)(1) of this section to correct a capital or management deficiency must:

(i) Explain the specific actions that the company will take to correct all areas of noncompliance;

(ii) Provide a schedule within which each action will be taken;

(iii) Provide any other information that the Board may require; and

(iv) Be acceptable to the Board.

(d) *Limitations during period of noncompliance*—Until the Board determines that a company has corrected the conditions described in a notice under paragraph (a) of this section:

(1) The Board may impose any limitations or conditions on the conduct or activities of the company or any of its affiliates as the Board finds to be appropriate and consistent with the purposes of the BHC Act; and

(2) The company and its affiliates may not commence any additional activity or acquire control or shares of any company under section 4(k) of the BHC Act without prior approval from the Board.

(e) *Consequences of failure to correct conditions within 180 days*—(1) *Divestiture of depository institutions.* If a company does not correct the conditions described in a notice under paragraph (a) of this section within 180 days of receipt of the notice or such additional time as the Board may permit, the Board may order the company to divest ownership or control of any depository institution owned or controlled by the company. Such divestiture must be done in accordance with the terms and conditions established by the Board.

(2) *Alternative method of complying with a divestiture order.* A company may comply with an order issued under paragraph (e)(1) of this section by ceasing to engage (both directly and through any subsidiary that is not a depository institution or a subsidiary of a depository institution) in any activity that may be conducted only under section 4(k), (n), or (o) of the BHC Act (12 U.S.C. 1843(k), (n), or (o)). The termination of activities must be completed within the time period referred to in paragraph (e)(1) of this section and in accordance with the terms and conditions acceptable to the Board.

(f) *Consultation with other agencies.* In taking any action under this section, the Board will consult with the relevant Federal and state regulatory authorities.

§ 225.84 What are the consequences of failing to maintain a satisfactory or better rating under the Community Reinvestment Act at all insured depository institution subsidiaries?

(a) *Limitations on activities*—(1) *In general.* Upon receiving a notice regarding performance under the Community Reinvestment Act in accordance with paragraph (a)(2) of this section, a financial holding company may not:

(i) Commence any additional activity under section 4(k) or 4(n) of the BHC Act (12 U.S.C. 1843(k) or (n)); or

(ii) Directly or indirectly acquire control, including all or substantially all of the assets, of a company engaged in any activity under section 4(k) or 4(n) of the BHC Act (12 U.S.C. 1843(k) or (n)).

(2) *Notification.* A financial holding company receives notice for purposes of this paragraph at the time that the appropriate Federal banking agency for any insured depository institution controlled by the company or the Board provides notice to the institution or company that the institution has received a rating of ''needs to improve record of meeting community credit needs'' or ''substantial noncompliance in meeting community credit needs'' in the institution's most recent examination under the Community Reinvestment Act.

(b) *Exceptions for certain activities*—(1) *Continuation of investment activities.* The prohibition in paragraph (a) of this section does not prevent a financial holding company from continuing to make investments in the ordinary course of conducting merchant banking activities under section 4(k)(4)(H) of the BHC Act (12 U.S.C. 1843(k)(4)(H)) or insurance company investment activities under section 4(k)(4)(I) of the BHC Act (12 U.S.C. 1843(k)(4)(I))if:

(i) The financial holding company lawfully was a financial holding company and commenced the merchant banking activity under section 4(k)(4)(H) of the BHC Act (12 U.S.C. 1843(k)(4)(H)) or the insurance company investment activity under section 4(k)(4)(I) of the BHC Act (12 U.S.C. 1843(k)(4)(I)) prior to the time that an insured depository institution controlled by the financial holding company received a rating below ''satisfactory record of meeting community credit needs'' under the Community Reinvestment Act; and

(ii) The Board has not, in the exercise of its supervisory authority, advised the financial holding company that these activities must be restricted.

(2) *Activities that are closely related to banking.* The prohibition in paragraph (a) of this section does not prevent a financial holding company from commencing any additional activity or acquiring control of a company engaged in any activity under section 4(c) of the BHC Act (12 U.S.C. 1843(c)), if the company complies with the notice, approval, and other requirements of that section and section 4(j) of the BHC Act (12 U.S.C. 1843(j)).

(c) *Duration of prohibitions.* The prohibitions described in paragraph (a) of this section shall continue in effect until such time as each insured depository institution controlled by the financial holding company has achieved at least a rating of ''satisfactory record of meeting community credit needs'' under the Community Reinvestment Act at the most recent examination of the institution.

§ 225.85 Is notice to or approval from the Board required prior to engaging in a financial activity?

(a) *No prior approval required generally*—(1) *In general.* A financial holding company and any subsidiary (other than a depository institution or subsidiary of a depository institution) of the financial holding company may engage in any activity listed in § 225.86, or acquire shares or control of a company engaged exclusively in activities listed in § 225.86, without providing prior notice to or obtaining prior approval from the Board unless required under paragraph (c) of this section.

(2) *Acquisitions by a financial holding company of a company engaged in other permissible activities.* In addition to the activities listed in § 225.86, a company acquired or to be acquired by a financial holding company under paragraph (a)(1) of this section may engage in activities otherwise permissible for a financial holding company under this part in accordance with any applicable notice, approval, or other requirement.

(3) *Acquisition by a financial holding company of a company engaged in limited nonfinancial activities*—(i) *Mixed acquisitions generally permitted.* A financial holding company may under this subpart acquire more than 5 percent of the outstanding shares of any class of voting securities or control of a company that is not engaged exclusively in activities that are financial in nature, incidental to a financial activity, or otherwise permissible for the financial holding company under section 4(c) of the BHC Act (12 U.S.C. 1843(c)) if:

(A) The company to be acquired is substantially engaged in activities that are financial in nature, incidental to a financial activity, or otherwise permissible for the financial holding company under section 4(c) of the BHC Act (12 U.S.C. 1843(c));

(B) The financial holding company complies with the notice requirements of § 225.87, if applicable; and

(C) The company conforms, terminates, or divests, within 2 years of the date the financial holding company acquires shares or control of the company, all activities that are not financial in nature, incidental to a financial activity, or otherwise permissible for the financial holding company under section 4(c) (12 U.S.C. 1843(c))of the BHC Act.

(ii) *Definition of ''substantially engaged.''* Unless the Board determines otherwise, a company will be considered to be ''substantially engaged'' in activities permissible for a financial holding company for purposes of paragraph (a)(3)(A) of this section if at least 85 percent of the company's consolidated total annual gross revenues is derived from and at least 85 percent of the company's consolidated total assets is attributable to the conduct of activities that are financial in nature, incidental to a financial activity, or otherwise permissible for a financial holding company under section 4(c) of the BHC Act (12 U.S.C. 1843(c)).

(b) *Locations in which a financial holding company may conduct financial activities.* A financial holding company may conduct any activity listed in § 225.86 at any location in the United States or at any location outside of the United States subject to the laws of the jurisdiction in which the activity is conducted.

(c) *Circumstances under which prior notice to the Board is required*—(1) *Acquisition of more than 5 percent of the shares of a savings association.* A financial holding company must obtain Board approval in accordance with section 4(j) of the BHC Act (12 U.S.C. 1843(j)) and either § 225.14 or § 225.24, as appropriate, prior to acquiring control or more than 5 percent of the outstanding shares of any class of voting securities of a savings association or of a company that owns, operates, or controls a savings association.

(2) *Supervisory actions.* The Board may, if appropriate in the exercise of its supervisory or other authority, including under § 225.82(g) or § 225.83(d) or other relevant authority, require a financial holding company to provide notice to or obtain approval from the Board prior to engaging in any activity or acquiring shares or control of any company.

§ 225.86 What activities are permissible for any financial holding company?

The following activities are financial in nature or incidental to a financial activity:

(a) *Activities determined to be closely related to banking.* (1) Any activity that the Board had determined by regulation prior to November 12, 1999, to be so closely related to banking as to be a proper incident thereto, subject to the terms and conditions contained in this part, unless modified by the Board. These activities are listed in § 225.28.

(2) Any activity that the Board had determined by an order that was in effect on November 12, 1999, to be so closely related to banking as to be a proper incident thereto, subject to the terms and conditions contained in this part and those in the authorizing orders. These activities are:

(i) Providing administrative and other services to mutual funds (*Societe Generale*, 84 Federal Reserve Bulletin 680 (1998));

(ii) Owning shares of a securities exchange (*J.P. Morgan & Co, Inc., and UBS AG*, 86 Federal Reserve Bulletin 61 (2000));

(iii) Acting as a certification authority for digital signatures and authenticating the identity of persons conducting financial and nonfinancial transactions (*Bayerische Hypo- und Vereinsbank AG, et al.*, 86 Federal Reserve Bulletin 56 (2000));

(iv) Providing employment histories to third parties for use in making credit decisions and to depository institutions and their affiliates for use in the ordinary course of business (*Norwest Corporation*, 81 Federal Reserve Bulletin 732 (1995));

(v) Check cashing and wire transmission services (*Midland Bank, PLC*, 76 Federal Reserve Bulletin 860 (1990) (check cashing); *Norwest Corporation*, 81 Federal Reserve Bulletin 1130 (1995) (money transmission));

(vi) In connection with offering banking services, providing notary public services, selling postage stamps and postage-paid envelopes, providing vehicle registration services, and selling public transportation tickets and tokens (*Popular, Inc.*, 84 Federal Reserve Bulletin 481 (1998)); and

(vii) Real estate title abstracting (*The First National Company*, 81 Federal Reserve Bulletin 805 (1995)).

(b) *Activities determined to be usual in connection with the transaction of banking abroad.* Any activity that the Board had determined by regulation in effect on November 11, 1999, to be usual in connection with the transaction of banking or other financial operations abroad (*see* § 211.5(d) of this chapter), subject to the terms and conditions in part 211 and Board interpretations in effect on that date regarding the scope and conduct of the activity. In addition to the activities listed in paragraphs (a) and (c) of this section, these activities are:

(1) Providing management consulting services, including to any person with respect to nonfinancial matters, so long as the management consulting services are advisory and do not allow the financial holding company to control the person to which the services are provided;

(2) Operating a travel agency in connection with financial services offered by the financial holding company or others; and

(3) Organizing, sponsoring, and managing a mutual fund, so long as:

(i) The fund does not exercise managerial control over the entities in which the fund invests; and

(ii) The financial holding company reduces its ownership in the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund or such additional period as the Board permits.

(c) *Activities permitted under section 4(k)(4) of the BHC Act* (12 U.S.C. 1843(k)(4)). Any activity defined to be financial in nature under sections 4(k)(4)(A) through (E), (H) and (I) of the BHC Act (12 U.S.C. 1843(k)(4)(A) through (E), (H) and (I)).

(d) *Activities determined to be financial in nature or incidental to financial activities by the Board*—(1) *Acting as a finder*—Acting as a finder in bringing together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate and consummate.

(i) *What is the scope of finder activities?* Acting as a finder includes providing any or all of the following services through any means—

(A) Identifying potential parties, making inquiries as to interest, introducing and referring potential parties to each other, and arranging contacts between and meetings of interested parties;

(B) Conveying between interested parties expressions of interest, bids, offers, orders and confirmations relating to a transaction; and

(C) Transmitting information concerning products and services to potential parties in connection with the activities described in paragraphs (d)(1)(i)(A) and (B) of this section.

(ii) *What are some examples of finder services?* The following are examples of the services that may be provided by a finder when done in accordance with paragraphs (d)(1)(iii) and (iv) of this section. These examples are not exclusive.

(A) Hosting an electronic marketplace on the financial holding company's Internet web site by providing hypertext or similar links to the web sites of third party buyers or sellers.

(B) Hosting on the financial holding company's servers the Internet web site of—

(*1*) A buyer (or seller) that provides information concerning the buyer (or seller) and the products or services it seeks to buy (or sell) and allows sellers (or buyers) to submit expressions of interest, bids, offers, orders and confirmations relating to such products or services; or

(*2*) A government or government agency that provides information concerning the services or benefits made available by the government or government agency, assists persons in completing applications to receive such services or benefits from the government or agency, and allows persons to transmit their applications for services or benefits to the government or agency.

(C) Operating an Internet web site that allows multiple buyers and sellers to exchange information concerning the products and services that they are willing to purchase or sell, locate potential counterparties for transactions, aggregate orders for goods or services with those made by other parties, and enter into transactions between themselves.

(D) Operating a telephone call center that provides permissible finder services.

(iii) *What limitations are applicable to a financial holding company acting as a finder?* (A) A finder may act only as an intermediary between a buyer and a seller.

(B) A finder may not bind any buyer or seller to the terms of a specific transaction or negotiate the terms of a specific transaction on behalf of a buyer or seller, except that a finder may—

(*1*) Arrange for buyers to receive preferred terms from sellers so long as the terms are not negotiated as part of any individual transaction, are provided generally to customers or broad categories of customers, and are made available by the seller (and not by the financial holding company); and

(*2*) Establish rules of general applicability governing the use and operation of the finder service, including rules that—

(*i*) Govern the submission of bids and offers by buyers and sellers that use the finder service and the circumstances under which the finder service will match bids and offers submitted by buyers and sellers; and

(*ii*) Govern the manner in which buyers and sellers may bind themselves to the terms of a specific transaction.

(C) A finder may not—

(*1*) Take title to or acquire or hold an ownership interest in any product or service offered or sold through the finder service;

(*2*) Provide distribution services for physical products or services offered or sold through the finder service;

(*3*) Own or operate any real or personal property that is used for the purpose of manufacturing, storing, transporting, or assembling physical products offered or sold by third parties; or

(*4*) Own or operate any real or personal property that serves as a physical location for the physical purchase, sale or distribution of products or services offered or sold by third parties.

(D) A finder may not engage in any activity that would require the company to register or obtain a license as a real estate agent or broker under applicable law.

(iv) *What disclosures are required?* A finder must distinguish the products and services offered by the financial holding company from those offered by a third party through the finder service.

(2) [Reserved]

(e) *Activities permitted under section 4(k)(5) of the Bank Holding Company Act (12 U.S.C. 1843(k)(5)).* (1) The following types of activities are financial in nature or incidental to a financial activity when conducted pursuant to a determination by the Board under paragraph (e)(2) of this section:

(i) Lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities;

(ii) Providing any device or other instrumentality for transferring money or other financial assets; and

(iii) Arranging, effecting, or facilitating financial transactions for the account of third parties.

(2) *Review of specific activities*—(i) *Is a specific request required?* A financial holding company that wishes to engage on the basis of paragraph (e)(1) of this section in an activity that is not otherwise permissible for a financial holding company must obtain a determination from the Board that the activity is permitted under paragraph (e)(1).

(ii) *Consultation with the Secretary of the Treasury.* After receiving a request under this section, the Board will provide the Secretary of the Treasury with a copy of the request and consult with the Secretary in accordance with section 4(k)(2)(A) of the Bank Holding Company Act (12 U.S.C. 1843(k)(2)(A)).

(iii) *Board action on requests.* After consultation with the Secretary, the Board will promptly make a written determination regarding whether the specific activity described in the request is included in an activity category listed in paragraph (e)(1) of this section and is therefore either financial in nature or incidental to a financial activity.

(3) *What factors will the Board consider?* In evaluating a request made under this section, the Board will take into account the factors listed in section 4(k)(3) of the BHC Act (12 U.S.C. 1843(k)(3)) that it must consider when determining whether an activity is financial in nature or incidental to a financial activity.

(4) *What information must the request contain?* Any request by a financial holding company under this section must be in writing and must:

(i) Identify and define the activity for which the determination is sought, specifically describing what the activity would involve and how the activity would be conducted; and

(ii) Provide information supporting the requested determination, including information regarding how the proposed activity falls into one of the categories listed in paragraph (e)(1) of this section, and any other information required by the Board concerning the proposed activity.

[Reg. Y, 66 FR 415, Jan. 3, 2001, as amended at 66 FR 19081, Apr. 13, 2001]

§ 225.87 Is notice to the Board required after engaging in a financial activity?

(a) *Post-transaction notice generally required to engage in a financial activity.* A financial holding company that commences an activity or acquires shares of a company engaged in an activity listed in § 225.86 must notify the appropriate Reserve Bank in writing within 30 calendar days after commencing the activity or consummating the acquisition by using the appropriate form.

(b) *Cases in which notice to the Board is not required*—(1) *Acquisitions that do not involve control of a company.* A notice under paragraph (a) of this section is not required in connection with the acquisition of shares of a company if, following the acquisition, the financial holding company does not control the company.

(2) *No additional notice required to engage* de novo *in an activity for which a financial holding company already has provided notice.* After a financial holding company provides the appropriate Reserve Bank with notice that the company is engaged in an activity listed in § 225.86, a financial holding company may, unless otherwise notified by the Board, commence the activity *de novo* through any subsidiary that the financial holding company is authorized to control without providing additional notice under paragraph (a) of this section.

(3) *Conduct of certain investment activities.* Unless required by paragraph (b)(4) of this section, a financial holding company is not required to provide notice under paragraph (a) of this section of any individual acquisition of shares of a company as part of the conduct by a financial holding company of securities underwriting, dealing, or market making activities as described in section 4(k)(4)(E) of the BHC Act (12 U.S.C. 1843(k)(4)(E)), merchant banking activities conducted pursuant to section 4(k)(4)(H) of the BHC Act (12 U.S.C. 1843(k)(4)(H)), or insurance company investment activities conducted pursuant to section 4(k)(4)(I) of the BHC Act (12 U.S.C. 1843(k)(4)(I)), if the financial holding company previously has notified the Board under paragraph (a) of this section that the company has commenced the relevant securities, merchant banking, or insurance company investment activities, as relevant.

(4) *Notice of large merchant banking or insurance company investments.* Notwithstanding paragraph (b)(1) or (b)(3) of this section, a financial holding company must provide notice under paragraph (a) of the section if:

(i) As part of a merchant banking activity conducted under section 4(k)(4)(H) of the BHC Act (12 U.S.C. 1843(k)(4)(H)), the financial holding company acquires more than 5 percent of the shares, assets, or ownership interests of any company at a total cost that exceeds the lesser of 5 percent of the financial holding company's Tier 1 capital or $200 million;

(ii) As part of an insurance company investment activity conducted under section 4(k)(4)(I) of the BHC Act (12 U.S.C. 1843(k)(4)(I)), the financial holding company acquires more than 5 percent of the shares, assets, or ownership interests of any company at a total cost that exceeds the lesser of 5 percent of the financial holding company's Tier 1 capital or $200 million; or

(iii) The Board in the exercise of its supervisory authority notifies the financial holding company that a notice is necessary.

§ 225.88 How to request the Board to determine that an activity is financial in nature or incidental to a financial activity?

(a) *Requests regarding activities that may be financial in nature or incidental to a financial activity.* A financial holding company or other interested party may request a determination from the Board that an activity not listed in § 225.86 is financial in nature or incidental to a financial activity.

(b) *Required information.* A request submitted under this section must be in writing and must:

(1) Identify and define the activity for which the determination is sought, specifically describing what the activity would involve and how the activity would be conducted;

(2) Explain in detail why the activity should be considered financial in nature or incidental to a financial activity; and

(3) Provide information supporting the requested determination and any other information required by the Board concerning the proposed activity.

(c) *Board procedures for reviewing requests*—(1) *Consultation with the Secretary of the Treasury.* Upon receipt of the request, the Board will provide the Secretary of the Treasury a copy of the request and consult with the Secretary in accordance with section 4(k)(2)(A) of the BHC Act (12 U.S.C. 1843(k)(2)(A)).

(2) *Public notice.* The Board may, as appropriate and after consultation with the Secretary, publish a description of the proposal in the FEDERAL REGISTER with a request for public comment.

(d) *Board action.* The Board will endeavor to make a decision on any request filed under paragraph (a) of this section within 60 calendar days following the completion of both the consultative process described in paragraph (c)(1) of this section and the public comment period, if any.

(e) *Advisory opinions regarding scope of financial activities*—(1) *Written request.* A financial holding company or other interested party may request an advisory opinion from the Board about whether a specific proposed activity falls within the scope of an activity listed in § 225.86 as financial in nature or incidental to a financial activity. The request must be submitted in writing and must contain:

(i) A detailed description of the particular activity in which the company proposes to engage or the product or service the company proposes to provide;

(ii) An explanation supporting an interpretation regarding the scope of the permissible financial activity; and

(iii) Any additional information requested by the Board regarding the activity.

(2) *Board response.* The Board will provide an advisory opinion within 45 calendar days of receiving a complete written request under paragraph (e)(1) of this section.

§ 225.89 How to request approval to engage in an activity that is complementary to a financial activity?

(a) *Prior Board approval is required.* A financial holding company that seeks to engage in or acquire more than 5 percent of the outstanding shares of any class of voting securities of a company engaged in an activity that the financial holding company believes is complementary to a financial activity must obtain prior approval from the Board in accordance with section 4(j) of the BHC Act (12 U.S.C. 1843(j)). The notice must be in writing and must:

(1) Identify and define the proposed complementary activity, specifically describing what the activity would involve and how the activity would be conducted;

(2) Identify the financial activity for which the proposed activity would be complementary and provide detailed information sufficient to support a finding that the proposed activity should be considered complementary to the identified financial activity;

(3) Describe the scope and relative size of the proposed activity, as measured by the percentage of the projected financial holding company revenues expected to be derived from and assets associated with conducting the activity;

(4) Discuss the risks that conducting the activity may reasonably be expected to pose to the safety and soundness of the subsidiary depository institutions of the financial holding company and to the financial system generally;

(5) Describe the potential adverse effects, including potential conflicts of interest, decreased or unfair competition, or other risks, that conducting the activity could raise, and explain the measures the financial holding company proposes to take to address those potential effects;

(6) Describe the potential benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that the proposal reasonably can be expected to produce; and

(7) Provide any information about the financial and managerial resources of the financial holding company and any other information requested by the Board.

(b) *Factors for consideration by the Board.* In evaluating a notice to engage in a complementary activity, the Board must consider whether:

(1) The proposed activity is complementary to a financial activity;

(2) The proposed activity would pose a substantial risk to the safety or soundness of depository institutions or the financial system generally; and

(3) The proposal could be expected to produce benefits to the public that outweigh possible adverse effects.

(c) *Board action.* The Board will inform the financial holding company in writing of the Board's determination regarding the proposed activity within the period described in section 4(j) of the BHC Act (12 U.S.C. 1843(j)).

§ 225.90 What are the requirements for a foreign bank to be treated as a financial holding company?

(a) *Foreign banks as financial holding companies.* A foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States, and any company that owns or controls such a foreign bank, will be treated as a financial holding company if:

(1) The foreign bank, any other foreign bank that maintains a U.S. branch, agency, or commercial lending company and is controlled by the foreign bank or company, and any U.S. depository institution subsidiary that is owned or controlled by the foreign bank or company, is and remains well capitalized and well managed; and

(2) The foreign bank, and any company that owns or controls the foreign bank, has made an effective election to be treated as a financial holding company under this subpart.

(b) *Standards for ''well capitalized.''* A foreign bank will be considered ''well capitalized'' if either:

(1)(i) Its home country supervisor, as defined in § 211.21 of the Board's Regulation K (12 CFR 211.21), has adopted risk-based capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision (Basel Accord);

(ii) The foreign bank maintains a Tier 1 capital to total risk-based assets ratio of 6 percent and a total capital to total risk-based assets ratio of 10 percent, as calculated under its home country standard; and

(iii) The foreign bank's capital is comparable to the capital required for a U.S. bank owned by a financial holding company; or

(2) The foreign bank has obtained a determination from the Board under § 225.91(c) that the foreign bank's capital is otherwise comparable to the capital that would be required of a U.S. bank owned by a financial holding company.

(c) *Standards for ''well managed.''* A foreign bank will be considered ''well managed'' if:

(1) The foreign bank has received at least a satisfactory composite rating of its U.S. branch, agency, and commercial lending company operations at its most recent assessment;

(2) The home country supervisor of the foreign bank consents to the foreign bank expanding its activities in the United States to include activities permissible for a financial holding company; and

(3) The management of the foreign bank meets standards comparable to those required of a U.S. bank owned by a financial holding company.

§ 225.91 How may a foreign bank elect to be treated as a financial holding company?

(a) *Filing requirement.* A foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States, or a company that owns or controls such a foreign bank, may elect to be treated as a financial holding company by filing a written declaration with the appropriate Reserve Bank.

(b) *Contents of declaration.* The declaration must:

(1) State that the foreign bank or the company elects to be treated as a financial holding company;

(2) Provide the risk-based capital ratios and amount of Tier 1 capital and total assets of the foreign bank, and of each foreign bank that maintains a U.S. branch, agency, or commercial lending company and is controlled by the foreign bank or company, as of the close of the most recent quarter and as of the close of the most recent audited reporting period;

(3) Certify that the foreign bank, and each foreign bank that maintains a U.S. branch, agency, or commercial lending company and is controlled by the foreign bank or company, meets the standards of well capitalized set out in § 225.90(b)(1)(i) and (ii) or § 225.90(b)(2) as of the date the foreign bank or company files its election;

(4) Certify that the foreign bank, and each foreign bank that maintains a U.S. branch, agency, or commercial lending company and is controlled by the foreign bank or company, is well managed as defined in § 225.90(c)(1) as of the date the foreign bank or company files its election;

(5) Certify that all U.S. depository institution subsidiaries of the foreign bank or company are well capitalized and well managed as of the date the foreign bank or company files its election; and

(6) Provide the capital ratios for all relevant capital measures (as defined in section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831(o))) as of the close of the previous quarter for each U.S. depository institution subsidiary of the foreign bank or company.

(c) *Pre-clearance process.* Before filing an election to be treated as a financial holding company, a foreign bank or company may file a request for review of its qualifications to be treated as a financial holding company. The Board will endeavor to make a determination on such requests within 30 days of receipt. A foreign bank that has not been found, or that is chartered in a country where no bank from that country has been found, by the Board under the Bank Holding Company Act or the International Banking Act to be subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor is required to use this process.

§ 225.92 How does an election by a foreign bank become effective?

(a) *In general.* An election described in § 225.91 is effective on the 31st day after the date that an election was received by the appropriate Federal Reserve Bank, unless the Board notifies the foreign bank or company prior to that time that:

(1) The election is ineffective; or

(2) The period is extended with the consent of the foreign bank or company making the election.

(b) *Earlier notification that an election is effective.* The Board or the appropriate Federal Reserve Bank may notify a foreign bank or company that its election to be treated as a financial holding company is effective prior to the 31st day after the election was filed with the appropriate Federal Reserve Bank. Such notification must be in writing.

(c) *Under what circumstances will the Board find an election to be ineffective?* An election to be treated as a financial holding company shall not be effective if, during the period provided in paragraph (a) of this section, the Board finds that:

(1) The foreign bank certificant, or any foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States and is controlled by a foreign bank or company certificant, is not both well capitalized and well managed;

(2) Any U.S. insured depository institution subsidiary of the foreign bank or company (except an institution excluded under paragraph (d) of this section) or any U.S. branch of a foreign bank that is insured by the Federal Deposit Insurance Corporation has not achieved at least a rating of ''satisfactory record of meeting community needs'' under the Community Reinvestment Act at the institution's most recent examination;

(3) Any U.S. depository institution subsidiary of the foreign bank or company is not both well capitalized and well managed; or

(4) The Board does not have sufficient information to assess whether the foreign bank or company making the election meets the requirements of this subpart.

(d) *How is CRA performance of recently acquired insured depository institutions considered?* An insured depository institution will be excluded for purposes of the review of CRA ratings described in paragraph (c)(2) of this section consistent with the provisions of § 225.82(d).

(e) *Factors used in the Board's determination regarding comparability of capital and management*—(1) *In general.* In determining whether a foreign bank is well capitalized and well managed in accordance with comparable capital and management standards, the Board will give due regard to national treatment and equality of competitive opportunity. In this regard, the Board may take into account the foreign bank's composition of capital, Tier 1 capital to total assets leverage ratio, accounting standards, long-term debt ratings, reliance on government support to meet capital requirements, the foreign bank's anti-money laundering procedures, whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis, and other factors that may affect analysis of capital and management. The Board will consult with the home country supervisor for the foreign bank as appropriate.

(2) *Assessment of consolidated supervision.* A foreign bank that is not subject to comprehensive supervision on a consolidated basis by its home country authorities may not be considered well capitalized and well managed unless:

(i) The home country has made significant progress in establishing arrangements for comprehensive supervision on a consolidated basis; and

(ii) The foreign bank is in strong financial condition as demonstrated, for example, by capital levels that significantly exceed the minimum levels that are required for a well capitalized determination and strong asset quality.

§ 225.93 What are the consequences of a foreign bank failing to continue to meet applicable capital and management requirements?

(a) *Notice by the Board.* If a foreign bank or company has made an effective election to be treated as a financial holding company under this subpart and the Board finds that the foreign bank, any foreign bank that maintains a U.S. branch, agency, or commercial lending company and is controlled by the foreign bank or company, or any U.S. depository institution subsidiary controlled by the foreign bank or company, ceases to be well capitalized or well managed, the Board will notify the foreign bank and company, if any, in writing that it is not in compliance with the applicable requirement(s) for a financial holding company and identify the areas of noncompliance.

(b) *Notification by a financial holding company required*—(1) *Notice to Board.* Promptly upon becoming aware that the foreign bank, any foreign bank that maintains a U.S. branch, agency, or commercial lending company and is controlled by the foreign bank or company, or any U.S. depository institution subsidiary of the foreign bank or company, has ceased to be well capitalized or well managed, the foreign bank and company, if any, must notify the Board and identify the area of noncompliance.

(2) *Triggering events for notice to the Board*—(i) *Well capitalized.* A foreign bank becomes aware that it is no longer well capitalized at the time that the foreign bank or company is required to file a report of condition (or similar supervisory report) with its home country supervisor or the appropriate Federal Reserve Bank that indicates that the foreign bank no longer meets the well capitalized standards.

(ii) *Well managed.* A foreign bank becomes aware that it is no longer well managed at the time that the foreign bank receives written notice from the appropriate Federal Reserve Bank that the composite rating of its U.S. branch, agency, and commercial lending company operations is not at least satisfactory.

(c) *Execution of agreement acceptable to the Board*—(1) *Agreement required; time period.* Within 45 days after receiving a notice under paragraph (a) of this section, the foreign bank or company must execute an agreement acceptable to the Board to comply with all applicable capital and management requirements.

(2) *Extension of time for executing agreement.* Upon request by the foreign bank or company, the Board may extend the 45-day period under paragraph (c)(1) of this section if the Board determines that granting additional time is appropriate under the circumstances. A request by a foreign bank or company for additional time must include an explanation of why an extension is necessary.

(3) *Agreement requirements.* An agreement required by paragraph (c)(1) of this section to correct a capital or management deficiency must:

(i) Explain the specific actions that the foreign bank or company will take to correct all areas of noncompliance;

(ii) Provide a schedule within which each action will be taken;

(iii) Provide any other information that the Board may require; and

(iv) Be acceptable to the Board.

(d) *Limitations during period of noncompliance*—Until the Board determines that a foreign bank or company has corrected the conditions described in a notice under paragraph (a) of this section:

(1) The Board may impose any limitations or conditions on the conduct or the U.S. activities of the foreign bank or company or any of its affiliates as the Board finds to be appropriate and consistent with the purposes of the Bank Holding Company Act; and

(2) The foreign bank or company and its affiliates may not commence any additional activity in the United States or acquire control or shares of any company under section 4(k) of the Bank Holding Company Act (12 U.S.C. 1843(k)) without prior approval from the Board.

(e) *Consequences of failure to correct conditions within 180 days*—(1) *Termination of Offices and Divestiture.* If a foreign bank or company does not correct the conditions described in a notice under paragraph (a) of this section within 180 days of receipt of the notice or such additional time as the Board may permit, the Board may order the foreign bank or company to terminate the foreign bank's U.S. branches and agencies and divest any commercial lending companies owned or controlled by the foreign bank or company. Such divestiture must be done in accordance with the terms and conditions established by the Board.

(2) *Alternative method of complying with a divestiture order.* A foreign bank or company may comply with an order issued under paragraph (e)(1) of this section by ceasing to engage (both directly and through any subsidiary that is not a depository institution or a subsidiary of a depository institution) in any activity that may be conducted only under section 4(k), (n), or (o) of the BHC Act (12 U.S.C. 1843(k), (n) and (o)). The termination of activities must be completed within the time period referred to in paragraph (e)(1) of this section and subject to terms and conditions acceptable to the Board.

(f) *Consultation with Other Agencies.* In taking any action under this section, the Board will consult with the relevant Federal and state regulatory authorities and the appropriate home country supervisor(s) of the foreign bank.

§ 225.94 What are the consequences of an insured branch or depository institution failing to maintain a satisfactory or better rating under the Community Reinvestment Act?

(a) *Insured branch as an ''insured depository institution.''* A U.S. branch of a foreign bank that is insured by the Federal Deposit Insurance Corporation shall be treated as an ''insured depository institution'' for purposes of § 225.84.

(b) *Applicability.* The provisions of § 225.84, with the modifications contained in this section, shall apply to a foreign bank that operates an insured branch referred to in paragraph (a) of this section or an insured depository institution in the United States, and any company that owns or controls such a foreign bank, that has made an effective election under § 225.92 in the same manner and to the same extent as they apply to a financial holding company.

INTERPRETATIONS

§225.101 Bank holding company's subsidiary banks owning shares of nonbanking companies.

(a) The Board's opinion has been requested on the following related matters under the Bank Holding Company Act of 1956.

(b) The question is raised as to whether shares in a nonbanking company which were acquired by a banking subsidiary of the bank holding company many years ago when their acquisition was lawful and are now held as investments, and which do not include more than 5 percent of the outstanding voting securities of such nonbanking company and do not have a value greater than 5 percent of the value of the bank holding company's total assets, are exempted from the divestment requirements of the Act by the provisions of section 4(c)(5) of the Act.

(c) In the Board's opinion, this exemption is as applicable to such shares when held by a banking subsidiary of a bank holding company as when held directly by the bank holding company itself. While the exemption specifically refers only to shares held or acquired by the bank holding company, the prohibition of the Act against retention of nonbanking interests applies to indirect as well as direct ownership of shares of a nonbanking company, and, in the absence of a clear mandate to the contrary, any exception to this prohibition should be given equal breadth with the prohibition. Any other interpretation would lead to unwarranted results.

(d) Although certain of the other exemptions in section 4(c) of the Act specifically refer to shares held or acquired by banking subsidiaries, an analysis of those exemptions suggests that such specific reference to banking subsidiaries was for the purpose of excluding nonbanking subsidiaries from such exemptions, rather than for the purpose of providing an inclusionary emphasis on banking subsidiaries.

(e) It should be noted that the Board's view as to this question should not be interpreted as meaning that each banking subsidiary could own up to 5 percent of the stock of the same nonbanking organization. In the Board's opinion the limitations set forth in section 4(c)(5) apply to the aggregate amount of stock held in a particular organization by the bank holding company itself and by all of its subsidiaries.

(f) Secondly, question is raised as to whether shares in a nonbanking company acquired in satisfaction of debts previously contracted (d.p.c.) by a banking subsidiary of the bank holding company may be retained if such shares meet the conditions contained in section 4(c)(5) as to value and amount, notwithstanding the requirement of section 4(c)(2) that shares acquired d.p.c. be disposed of within two years after the date of their acquisition or the date of the Act, whichever is later. In the Board's opinion, the 5 percent exemption provided by section 4(c)(5) covers any shares, including shares acquired d.p.c., that meet the conditions set forth in that exemption, and, consequently, d.p.c. shares held by a banking subsidiary of a bank holding company which meet such conditions are not subject to the two-year disposition requirement prescribed by section 4(c)(2), although any such shares would, of course, continue to be subject to such requirement for disposition as may be prescribed by provisions of any applicable banking laws or by the appropriate bank supervisory authorities.

(g) Finally, question is raised as to whether shares held by banking subsidiaries of the bank holding company in companies holding bank premises of such subsidiaries are exempted from the divestment requirements by section 4(c)(1) of the Act. It is the Board's view that section 4(c)(1), exempting shares owned or acquired by a bank holding company in any company engaged solely in holding or operating properties used wholly or substantially by any subsidiary bank, is to be read and interpreted, like section 4(c)(5), as applying to shares owned indirectly by a bank holding company through a banking subsidiary as well as to shares held directly by the bank holding company. A contrary interpretation would impair the right that member banks controlled by bank holding companies would otherwise have to invest, subject to the limitations of section 24A of the

Federal Reserve Act, in stock of companies holding their bank premises; and such a result was not, in the Board's opinion, intended by the Bank Holding Company Act.

[21 FR 10472, Dec. 29, 1956. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.102 Bank holding company indirectly owning nonbanking company through subsidiaries.

(a) The Board of Governors has been requested for an opinion regarding the exemptions contained in section 4(c)(5) of the Bank Holding Company Act of 1956. It is stated that Y Company is an investment company which is not a bank holding company and which is not engaged in any business other than investing in securities, which securities do not include more than 5 per centum of the outstanding voting securities of any company and do not include any asset having a value greater than 5 per centum of the value of the total assets of X Corporation, a bank holding company. It is stated that direct ownership by X Corporation of voting shares of Y Company would be exempt by reason of section 4(c)(5) from the prohibition of section 4 of the Act against ownership by bank holding companies of nonbanking assets.

(b) It was asked whether it makes any difference that the shares of Y Company are not owned directly by X Corporation but instead are owned through Subsidiaries A and B. X Corporation owns all the voting shares of Subsidiary A, which owns one-half of the voting shares of Subsidiary B. Subsidiaries A and B each own one-third of the voting shares of Y Company.

(c) Section 4(c)(5) is divided into two parts. The first part exempts the ownership of securities of nonbanking companies when the securities do not include more than 5 percent of the voting securities of the nonbanking company and do not have a value greater than 5 percent of the value of the total assets of the bank holding company. The second part exempts the ownership of securities of an investment company which is not a bank holding company and is not engaged in any business other than investing in securities, provided the securities held by the investment company meet the 5 percent tests mentioned above.

(d) In § 225.101, the Board expressed the opinion that the first exemption in section 4(c)(5):

> * * * is as applicable to such shares when held by a banking subsidiary of a bank holding company as when held directly by the bank holding company itself. While the exemption specifically refers only to shares held or acquired by the bank holding company, the prohibition of the Act against retention of nonbanking interests applies to indirect as well as direct ownership of shares of a nonbanking company, and, in the absence of a clear mandate to the contrary, any exception to this prohibition should be given equal breadth with the prohibition. Any other interpretation would lead to unwarranted results.

(e) The Board is of the view that the principles stated in that opinion are also applicable to the second exemption in section 4(c)(5), and that they apply whether or not the subsidiary owning the shares is a banking subsidiary. Accordingly, on the basis of the facts presented, the Board is of the opinion that the second exemption in section 4(c)(5) applies to the indirect ownership by X Corporation of shares of Y Company through Subsidiaries A and B.

[22 FR 2533, Apr. 13, 1957. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.103 Bank holding company acquiring stock by dividends, stock splits or exercise of rights.

(a) The Board of Governors has been asked whether a bank holding company may receive bank stock dividends or participate in bank stock splits without the Board's prior approval, and whether such a company may exercise, without the Board's prior approval, rights to subscribe to new stock issued by banks in which the holding company already owns stock.

(b) Neither a stock dividend nor a stock split results in any change in a stockholder's proportional interest in the issuing company or any increase in the assets of that company. Such a transaction would have no effect upon the extent of a holding company's control of the bank involved; and none of the five factors required by the Bank Holding Company Act to be considered by the Board in approving a stock acquisition would seem to have any application. In view of the objectives and purposes of the act, the word ''acquire'' would not seem reasonably to include transactions of this kind.

(c) On the other hand, the exercise by a bank holding company of the right to subscribe to an issue of additional stock of a bank could result in an increase in the holding company's proportional interest in the bank. The holding company would voluntarily pay additional funds for the extra shares and would ''acquire'' the additional stock even under a narrow meaning of that term. Moreover, the exercise of such rights would cause the assets of the issuing company to be increased and in a sense, therefore, the ''size or extent'' of the bank holding company system would be expanded.

(d) In the circumstances, it is the Board's opinion that receipt of bank stock by means of a stock dividend or stock split, assuming no change in the class of stock, does not require the Board's prior approval under the act, but that purchase of bank stock by a bank holding company through the exercise of rights does require the Board's prior approval, unless one of the exceptions set forth in section 3(a) is applicable.

[22 FR 7461, Sept. 19, 1957. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.104 "Services" under section 4(c)(1) of Bank Holding Company Act.

(a) Section 4(c)(1) of the Bank Holding Company Act, among other things, exempts from the nonbanking divestment requirements of section 4(a) of the Act shares of a company engaged ''solely in the business of furnishing services to or performing services for'' its bank holding company or subsidiary banks thereof.

(b) The Board of Governors has had occasion to express opinions as to whether this section of law applies to the following two sets of facts:

(1) In the first case, Corporation X, a nonbanking subsidiary of a bank holding company (Holding Company A), was engaged in the business of purchasing installment paper suitable for investment by banking subsidiaries of Holding Company A. All installment paper purchased by Corporation X was sold by it to a bank which is a subsidiary of Holding Company A, without recourse, at a price equal to the cost of the installment paper to Corporation X, and with compensation to the latter based on the earnings from such paper remaining after certain reserves, expenses and charges. The subsidiary bank sold participations in such installment paper to the other affiliated banks of Holding Company A which desired to participate. Purchases by Corporation X consisted mainly of paper insured under Title I of the National Housing Act and, in addition, Corporation X purchased time payment contracts covering sales of appliances by dealers under contractual arrangements with utilities, as well as paper covering home improvements which was not insured. Pursuant to certain service agreements, Corporation X made all collections, enforced guaranties, filed claims under Title I insurance and performed other services for the affiliated banks. Also Corporation X rendered to banking subsidiaries of Holding Company A various accounting, statistical and advisory services such as payroll, life insurance and budget loan installment account.

(2) In the second case, Corporation Y, a nonbanking subsidiary of a bank holding company (Holding Company B, which was also a bank), solicited business on behalf of Holding Company B from dealers, throughout several adjoining or contiguous States, who made time sales and desired to convert their time sales paper into cash; but Corporation Y made no loans or purchases of sales contracts and did not discount or advance money for time sales obligations. Corporation Y investigated credit standings of purchasers obligated on time sale contracts to be acquired by Holding Company B, Corporation Y received from dealers the papers offered by them and inspected such papers to see that they were in order, and transmitted to Holding Company B for its determination to purchase, including, in some cases, issuance of drafts in favor of dealers in order to facilitate their prompt receipt

of payment for installment paper purchased by Holding Company B. Corporation Y made collections of delinquent paper or delinquent installments, which sometimes involved repossession and resale of the automobile or other property which secured the paper. Also, upon request of purchasers obligated on paper held by Holding Company B, Corporation Y transmitted installment payments to Holding Company B. Holding Company B reimbursed Corporation Y for its actual costs and expenses in performing the services mentioned above, including the salaries and wages of all Corporation Y officers and employees.

(c) While the term ''services'' is sometimes used in a broad and general sense, the legislative history of the Bank Holding Company Act indicates that in section 4(c)(1) the word was meant to be somewhat more limited in its application. An early version of the bill specifically exempted companies engaged in serving the bank holding company and its subsidiary banks in ''auditing, appraising, investment counseling''. The statute as finally enacted does not expressly mention any specific type of servicing activity for exemption. In recommending the change, the Senate Banking and Currency Committee stated that the types of services contemplated are ''in the fields of advertising, public relations, developing new business, organizations, operations, preparing tax returns, personnel, and many others'', which indicates that latitude should be given to the range of activities contemplated by this section beyond those specifically set forth in the early draft of the bill. (84th Cong., 2d Sess., Senate Report 1095, Part 2, p. 3.) It nevertheless seems evident that Congress intended such services to be types of activities generally comparable to those mentioned above from the early bill (''auditing, appraising, investment counseling'') and in the excerpt from the Committee Report on the later bill (''advertising, public relations, developing new business, organization, operations, preparing tax returns, personnel, and many others''). This legislative history and the context in which the term ''services'' is used in section 4(c)(1) seem to suggest that the term was in general intended to refer to servicing operations which a bank could carry on itself, but which the bank or its holding company chooses to have done through another organization. Moreover, the report of the Senate Banking and Currency Committee indicated that the types of servicing permitted under section 4(c)(1) are to be distinguished from activities of a ''financial, fiduciary, or insurance nature'', such as those which might be considered for possible exemption under section 4(c)(6) of the Act.

(d) With respect to the first set of facts, the Board expressed the opinion that certain of the activities of Corporation X, such as the accounting, statistical and advisory services referred to above, may be within the range of servicing activities contemplated by section 4(c)(1), but that this would not appear to be the case with the main activity of Corporation X, which was the purchase of installment paper and the resale of such paper at cost, without recourse, to banking subsidiaries of Holding Company A. This latter and basic activity of Corporation X appeared to involve essentially a financial relationship between it and the banking subsidiaries of Holding Company A and appeared beyond the category of servicing exemptions contemplated by section 4(c)(1) of the Act. Accordingly, it was the Board's view that Corporation X could not be regarded as qualifying under section 4 (c)(1) as a company engaged ''solely in the business of furnishing services to or performing services for'' Holding Company A or subsidiary banks thereof.

(e) With respect to the second set of facts, the Board expressed the opinion that some of the activities engaged in by Corporation Y were clearly within the range of servicing activities contemplated by section 4(c)(1). There was some question as to whether or not some of the other activities of Corporation Y mentioned above could meet the test, but on balance, it seemed that all such activities probably were activities in which Holding Company B, which as already indicated was a bank, could itself engage, at the present locations of Corporation Y, without being engaged in the operation of bank branches at those locations. In the circumstances, while the question was not free from doubt, the Board expressed the opinion that the activities of Corporation Y were those of a company engaged ''solely in the business of furnishing services to or performing services for'' Holding Company B within the meaning of section 4(c)(1) of the Act, and that, accordingly, the control by Holding Company B of shares in Corporation Y was exempted under that section.

[23 FR 2675, May 23, 1958. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.107 Acquisition of stock in small business investment company.

(a) A registered bank holding company requested an opinion by the Board of Governors with respect to whether that company and its banking subsidiaries may acquire stock in a small business investment company organized pursuant to the Small Business Investment Act of 1958.

(b) It is understood that the bank holding company and its subsidiary banks propose to organize and subscribe for stock in a small business investment company which would be chartered pursuant to the Small Business Investment Act of 1958 which provides for long-term credit and equity financing for small business concerns.

(c) Section 302(b) of the Small Business Investment Act authorizes national banks, as well as other member banks and nonmember insured banks to the extent permitted by applicable State law, to invest capital in small business investment companies not exceeding one percent of the capital and surplus of such banks. Section 4(c)(4) of the Bank Holding Company Act exempts from the prohibitions of section 4 of the Act ''shares which are of the kinds and amounts eligible for investment by National banking associations under the provisions of section 5136 of the Revised Statutes''. Section 5136 of the Revised Statutes (paragraph ''Seventh'') in turn provides, in part, as follows:

Except as hereinafter provided or otherwise permitted by law nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation.

Since the shares of a small business investment company are of a kind and amount expressly made eligible for investment by a national bank under the Small Business Investment Act of 1958, it follows, therefore, that the ownership or control of such shares by a bank holding company would be exempt from the prohibitions of section 4 of the Bank Holding Company Act by virtue of the provisions of section 4(c)(4) of that Act. Accordingly, the ownership or control of such shares by the bank holding company would be exempt from the prohibitions of section 4 of the Bank Holding Company Act.

(d) An additional question is presented, however, as to whether section 6 of the Bank Holding Company Act prohibits banking subsidiaries of the bank holding company from purchasing stock in a small business investment company where the latter is a ''subsidiary'' under that Act.

(e) Section 6(a)(1) of the Act makes it unlawful for a bank to invest any of its funds in the capital stock of any other subsidiary of the bank holding company. However, section 6(a)(1) was, in effect, amended by section 302(b) of the Small Business Investment Act (15 U.S.C. 682) as amended by the Act of June 11, 1960 (Pub. L. 86–502) so as to nullify this prohibition when the ''subsidiary'' is a small business investment company.

(f) Accordingly, section 6 of the Bank Holding Company Act does not prohibit banking subsidiaries of the bank holding company from purchasing stock in a small business investment company organized pursuant to the Small Business Investment Act of 1958, where that company is or will be a subsidiary of the bank holding company.

[25 FR 7485, Aug. 9, 1960. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.109 "Services" under section 4(c)(1) of Bank Holding Company Act.

(a) The Board of Governors has been requested by a bank holding company for an interpretation under section 4(c)(1) of the Bank Holding Company Act which, among other things, exempts from the nonbanking divestment requirements of section 4(a) of the Act, shares of a company engaged ''solely in the business of furnishing services to or performing services for'' its bank holding company or subsidiary banks thereof.

(b) It is understood that a nonbanking subsidiary of the holding company engages in writing comprehensive automobile insurance (fire, theft, and collision) which is sold only to customers of a subsidiary bank of the holding company in connection with the bank's retail installment loans; that when payment is made on a loan secured by a lien on a motor vehicle, renewal policies are not issued by the insurance company; and that the insurance company receives the usual agency commissions on all comprehensive automobile insurance written for customers of the bank.

(c) It is also understood that the insurance company writes credit life insurance for the benefit of the bank and its installment-loan customers; that each insured debtor is covered for an amount equal to the unpaid balance of his note to the bank, not to exceed $5,000; that as the note is reduced by regular monthly payments, the amount of insurance is correspondingly reduced so that at all times the debtor is insured for the unpaid balance of his note; that each insurance contract provides for payment in full of the entire loan balance upon the death or permanent disability of the insured borrower; and that this credit life insurance is written only at the request of, and solely for, the bank's borrowing customers. It is further understood that the insurance company engages in no other activity.

(d) As indicated in § 225.104 (23 FR 2675), the term ''services,'' while sometimes used in a broad and general sense, appears to be somewhat more limited in its application in section 4(c)(1) of the Bank Holding Company Act. Unlike an early version of the Senate bill (S. 2577, before amendment), the act as finally enacted does not expressly mention any type of servicing activity for exemption. The legislative history of the Act, however, as indicated in the relevant portion of the record of the Senate Banking and Currency Committee on amended S. 2577 (84th Cong., 2d Sess., Senate Report 1095, Part 2, p. 3) makes it evident that Congress had in mind the exemption of services comparable to the types of activities mentioned expressly in the early Senate bill (''auditing, appraising, investment counseling'') and in the Committee Report on the later bill (''advertising, public relations, developing new business, organization, operations, preparing tax returns, personnel, and many others''). Furthermore, this Committee Report expressly stated that the provision of section 4(c)(1) with respect to ''furnishing services to or performing services for'' was not intended to supplant the exemption contained under section 4 (c)(6) of the Act.

(e) The only activity of the insurance company (writing comprehensive automobile insurance and credit life insurance) appears to involve an insurance relationship between it and a banking subsidiary of the holding company which the legislative history clearly indicates does not come within the meaning of the phrase ''furnishing services to or performing services for'' a bank holding company or its banking subsidiaries.

(f) Accordingly, it is the Board's view that the insurance company could not be regarded as qualifying as a company engaged ''solely in the business of furnishing services to or performing services for'' the bank holding company or banks with respect to which the latter is a bank holding company.

[23 FR 9017, Nov. 20, 1958. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.111 Limit on investment by bank holding company system in stock of small business investment companies.

(a) Under the provisions of section 4(c)(5) of the Bank Holding Company Act, as amended (12 U.S.C. 1843), a bank holding company may acquire shares of nonbank companies ''which are of the kinds and amounts eligible for investment'' by national banks. Pursuant to section 302(b) of the Small Business Investment Act of 1958 (15 U.S.C. 682(b)), as amended by Title II of the Small Business Act Amendments of 1967 (Pub. L. 90–104, 81 Stat. 268, 270), a national bank may invest in stock of small business investment companies (SBICs) subject to certain restrictions.

(b) On the basis of the foregoing statutory provisions, it is the position of the Board that a bank holding company may acquire direct or indirect ownership or control of stock of an SBIC subject to the following limits:

(1) The total direct and indirect investments of a bank holding company in stock of SBICs may not exceed:

(i) With respect to all stock of SBICs owned or controlled directly or indirectly by a subsidiary bank, 5 percent of that bank's capital and surplus;

(ii) With respect to all stock of SBICs owned directly by a bank holding company that is a bank, 5 percent of that bank's capital and surplus; and

(iii) With respect to all stock of SBICs otherwise owned or controlled directly or indirectly by a bank holding company, 5 percent of its proportionate interest in the capital and surplus of each subsidiary bank (that is, the holding company's percentage of that bank's stock times that bank's capital and surplus) less that bank's investment in stock of SBICs; and

(2) A bank holding company may not acquire direct or indirect ownership or control of 50 percent or more of the shares of any class of equity securities of an SBIC that have actual or potential voting rights.

(c) A bank holding company or a bank subsidiary that acquired direct or indirect ownership or control of 50 percent or more of any such class of equity securities prior to January 9, 1968, is not required to divest to a level below 50 percent. A bank that acquired 50 percent or more prior to January 9, 1968, may become a subsidiary in a holding company system without any necessity for divesting to a level below 50 percent: *Provided*, That such action does not result in the bank holding company acquiring control of a percentage greater than that controlled by such bank.

(12 U.S.C. 248. Interprets 12 U.S.C. 1843, 15 U.S.C. 682)

[33 FR 6967, May 9, 1968. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.112 Indirect control of small business concern through convertible debentures held by small business investment company.

(a) A question has been raised concerning the applicability of provisions of the Bank Holding Company Act of 1956 to the acquisition by a bank holding company of stock of a small business investment company (''SBIC'') organized pursuant to the Small Business Investment Act of 1958 (''SBI Act'').

(b) As indicated in the interpretation of the Board (§ 225.107) published at 23 FR 7813, it is the Board's opinion that, since stock of an SBIC is eligible for purchase by national banks and since section 4(c)(4) of the Holding Company Act exempts stock eligible for investment by national banks from the prohibitions of section 4 of that Act, a bank holding company may lawfully acquire stock in such an SBIC.

(c) However, section 304 of the SBI Act provides that debentures of a small business concern purchased by a small business investment company may be converted at the option of such company into stock of the small business concern. The question therefore arises as to whether, in the event of such conversion, the parent bank holding company would be regarded as having acquired ''direct or indirect ownership or control'' of stock of the small business concern in violation of section 4(a) of the Holding Company Act.

(d) The Small Business Investment Act clearly contemplates that one of the primary purposes of that Act was to enable SBICs to provide needed equity capital to small business concerns through the purchase of debentures convertible into stock. Thus, to the extent that a stockholder in an SBIC might acquire indirect control of stock of a small business concern, such control appears to be a natural and contemplated incident of ownership of stock of the SBIC. The Office of the Comptroller of the Currency has informally indicated concurrence with this interpretation insofar as it affects investments by national banks in stock of an SBIC.

(e) Since the exception as to stock eligible for investment by national banks contained in section 4(c)(4) of the Holding Company Act was apparently intended to permit a bank holding company to acquire any stock that would be eligible for purchase by a national bank, it is the Board's view that section 4(a)(1) of the Act does not prohibit a bank holding company from acquiring stock of an SBIC, even though ownership of such stock may result in the acquisition of indirect ownership or control of stock of a small business concern which would not itself be eligible for purchase directly by a national bank or a bank holding company.

[24 FR 1584, Mar. 4, 1959. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.113 Services under section 4(a) of Bank Holding Company Act.

(a) The Board of Governors has been requested for an opinion as to whether the performance of certain functions by a bank holding company for four banks of which it owns less than 25 percent of the voting shares is in violation of section 4(a) of the Bank Holding Company Act.

(b) It is claimed that the holding company is engaged in ''managing'' four nonsubsidiary banks, for which services it receives ''management fees.'' Specifically, the company engages in the following activities for the four nonsubsidiary banks: (1) Establishment and supervision of loaning policies; (2) direction of the purchase and sale of investment securities; (3) selection and training of officer personnel; (4) establishment and enforcement of operating policies; and (5) general supervision over all policies and practices.

(c) The question raised is whether these activities are prohibited by section 4(a)(2) of the Bank Holding Company Act, which permits a bank holding company to engage in only three categories of business: (1) Banking; (2) managing or controlling banks; and (3) furnishing services to or performing services for any bank of which the holding company owns or controls 25 percent or more of the voting shares.

(d) Clearly, the activities of the company with respect to the four nonsubsidiary banks do not constitute ''banking.'' With respect to the business of ''managing or controlling'' banks, it is the Board's view that such business, within the purview of section 4(a)(2), is essentially the exercise of a broad governing influence of the sort usually exercised by bank stockholders, as distinguished from direct or active participation in the establishment or carrying out of particular policies or operations. The latter kinds of activities fall within the third category of businesses in which a bank holding company is permitted to engage. In the Board's view, the activities enumerated above fall in substantial part within that third category.

(e) Section 4(a)(2), like all other sections of the Holding Company Act, must be interpreted in the light of all of its provisions, as well as in the light of other sections of the Act. The expression ''managing * * * banks,'' if it could be taken by itself, might appear to include activities of the sort enumerated. However, such an interpretation of those words would virtually nullify the last portion of section 4(a)(2), which permits a holding company to furnish services to or perform services for ''any bank of which it owns or controls 25 per centum or more of the voting shares.''

(f) Since Congress explicitly authorized the performance of services for banks that are at least 25 percent owned by a holding company, it obviously intended that the holding company should not perform services for banks in which it owns less than 25 percent of the voting shares. However, if the second category—''managing or controlling banks''—were interpreted to permit the holding company to perform services for any bank, including a bank in which it held less than 25 percent of the stock (or no stock whatsoever), the last clause of section 4(a)(2) would be meaningless.

(g) It is principally for this reason—that is, to give effective meaning to the final clause of section 4(a)(2)—that the Board interprets ''managing or controlling banks'' in that provision as referring to the exercise of a stockholder's management or control of banks, rather than direct and active participation in their operations. To repeat, such active participation in operations falls within the third category (''furnishing services to or performing services for any bank'') and consequently may be engaged in only with respect to banks in which the holding company ''owns or controls 25 per centum or more of the voting shares.''

(h) Accordingly, it is the Board's conclusion that, in performing the services enumerated, the bank holding company is ''furnishing services to or performing services for'' the four banks referred to. Under the Act such furnishing or performing of services is permissible only if the holding company owns or controls 25 percent of the voting shares of each bank receiving such services, and, since the company owns less than 25 percent of the voting shares of these banks, it follows that these activities are prohibited by section 4(a)(2).

(i) While this conclusion is required, in the Board's opinion, by the language of the statute, it may be noted further that any other conclusion would make it possible for bank holding company or any other corporation, through arrangements for the ''managing'' of banks in the manner here involved, to acquire effective control of banks without acquiring bank stocks and thus to evade the underlying objectives of section 3 of the Act.

[25 FR 281, Jan. 14, 1960. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.115 Applicability of Bank Service Corporation Act in certain bank holding company situations.

(a) Questions have been presented to the Board of Governors regarding the applicability of the recently enacted Bank Service Corporation Act (Pub. L. 87–856, approved October 23, 1962) in cases involving service corporations that are subsidiaries of bank holding companies under the Bank Holding Company Act of 1956. In addition to being charged with the administration of the latter Act, the Board is named in the Bank Service Corporation Act as the Federal supervisory agency with respect to the performance of bank services for State member banks.

(b) *Holding company-owned corporation serving only subsidiary banks.* (1) One question is whether the Bank Service Corporation Act is applicable in the case of a corporation, wholly owned by a bank holding company, which is engaged in performing ''bank services'', as defined in section 1(b) of the Act, exclusively for subsidiary banks of the holding company.

(2) Except as noted below with respect to section 5 thereof, the Bank Service Corporation Act is not applicable in this case. This is true because none of the stock of the corporation performing the services is owned by any bank and the corporation, therefore, is not a ''bank service corporation'' as defined in section 1(c) of the Act. A corporation cannot meet that definition unless part of its stock is owned by two or more banks. The situation clearly is unaffected by section 2(b) of the Act which permits a corporation that fell within the definition initially to continue to function as a bank service corporation although subsequently only one of the banks remains as a stockholder in the corporation.

(3) However, although it is not a bank service corporation, the corporation in question and each of the banks for which it performs bank services are subject to section 5 of the Bank Service Corporation Act. That section, which requires the furnishing of certain assurances to the appropriate Federal supervisory agency in connection with the performance of bank services for a bank, is applicable whether such services are performed by a bank service corporation or by others.

(4) Section 4(a)(1) of the Bank Holding Company Act prohibits the acquisition by a bank holding company of ''direct or indirect ownership or control'' of shares of a nonbanking company, subject to certain exceptions. Section 4(c)(1) of the Act exempts from section 4(a)(1) shares of a company engaged ''solely in the business of furnishing services to or performing services for'' its bank holding company or subsidiary banks thereof. Assuming that the bank services performed by the corporation in question are ''services'' of the kinds contemplated by section 4(c)(1) of the Bank Holding Company Act (as would be true, for example, of the electronic data processing of deposit accounts), the holding company's ownership of the corporation's shares in the situation described above clearly is permissible under that section of the Act.

(c) *Bank service corporation owned by holding company subsidiaries and serving also other banks.* (1) The other question concerns the applicability of the Bank Service Corporation Act and the Bank Holding Company Act in the case of a corporation, all the stock of which is owned either by a bank holding company and its subsidiary banks together or by the subsidiary banks alone, which is engaged in performing "bank services", as defined in section 1(b) of the Bank Service Corporation Act, for the subsidiary banks and for other banks, as well.

(2) In contrast to the situation under paragraph (b) of this section, the corporation in this case is a "bank service corporation" within the meaning of section 1(c) of the Bank Service Corporation Act because of the ownership by each of the subsidiary banks of a part of the corporation's stock. This stock ownership is one of the important facts differentiating this case from the first one. Being a bank service corporation, the corporation in question is subject to section 3 of the Act concerning applications to bank service corporations by competitive banks for bank services, and to section 4 forbidding a bank service corporation from engaging in any activity other than the performance of bank services for banks. Section 5, mentioned previously and relating to "assurances", also is applicable in this case.

(3) The other important difference between this case and the situation in paragraph (b) of this section is that here the bank service corporation performs services for nonsubsidiary banks, as well as for subsidiary banks. This is permissible because section 2(a) of the Bank Service Corporation Act, which authorizes any two or more banks to invest limited amounts in a bank service corporation, removes all limitations and prohibitions of Federal law exclusively relating to banks that otherwise would prevent any such investment. From the legislative history of section 2(a), it is clear that section 6 of the Bank Holding Company Act is among the limitations and prohibitions so removed. But for such removal, section 6(a)(1) of that Act would make it unlawful for any of the subsidiary banks of the bank holding company in question to own stock in the bank service corporation subsidiary of the holding company, as the exemption in section 6(b)(1) would not apply because of the servicing by the bank service corporation of nonsubsidiary banks.

(4) Because the bank service corporation referred to in the question is serving banks other than the subsidiary banks, the bank holding company is not exempt under section 4(c)(1) of the Bank Holding Company Act from the prohibition of acquisition of nonbanking interests in section 4(a)(1) of that Act. The bank holding company, however, is entitled to the benefit of the exemption in section 4(c)(4) of the Act. That section exempts from section 4(a) "shares which are of the kinds and amounts eligible for investment by National banking associations under the provisions of section 5136 of the Revised Statutes". Section 5136 provides, in part, that: "Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation." As the provisions of section 2(a) of the Bank Service Corporation Act and its legislative history make it clear that shares of a bank service corporation are of a kind eligible for investment by national banks under section 5136, it follows that the direct or indirect ownership on control of such shares by a bank holding company are permissible within the amount limitation discussed in paragraph (d) of this section.

(d) *Limit on investment by bank holding company system in stock of bank service corporation.* (1) In the situation presented by paragraph (c) the bank holding company clearly owns or controls, directly or indirectly, all of the stock of the bank service corporation. The remaining question, therefore, is whether the total direct and indirect investment of the bank holding company in the bank service corporation exceeds the amount permissible under the Bank Holding Company Act.

(2) The effect of sections 4(a)(1) and 4(c)(4) of the Bank Holding Company Act is to limit the amount of shares of a bank service corporation that a bank holding company may own or control, directly or indirectly, to the amount

eligible for investment by a national bank, as previously indicated. Under section 2(a) of the Bank Service Corporation Act, the amount of shares of a bank service corporation eligible for investment by a national bank may not exceed ''10 per centum [of the bank's] * * * paid-in and unimpaired capital and unimpaired surplus''.

(3) The Board's view is that this aspect of the matter should be determined in accordance with the principles set forth in § 225.111, as revised (27 FR 12671), involving the application of sections 4(a)(1) and 4(c)(4) of the Bank Holding Company Act in the light of section 302(b) of the Small Business Investment Act limiting the amount eligible for investment by a national bank in the shares of a small business investment company to two percent of the bank's ''capital and surplus''.

(4) Except for the differences in the percentage figures, the investment limitation in section 302(b) of the Small Business Investment Act is essentially the same as the investment limitation in section 2(a) of the Bank Service Corporation Act since, as an accounting matter and for the purposes under consideration, ''capital and surplus'' may be regarded as equivalent in meaning to ''paid-in and unimpaired capital and unimpaired surplus.'' Accordingly, the maximum permissible investment by a bank holding company system in the stock of a bank service corporation should be determined in accordance with the formula prescribed in § 222.111.

[27 FR 12918, Dec. 29, 1962. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.118 Computer services for customers of subsidiary banks.

(a) The question has been presented to the Board of Governors whether a wholly-owned nonbanking subsidiary (''service company'') of a bank holding company, which is now exempt from the prohibitions of section 4 of the Bank Holding Company Act of 1956 (''the Act'') because its sole business is the providing of services for the holding company and the latter's subsidiary banks, would lose its exempt status if it should provide data processing services for customers of the subsidiary banks.

(b) The Board understood from the facts presented that the service company owns a computer which it utilizes to furnish data processing services for the subsidiary banks of its parent holding company. Customers of these banks have requested that the banks provide for them computerized billing, accounting, and financial records maintenance services. The banks wish to utilize the computer services of the service company in providing these and other services of a similar nature. It is proposed that, in each instance where a subsidiary bank undertakes to provide such services, the bank will enter into a contract directly with the customer and then arrange to have the service company perform the services for it, the bank. In no case will the service company provide services for anyone other than its affiliated banks. Moreover, it will not hold itself out as, nor will its parent corporation or affiliated banks represent it to be, authorized or willing to provide services for others.

(c) Section 4(c)(1) of the Act permits a holding company to own shares in ''any company engaged solely * * * in the business of furnishing services to or performing services for such holding company and banks with respect to which it is a bank holding company * * *.'' The Board has ruled heretofore that the term ''services'' as used in section 4(c)(1) is to be read as relating to those services (excluding ''closely related'' activities of ''a financial, fiduciary, or insurance nature'' within the meaning of section 4(c)(6)) which a bank itself can provide for its customers (§ 225.104). A determination as to whether a particular service may legitimately be rendered or performed by a bank for its customers must be made in the light of applicable Federal or State statutory or regulatory provisions. In the case of a State-chartered bank, the laws of the State in which the bank operates, together with any interpretations thereunder rendered by appropriate bank authorities, would govern the right of the bank to provide a particular service. In the case of a national bank, a similar determination would require reference to provisions of Federal law relating to the establishment and operation of national banks, as well as to pertinent rulings or interpretations promulgated thereunder.

(d) Accordingly, on the assumption that all of the services to be performed are of the kinds that the holding company's subsidiary banks may render for their customers under applicable Federal or State law, the Board concluded that the rendition of such services by the service company for its affiliated banks would not adversely affect its exempt status under section 4(c)(1) of the Act.

(e) In arriving at the above conclusion, the Board emphasized that its views were premised explicitly upon the facts presented to it, and particularly its understanding that banks are permitted, under applicable Federal or State law to provide the proposed computer services. The Board emphasized also that in respect to the service company's operations, there continues in effect the requirement under section 4(c)(1) that the service company engage solely in the business of furnishing services to or performing services for the bank holding company and its subsidiary banks. The Board added that any substantial change in the facts that had been presented might require re-examination of the service company's status under section 4(c)(1).

[29 FR 12361, Aug. 28, 1964. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.121 Acquisition of Edge corporation affiliate by State member banks of registered bank holding company.

(a) The Board has been asked whether it is permissible for the commercial banking affiliates of a bank holding company registered under the Bank Holding Company Act of 1956, as amended, to acquire and hold the shares of the holding company's Edge corporation subsidiary organized under section 25(a) of the Federal Reserve Act.

(b) Section 9 of the Bank Holding Company Act amendments of 1966 (Pub. L. 89–485, approved July 1, 1966) repealed section 6 of the Bank Holding Company Act of 1956. That rendered obsolete the Board's interpretation of section 6 that was published in the March 1966 Federal Reserve Bulletin, page 339 (§ 225.120). Thus, so far as Federal Banking law applicable to State member banks is concerned, the answer to the foregoing question depends on the provisions of section 23A of the Federal Reserve Act, as amended by the 1966 amendments to the Bank Holding Company Act. By its specific terms, the provisions of section 23A do not apply to an affiliate organized under section 25(a) of the Federal Reserve Act.

(c) Accordingly, the Board concludes that, except for such restrictions as may exist under applicable State law, it would be legally permissible by virtue of paragraph 20 of section 9 of the Federal Reserve Act for any or all of the State member banks that are affiliates of a registered bank holding company to acquire and hold shares of the Edge corporation subsidiary of the bank holding company within the amount limitation in the last sentence of paragraph 12 of section 25(a) of the Federal Reserve Act.

(12 U.S.C. 24, 248, 335, 371c, 611, 618)

[31 FR 10263, July 29, 1966. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.122 Bank holding company ownership of mortgage companies.

(a) The Board of Governors recently considered whether a bank holding may acquire, either directly or through a subsidiary, the stock of a so-called ''mortgage company'' that would be operated on the following basis: The company would solicit mortgage loans on behalf of a bank in the holding company system, assemble credit information, make property inspections and appraisals, and secure title information. The company would also participate in the preparation of applications for mortgage loans, which it would submit, together with recommendations with respect to action thereon, to the bank, which alone would decide whether to make any or all of the loans requested. The company would in addition solicit investors to purchase mortgage loans from the bank and would seek to have such investors contract with the bank for the servicing of such loans.

(b) Under section 4 of the Bank Holding Company Act (12 U.S.C. 1843), a bank holding company is generally prohibited from acquiring ''direct or indirect ownership'' of stock of nonbanking corporations. The two exceptions principally involved in the question presented are with respect to (1) stock that is eligible for investment by a national bank (section 4(c)(5) of the Act) and (2) shares of a company ''furnishing services to or performing services for such bank holding company or its banking subsidiaries'' (section 4(c)(1)(C) of the Act).

(c) The Board has previously indicated its view that a national bank is forbidden by the so-called ''stock-purchase prohibition'' of paragraph ''Seventh'' of section 5136 of the Revised Statutes (12 U.S.C. 24) to purchase ''for its own account * * * any shares of stock of any corporation'' except (1) to the extent permitted by specific provisions of Federal law or (2) as comprised within the concept of ''such incidental powers as shall be necessary to carry on the business of banking'' referred to in the first sentence of said paragraph ''Seventh''. There is no specific statutory provision authorizing a national bank to purchase stock in a mortgage company, and in the Board's view such purchase may not properly be regarded as authorized under the ''incidental powers'' clause. (See 1966 Federal Reserve Bulletin 1151; 12 CFR 208.119.) Accordingly, a bank holding company may not acquire stock in a mortgage company on the basis of the section 4(c)(5) exemption.

(d) However, the Board does not believe that such conclusion prejudices consideration of the question whether such a company is within the section 4(c)(1)(C) ''servicing exemption''. The basic purpose of section 4 of the Act is to confine a bank holding company's activities to the management and control of banks. In determining whether an activity in which a bank could itself engage is within the servicing exemption, the question is simply whether such activity may appropriately be considered as ''furnishing services to or performing services for'' a bank.

(e) As indicated in the Board's interpretation published in the 1958 Federal Reserve Bulletin at page 431 (12 CFR 225.104), the legislative history of the servicing exemption indicates that it includes the following activities: ''auditing, appraising, investment counseling'' and ''advertising, public relations, developing new business, organization, operations, preparing tax returns, and personnel''. The legislative history further indicates that some other activities also are within the scope of the exemption. However, the types of servicing permitted under such exemption must be distinguished from activities of a ''financial fiduciary, or insurance nature'', such as those that might be considered for possible exemption under section 4(c)(8) of the Act.

(f) In considering the interrelation of these exemptions in the light of the purpose of the prohibition against bank holding company interests in nonbanking organizations, the Board has concluded that the appropriate test for determining whether a mortgage company may be considered as within the servicing exemption is whether the company will perform as principal any banking activities—such as receiving deposits, paying checks, extending credit, conducting a trust department, and the like. In other words, if the mortgage company is to act merely as an adjunct to a bank for the purpose of facilitating the banks operations, the company may appropriately be considered as within the scope of the servicing exemption. [1]

(g) On this basis the Board concluded that, insofar as the Bank Holding Company Act is concerned, a bank holding company may acquire, either directly or through a subsidiary, the stock of a mortgage company whose functions are as described in the question presented. On the other hand, in the Board's view, a bank holding company may not acquire, on the basis of the servicing exemption, a mortgage company whose

[1] Insofar as the 1958 interpretation referred to above suggested that the branch banking laws are an appropriate general test for determining the scope of the servicing exemption, such interpretation is hereby modified. In view of the different purposes to be served by the branch banking laws and by section 4 of the Bank Holding Company Act, the Board has concluded that basing determinations under the latter solely on the basis of determinations under the former is inappropriate.

functions include such activities as extending credit for its own account, arranging interim financing, entering into mortgage service contracts on a fee basis, or otherwise performing functions other than solely on behalf of a bank.

(12 U.S.C. 248)

[32 FR 15004, Oct. 3, 1967, as amended at 35 FR 19662, Dec. 29, 1970. Redesignated at 36 FR 21666, Nov. 12, 1971]

§ 225.123 Activities closely related to banking.

(a) Effective June 15, 1971, the Board of Governors has amended § 225.4(a) of Regulation Y to implement its regulatory authority under section 4(c)(8) of the Bank Holding Company Act. In some respects activities determined by the Board to be closely related to banking are described in general terms that will require interpretation from time to time. The Board's views on some questions that have arisen are set forth below.

(b) Section 225.4(a) states that a company whose ownership by a bank holding company is authorized on the basis of that section may engage solely in specified activities. That limitation refers only to activities the authority for which depends on section 4(c)(8) of the Act. It does not prevent a holding company from establishing one subsidiary to engage, for example, in activities specified in § 225.4(a) and also in activities that fall within the scope of section 4(c)(1)(C) of the Act—the ''servicing'' exemption.

(c) The amendments to § 225.4(a) do not apply to restrict the activities of a company previously approved by the Board on the basis of section 4(c)(8) of the Act. Activities of a company authorized on the basis of section 4(c)(8) either before the 1970 Amendments or pursuant to the amended § 225.4(a) may be shifted in a corporate reorganization to another company within the holding company system without complying with the procedures of § 225.4(b), as long as all the activities of such company are permissible under one of the exemptions in section 4 of the Act.

(d) Under the procedures in § 225.4(a)(c), a holding company that wishes to change the location at which it engages in activities authorized pursuant to § 225.4(a) must publish notice in a newspaper of general circulation in the community to be served. The Board does not regard minor changes in location as within the coverage of that requirement. A move from one site to another within a 1-mile radius would constitute such a minor change if the new site is in the same State.

(e) Data processing. In providing packaged data processing and transmission services for banking, financial and economic data for installation on the premises of the customer, as authorized by § 225.4(a)(8)(ii), a bank holding company should limit its activities to providing facilities that perform banking functions, such as check collection, or other similar functions for customers that are depository or other similar institutions, such as mortgage companies. In addition, the Board regards the following as incidental activities necessary to carry on the permissible activities in this area:

(1) Providing excess capacity, not limited to the processing or transmission of banking, financial or economic data on data processing or transmission equipment or facilities used in connection with permissible data processing and data transmission activities, where:

(A) Equipment is not purchased solely for the purpose of creating excess capacity;

(B) Hardware is not offered in connection therewith; and

(C) Facilities for the use of the excess capacity do not include the provision of any software, other than systems software (including language), network communications support, and the operating personnel and documentation necessary for the maintenance and use of these facilities.

(2) Providing by-products of permissible data processing and data transmission activities, where not designed, or appreciably enhanced, for the purpose of marketability.

(3) Furnishing any data processing service upon request of a customer if such data processing service is not otherwise reasonably available in the relevant market area; and

In order to eliminate or reduce to an insignificant degree any possibility of unfair competition where services, facilities, by-products or excess capacity are provided by a bank holding company's nonbank subsidiary or related entity, the entity providing the services, facilities, by-products and/or excess capacity should have separate books and financial statements, and should provide these books and statements to any new or renewal customer requesting financial data. Consolidated or other financial statements of the bank holding company should not be provided unless specifically requested by the customer.

(Interprets and applies 12 U.S.C. 1843 (c)(8))

[36 FR 10778, June 3, 1971, as amended at 36 FR 11806, June 19, 1971. Redesignated at 36 FR 21666, Nov. 12, 1971 and amended at 40 FR 13477, Mar. 27, 1975; 47 FR 37372, Aug. 26, 1982; 52 FR 45161, Nov. 25, 1987]

§ 225.124 Foreign bank holding companies.

(a) Effective December 1, 1971, the Board of Governors has added a new § 225.4(g) to Regulation Y implementing its authority under section 4(c)(9) of the Bank Holding Company Act. The Board's views on some questions that have arisen in connection with the meaning of terms used in § 225.4(g) are set forth in paragraphs (b) through (g) of this section.

(b) The term ''activities'' refers to nonbanking activities and does not include the banking activities that foreign banks conduct in the United States through branches or agencies licensed under the banking laws of any State of the United States or the District of Columbia.

(c) A company (including a bank holding company) will not be deemed to be engaged in ''activities'' in the United States merely because it exports (or imports) products to (or from) the United States, or furnishes services or finances goods or services in the United States, from locations outside the United States. A company is engaged in ''activities'' in the United States if it owns, leases, maintains, operates, or controls any of the following types of facilities in the United States:

(1) A factory,

(2) A wholesale distributor or purchasing agency,

(3) A distribution center,

(4) A retail sales or service outlet,

(5) A network of franchised dealers,

(6) A financing agency, or

(7) Similar facility for the manufacture, distribution, purchasing, furnishing, or financing of goods or services locally in the United States.

A company will not be considered to be engaged in ''activities'' in the United States if its products are sold to independent importers, or are distributed through independent warehouses, that are not controlled or franchised by it.

(d) In the Board's opinion, section 4 (a)(1) of the Bank Holding Company Act applies to ownership or control of shares of stock as an investment and does not apply to ownership or control of shares of stock in the capacity of an underwriter or dealer in securities. Underwriting or dealing in shares of stock are nonbanking activities prohibited to bank holding companies by section 4(a)(2) of the Act, unless otherwise exempted. Under § 225.4(g) of Regulation Y, foreign bank holding companies are exempt from the prohibitions of section 4 of the Act with respect to their activities outside the United States; thus foreign bank holding companies may underwrite or deal in shares of stock (including shares of United States issuers) to be distributed outside the United States, provided that shares so acquired are disposed of within a reasonable time.

(e) A foreign bank holding company does not ''indirectly'' own voting shares by reason of the ownership or control of such voting shares by any company in which it has a noncontrolling interest. A foreign bank holding company may, however, ''indirectly'' control such voting shares if its noncontrolling interest in such company is accompanied by other arrangements that, in the Board's judgment, result in control of such shares by the bank holding company. The Board has made one exception to this general approach. A foreign bank holding company will be considered to indirectly own or control voting shares of a bank if that bank holding company acquires more than 5 percent of any class of voting shares of another bank holding company. A bank holding company may make such an acquisition only with prior approval of the Board.

(f) A company is ''indirectly'' engaged in activities in the United States if any of its subsidiaries (whether or not incorporated under the laws of this country) is engaged in such activities. A company is not ''indirectly'' engaged in activities in the United States by reason of a noncontrolling interest in a company engaged in such activities.

(g) Under the foregoing rules, a foreign bank holding company may have a noncontrolling interest in a foreign company that has a U.S. subsidiary (but is not engaged in the securities business in the United States) if more than half of the foreign company's consolidated assets and revenues are located and derived outside the United States. For the purpose of such determination, the assets and revenues of the United States subsidiary would be counted among the consolidated assets and revenues of the foreign company to the extent required or permitted by generally accepted accounting principles in the United States. The foreign bank holding company would not, however, be permitted to ''indirectly'' control voting shares of the said U.S. subsidiary, as might be the case if there are other arrangements accompanying its noncontrolling interest in the foreign parent company that, in the Board's judgment, result in control of such shares by the bank holding company.

(Interprets and applies 12 U.S.C. 1843 (a) (1), (2), and (c)(9))

[36 FR 21808, Nov. 16, 1971]

§ 225.125 Investment adviser activities.

(a) Effective February 1, 1972, the Board of Governors amended § 225.4(a) of Regulation Y to add ''serving as investment adviser, as defined in section 2(a)(20) of the Investment Company Act of 1940, to an investment company registered under that Act'' to the list of activities it has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. During the course of the Board's consideration of this amendment several questions arose as to the scope of such activity, particularly in view of certain restrictions imposed by sections 16, 20, 21, and 32 of the Banking Act of 1933 (12 U.S.C. 24, 377, 378, 78) (sometimes referred to hereinafter as the ''Glass-Steagall Act provisions'') and the U.S. Supreme Court's decision in Investment Company Institute v. Camp, 401 U.S. 617 (1971). The Board's views with respect to some of these questions are set forth below.

(b) It is clear from the legislative history of the Bank Holding Company Act Amendments of 1970 (84 Stat. 1760) that the Glass-Steagall Act provisions were not intended to be affected thereby. Accordingly, the Board regards the Glass-Steagall Act provisions and the Board's prior interpretations thereof as applicable to a holding company's activities as an investment adviser. Consistently with the spirit and purpose of the Glass-Steagall Act, this interpretation applies to all bank holding companies registered under the Bank Holding Company Act irrespective of whether they have subsidiaries that are member banks.

(c) Under § 225.4(a)(5), as amended, bank holding companies (which term, as used herein, includes both their bank and nonbank subsidiaries) may, in accordance with the provisions of § 225.4 (b), act as investment advisers to various types of investment companies, such as ''open-end'' investment companies (commonly referred to as ''mutual funds'') and ''closed-end'' investment companies. Briefly, a mutual fund is an investment company which, typically, is continuously engaged in the issuance of its shares and stands ready at any time to redeem the securities as to which it is the issuer; a closed-end investment company typically does not issue shares after its initial organization except at infrequent intervals and does not stand ready to redeem its shares.

(d) The Board intends that a bank holding company may exercise all functions that are permitted to be exercised by an ''investment adviser'' under the Investment Company Act of 1940, except to the extent limited by the Glass-Steagall Act provisions, as described, in part, hereinafter.

(e) The Board recognizes that presently most mutual funds are organized, sponsored and managed by investment advisers with which they are affiliated and that their securities are distributed to the public by such affiliated investment advisers, or subsidiaries or affiliates thereof. However, the Board believes that (1) The Glass-Steagall Act provisions do not permit a bank holding company to perform all such functions, and (2) It is not necessary for a bank holding company to perform all such functions in order to engage effectively in the described activity.

(f) In the Board's opinion, the Glass-Steagall Act provisions, as interpreted by the U.S. Supreme Court, forbid a bank holding company to sponsor, organize, or control a mutual fund. However, the Board does not believe that such restrictions apply to closed-end investment companies as long as such companies are not primarily or frequently engaged in the issuance, sale, and distribution of securities. A bank holding company should not act as investment adviser to an investment company that has a name similar to the name of the holding company or any of its subsidiary banks, unless the prospectus of the investment company contains the disclosures required in paragraph (h) of this section. In no case should a bank holding company act as investment adviser to an investment company that has either the same name as the name of the holding company or any of its subsidiary banks, or a name that contains the word ''bank.''

(g) In view of the potential conflicts of interests that may exist, a bank holding company and its bank and nonbank subsidiaries should not purchase in their sole discretion, in a fiduciary capacity (including as managing agent), securities of any investment company for which the bank holding company acts as investment adviser unless, the purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.

(h) Under section 20 of the Glass-Steagall Act, a member bank is prohibited from being affiliated with a company that directly, or through a subsidiary, engages principally in the issue, flotation, underwriting, public sale, or distribution of securities. A bank holding company or its nonbank subsidiary may not engage, directly or indirectly, in the underwriting, public sale or distribution of securities of any investment company for which the holding company or any nonbank subsidiary provides investment advice except in compliance with the terms of section 20, and only after obtaining the Board's approval under section 4 of the Bank Holding Company Act and subject to the limitations and disclosures required by the Board in those cases. The Board has determined, however, that the conduct of securities brokerage activities by a bank holding company or its nonbank subsidiaries, when conducted individually or in combination with investment advisory activities, is not deemed to be the underwriting, public sale, or distribution of securities prohibited by the Glass-Steagall Act, and the U.S. Supreme Court has upheld that determination. *See Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 207 (1984); *see also Securities Industry Ass'n* v. *Board of Governors*, 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988). Accordingly, the Board believes that a bank holding company or any of its nonbank subsidiaries that has been authorized by the Board under the Bank Holding Company Act to conduct securities brokerage activities (either separately or in combination with investment advisory activities) may act as agent, upon the order and for the account of customers of the holding company or its nonbank subsidiary, to purchase or sell shares of an investment company for which the bank holding company or any of its subsidiaries acts as an investment adviser. In addition, a bank holding company or any of its nonbank subsidiaries that has been authorized by the Board under the Bank Holding Company Act to provide investment advice to third parties generally (either separately or in combination with securities brokerage services) may provide investment advice to customers with respect to the purchase or sale of shares of an investment company for which the holding company or any of its subsidiaries acts as an investment adviser. In the event that a bank holding company or any of its nonbank subsidiaries provides brokerage or investment advisory services (either separately or in combination) to customers in the situations described above, at the time the service is provided the bank holding company should instruct its officers and employees to caution customers to read the prospectus of the investment company before investing and must advise customers in writing that the investment company's shares are not insured by the Federal Deposit Insurance Corporation, and are not deposits, obligations of, or endorsed or guaranteed in any way by, any bank, unless that happens to be the case. The holding company or nonbank subsidiary must also disclose in writing to the customer the role of the company or affiliate as adviser to the investment company. These disclosures may be made orally so long as written disclosure is provided to the customer immediately thereafter. To the extent that a bank owned by a bank holding company engages in providing advisory or brokerage services to bank customers in connection with an investment company advised by the bank holding company or a nonbank affiliate, but is not required by the bank's primary regulator to make disclosures comparable to the disclosures required to be made by bank holding companies providing such services, the bank holding company should require its subsidiary bank to make the disclosures required in this paragraph to be made by a bank holding company that provides such advisory or brokerage services.

(i) Acting in such capacities as registrar, transfer agent, or custodian for an investment company is not a selling activity and is permitted under §225.4(a)(4) of Regulation Y. However, in view of potential conflicts of interests, a bank holding company which acts both as custodian and investment adviser for an investment company should exercise care to maintain at a minimal level demand deposit accounts of the investment company which are placed with a bank affiliate and should not invest cash funds of the investment company in time deposit accounts (including certificates of deposit) of any bank affiliate.

[37 FR 1464, Jan. 29, 1972, as amended by Reg. Y, 57 FR 30391, July 9, 1992; 61 FR 45875, Aug. 30, 1996; Reg. Y, 62 FR 9343, Feb. 28, 1997]

§ 225.126 Activities not closely related to banking.

Pursuant to section 4(c)(8) of the Bank Holding Company Act and §225.4(a) of Regulation Y, the Board of Governors has determined that the following activities are not so closely related to banking or managing or controlling banks as to be a proper incident thereto:

(a) Insurance premium funding—that is, the combined sale of mutual funds and insurance.

(b) Underwriting life insurance that is not sold in connection with a credit transaction by a bank holding company, or a subsidiary thereof.

(c) Real estate brokerage (see 1972 Fed. Res. Bulletin 428).

(d) Land development (see 1972 Fed. Res. Bulletin 429).

(e) Real estate syndication.

(f) Management consulting (see 1972 Fed. Res. Bulletin 571).

(g) Property management (see 1972 Fed. Res. Bulletin 652).

[Reg. Y, 37 FR 20329, Sept. 29, 1972; 37 FR 21938, Oct. 17, 1972, as amended at 54 FR 37302, Sept. 8, 1989]

§ 225.127 Investment in corporations or projects designed primarily to promote community welfare.

(a) Under §225.25(b)(6) of Regulation Y, a bank holding company may, in accordance with the provisions of §225.23, engage in "making equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas." The Board included that activity among those the Board has determined to be so closely related to banking or managing or controlling banks as be a proper incident thereto, in order to permit bank holding companies to fulfill their civic responsibilities. As indicated hereinafter in this interpretation, the Board intends §225.25(b)(6) to enable bank holding companies to take an active role in the quest for solutions to the Nation's social problems. Although the interpretation primarily focuses on low- and moderate-income housing, it is not intended to limit projects under §225.25(b)(6) to that area. Other investments primarily designed to promote community welfare are considered permissible, but have not been defined in order to provide bank holding companies flexibility in approaching community problems. For example, bank holding companies may utilize this flexibility to provide new and creative approaches to the promotion of employment opportunities for low-income persons. Bank holding companies possess a unique combination of financial and managerial resources making them particularly suited for a meaningful and substantial role in remedying our social ills. Section 225.25(b)(6) is intended to provide an opportunity for them to assume such a role.

(b) Under the authority of §225.25(b)(6), a bank holding company may invest in community development corporations established pursuant to Federal or State law. A bank holding company may also participate in other civic projects, such as a municipal parking facility sponsored by a local civic organization as a means to promote greater public use of the community's facilities.

(c) Within the category of permissible investments under §225.25(b)(6) are investments in projects to construct or rehabilitate multifamily low- or moderate-income housing with respect to which a mortgage is insured under section 221(d)(3), 221(d)(4), or 236 of the National Housing Act (12 U.S.C. 1701) and investments in projects to construct or rehabilitate low- or moderate-income housing which is financed or assisted by direct loan, tax abatement, or insurance under provisions of State or local law, similar to the aforementioned Federal programs, provided that, with respect to all such projects the owner is, by statute, regulation, or regulatory authority, limited as to the rate of return on his investment in the project, as to rentals or occupancy charges for units in the project, and in such other respects as would be a "limited dividend corporation" (as defined by the Secretary of Housing and Urban Development).

(d) Investments in other projects that may be considered to be designed primarily to promote community welfare include but are not limited to: (1) Projects for the construction or rehabilitation of housing for the benefit of persons of low- or moderate-income, (2) projects for the construction or rehabilitation of ancillary local commercial facilities necessary to provide goods or services principally to persons residing in low- or moderate-income housing, and (3) projects designed explicitly to create improved job opportunities for low- or moderate-income groups (for example, minority equity investments, on a temporary basis, in small or medium-sized locally-controlled businesses in low-income urban or other economically depressed areas). In the case of de novo projects, the copy of the notice with respect to such other projects which is to be furnished to Reserve Banks in accordance with the provisions of §225.23 should be accompanied by a memorandum which demonstrates that such projects meet the objectives of §225.25(b)(6).

(e) Investments in corporations or projects organized to build or rehabilitate high-income housing, or commercial, office, or industrial facilities that are not designed explicitly to create improved job opportunities for low-income persons shall be presumed not to be designed primarily to promote community welfare, unless there is substantial evidence to the contrary, even though to some extent the investment may benefit the community.

(f) Section 6 of the Depository Institutions Disaster Relief Act of 1992 permits state member banks (12 U.S.C. 338a) and national banks (12 U.S.C. 24 (Eleventh)) to invest in the stock of community development corporations that are designed primarily to promote the public welfare of low- and moderate-income communities and persons in the areas of housing, services and employment. The Board and the Office of the Comptroller of the Currency have adopted rules that permit state member banks and national banks to make certain investments without prior approval. The Board believes that these rules are consistent with the Board's interpretation of, and decisions regarding, the scope of community welfare activities permissible for bank holding companies. Accordingly, approval received by a bank holding company to conduct activities designed to promote the community welfare under section 4(c)(8) of the Bank Holding

Company Act (12 U.S.C. 1843(c)(8)) and §225.25(b)(6) of the Board's Regulation Y (12 CFR 225.25(b)(6)) includes approval to engage, either directly or through a subsidiary, in the following activities, up to five percent of the bank holding company's total consolidated capital stock and surplus, without additional Board or Reserve Bank approval:

(1) Invest in and provide financing to a corporation or project or class of corporations or projects that the Board previously has determined is a public welfare project pursuant to paragraph 23 of section 9 of the Federal Reserve Act (12 U.S.C. 338a);

(2) Invest in and provide financing to a corporation or project that the Office of the Comptroller of the Currency previously has determined, by order or regulation, is a public welfare investment pursuant to section 5136 of the Revised Statutes (12 U.S.C. 24 (Eleventh));

(3) Invest in and provide financing to a community development financial institution pursuant to section 103(5) of the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. 4702(5));

(4) Invest in, provide financing to, develop, rehabilitate, manage, sell, and rent residential property if a majority of the units will be occupied by low- and moderate-income persons or if the property is a ''qualified low-income building'' as defined in section 42(c)(2) of the Internal Revenue Code (26 U.S.C. 42(c)(2));

(5) Invest in, provide financing to, develop, rehabilitate, manage, sell, and rent nonresidential real property or other assets located in a low- or moderate-income area provided the property is used primarily for low- and moderate-income persons;

(6) Invest in and provide financing to one or more small businesses located in a low- or moderate-income area to stimulate economic development;

(7) Invest in, provide financing to, develop, and otherwise assist job training or placement facilities or programs designed primarily for low- and moderate-income persons;

(8) Invest in and provide financing to an entity located in a low- or moderate-income area if that entity creates long-term employment opportunities, a majority of which (based on full time equivalent positions) will be held by low- and moderate-income persons; and

(9) Provide technical assistance, credit counseling, research, and program development assistance to low- and moderate-income persons, small businesses, or nonprofit corporations to help achieve community development.

(g) For purposes of paragraph (f) of this section, low- and moderate-income persons or areas means individuals and communities whose incomes do not exceed 80 percent of the median income of the area involved, as determined by the U.S. Department of Housing and Urban Development. Small businesses are businesses that are smaller than the maximum size eligibility standards established by the Small Business Administration (SBA) for the Small Business Investment Company and Development Company Programs or the SBA section 7A loan program; and specifically include those businesses that are majority-owned by members of minority groups or by women.

(h) For purposes of paragraph (f) of this section, five percent of the total consolidated capital stock and surplus of a bank holding company includes its total investment in projects described in paragraph (f) of this section, when aggregated with similar types of investments made by depository institutions controlled by the bank holding company. The term total consolidated capital stock and surplus of the bank holding company means total equity capital and the allowance for loan and lease losses. For bank holding companies that file the FR Y–9C (Consolidated Financial Statements for Bank Holding Companies), these items are readily ascertained from Schedule HC—Consolidated Balance Sheet (total equity capital (line 27h) and allowance for loan and lease losses (line 4b)). For bank holding companies filing the FR Y-SP (Parent Company Only Financial Statements for Small Bank Holding Companies), an approximation of these items is ascertained from the Balance Sheet (total equity capital (line 16e)) and allowance for loan and lease losses (line 3b)) and from the Report of Condition for Insured Banks (Schedule RC—Balance Sheet (line 4b)).

[37 FR 11316, June 7, 1972; 37 FR 13336, July 7, 1972, as amended at Reg. Y, 59 FR 63713, Dec. 9, 1994]

§225.129 Activities closely related to banking.

Courier activities. The Board's amendment of §225.4(a), which adds courier services to the list of closely related activities is intended to permit holding companies to transport time critical materials of limited intrinsic value of the types utilized by banks and bank-related firms in performing their business activities. Such transportation activities are of particular importance in the check clearing process of the banking system, but are also important to the performance of other activities, including the processing of financially-related economic data. The authority is not intended to permit holding companies to engage generally in the provision of transportation services.

During the course of the Board's proceedings pertaining to courier services, objections were made that courier activities were not a proper incident to banking because of the possibility that holding companies would or had engaged in unfair competitive practices. The Board believes that adherence to the following principles will eliminate or reduce to an insignificant degree any possibility of unfair competition:

a. A holding company courier subsidiary established under section 4(c)(8) should be a separate, independent corporate entity, not merely a servicing arm of a bank.

b. As such, the subsidiary should exist as a separate, profit-oriented operation and should not be subsidized by the holding company system.

c. Services performed should be explicitly priced, and shall not be paid for indirectly, for example, on the basis of deposits maintained at or loan arrangements with affiliated banks.

Accordingly, entry of holding companies into courier activities on the basis of section 4(c)(8) will be conditioned as follows:

1. *The courier subsidiary shall perform services on an explicit fee basis and shall be structured as an individual profit center designed to be operated on a profitable basis.* The Board may regard operating losses sustained over an extended period as being inconsistent with continued authority to engage in courier activities.

2. *Courier services performed on behalf of an affiliate's customer (such as the carriage of incoming cash letters) shall be paid for by the customer. Such payments shall not be made indirectly, for example, on the basis of imputed earnings on deposits maintained at or of loan arrangements with subsidiaries of the holding company.* Concern has also been expressed that bank-affiliated courier services will be utilized to gain a competitive advantage over firms competing with other holding company affiliates. To reduce the possibility that courier affiliates might be so employed, the Board will impose the following third condition:

3. *The courier subsidiary shall, when requested by any bank or any data processing firm providing financially-related data processing services which firm competes with a banking or data processing* subsidiary of Applicant, furnish comparable service at comparable rates, unless compliance with such request would be beyond the courier subsidiary's practical capacity. In this regard, the courier subsidiary should make known to the public its minimum rate schedule for services and its general pricing policies thereto. The courier subsidiary is also expected to maintain for a reasonable period of time (not less than two years) each request denied with the reasons for such denial.

[38 FR 32126, Nov. 21, 1973, as amended at 40 FR 36309, Aug. 20, 1975]

§225.130 Issuance and sale of short-term debt obligations by bank holding companies.

For text of interpretation, see §250.221 of this chapter.

[38 FR 35231, Dec. 26, 1973]

§225.131 Activities closely related to banking.

(a) *Bank management consulting advice.* The Board's amendment of §225.4(a), which adds bank management consulting advice to the list of closely related activities, described in general terms the nature of such activity. This interpretation is intended to explain in greater detail certain of the terms in the amendment.

(b) It is expected that bank management consulting advice would include, but not be limited to, advice concerning: Bank operations, systems and procedures; computer operations and mechanization; implementation of electronic funds transfer systems; site planning and evaluation; bank mergers and the establishment of new branches; operation and management of a trust department; international banking; foreign exchange transactions; purchasing policies and practices; cost analysis, capital adequacy and planning; auditing; accounting procedures; tax planning; investment advice (as authorized in §225.4(a)(5)); credit policies and administration, including credit documentation, evaluation, and debt collection; product development, including specialized lending provisions; marketing operations, including research, market development and advertising programs; personnel operations, including recruiting, training, evaluation and compensation; and security measures and procedures.

(c) In permitting bank holding companies to provide management consulting advice to nonaffiliated "banks", the Board intends such advice to be given only to an institution that both accepts deposits that the depositor has a legal right to withdraw on demand and engages in the business of making commercial loans. It is also intended that such management consulting advice may be provided to the "operations subsidiaries" of a bank, since such subsidiaries perform functions that a bank is empowered to perform directly at locations at which the bank is authorized to engage in business (§250.141 of this chapter).

(d) Although a bank holding company providing management consulting advice is prohibited by the regulation from owning or controlling, directly or indirectly, any equity securities in a client bank, this limitation does not apply to shares of a client bank acquired, directly or indirectly, as a result of a default on a debt previously contracted. This limitation is also inapplicable to shares of a client bank acquired by a bank holding company, directly or indirectly, in a fiduciary capacity: *Provided*, That the bank holding company or its subsidiary does not have sole discretionary authority to vote such shares or shares held with sole voting rights constitute not more than five percent of the outstanding voting shares of a client bank.

[39 FR 8318, Mar. 5, 1974; 39 FR 21120, June 19, 1974]

§ 225.132 Acquisition of assets.

(a) From time to time questions have arisen as to whether and under what circumstances a bank holding company engaged in nonbank activities, directly or indirectly through a subsidiary, pursuant to section 4(c)(8) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)(3)), may acquire the assets and employees of another company, without first obtaining Board approval pursuant to section 4(c)(8) and the Board's Regulation Y (12 CFR 225.4(b)).

(b) In determining whether Board approval is required in connection with the acquisition of assets, it is necessary to determine (a) whether the acquisition is made in the ordinary course of business[1] or (b) whether it constitutes the acquisition, in whole or in part, of a going concern.[2]

(c) The following examples illustrate transactions where prior Board approval will generally be required:

(1) The transaction involves the acquisition of all or substantially all of the assets of a company, or a subsidiary, division, department or office thereof.

(2) The transaction involves the acquisition of less than "substantially all" of the assets of a company, or a subsidiary, division, department or office thereof, the operations of which are being terminated or substantially

[1] Section 225.4(c)(3) of the Board's Regulation Y (12 CFR 225.4(c)(3)) generally prohibits a bank holding company or its subsidiary engaged in activities pursuant to authority of section 4(c)(8) of the Act from being a party to any merger "or acquisition of assets other than in the ordinary course of business" without prior Board approval.

[2] In accordance with the provisions of section 4(c)(8) of the Act and §225.4(b) of Regulation Y, the acquisition of a going concern requires prior Board approval.

discontinued by the seller, but such asset acquisition is significant in relation to the size of the same line of nonbank activity of the holding company (e.g., consumer finance mortgage banking, data processing). For purposes of this interpretation, an acquisition would generally be presumed to be significant if the book value of the nonbank assets being acquired exceeds 50 percent of the book value of the nonbank assets of the holding company or nonbank subsidiary comprising the same line of activity.

(3) The transaction involves the acquisition of assets for resale and the sale of such assets is not a normal business activity of the acquiring holding company.

(4) The transaction involves the acquisition of the assets of a company, or a subsidiary, division, department or office thereof, and a major purpose of the transaction is to hire some of the seller's principal employees who are expert, skilled and experienced in the business of the company being acquired.

(d) In some cases it may be difficult, due to the wide variety of circumstances involving possible acquisition of assets, to determine whether such acquisitions require prior Board approval. Bank holding companies are encouraged to contact their local Reserve Bank for guidance where doubt exists as to whether such an acquisition is in the ordinary course of business or an acquisition, in whole or in part, of a going concern.

[39 FR 35128, Sept. 30, 1974, as amended at Reg. Y, 57 FR 28779, June 29, 1992]

§ 225.133 Computation of amount invested in foreign corporations under general consent procedures.

For text of this interpretation, see §211.111 of this subchapter.

[40 FR 43199, Sept. 19, 1975]

§ 225.134 Escrow arrangements involving bank stock resulting in a violation of the Bank Holding Company Act.

(a) In connection with a recent application to become a bank holding company, the Board considered a situation in which shares of a bank were acquired and then placed in escrow by the applicant prior to the Board's approval of the application. The facts indicated that the applicant company had incurred debt for the purpose of acquiring bank shares and immediately after the purchase the shares were transferred to an unaffiliated escrow agent with instructions to retain possession of the shares pending Board action on the company's application to become a bank holding company. The escrow agreement provided that, if the application were approved by the Board, the escrow agent was to return the shares to the applicant company; and, if the application were denied, the escrow agent was to deliver the shares to the applicant company's shareholders upon their assumption of debt originally incurred by the applicant in the acquisition of the bank shares. In addition, the escrow agreement provided that, while the shares were held in escrow, the applicant could not exercise voting or any other ownership rights with respect to those shares.

(b) On the basis of the above facts, the Board concluded that the company had violated the prior approval provisions of section 3 of the Bank Holding Company Act (''Act'') at the time that it made the initial acquisition of bank shares and that, for purposes of the Act, the company continued to control those shares in violation of the Act. In view of these findings, individuals and bank holding companies should not enter into escrow arrangements of the type described herein, or any similar arrangement, without securing the prior approval of the Board, since such action could constitute a violation of the Act.

(c) While the above represents the Board's conclusion with respect to the particular escrow arrangement involved in the proposal presented, the Board does not believe that the use of an escrow arrangement would always result in a violation of the Act. For example, it appears that a transaction whereby bank shares are placed in escrow pending Board action on an application would not involve a violation of the Act so long as title to such shares remains with the seller during the pendency of the application; there are no other indicia that the applicant controls the shares held in escrow; and, in the event of a Board denial of the application, the escrow agreement provides that the shares would be returned to the seller.

[41 FR 9859, Mar. 8, 1976. Correctly designated at 41 FR 12009, Mar. 23, 1976]

§ 225.136 Utilization of foreign subsidiaries to sell long-term debt obligations in foreign markets and to transfer the proceeds to their United States parent(s) for domestic purposes.

For text of this interpretation, see § 211.112 of this subchapter.

[42 FR 752, Jan. 4, 1977]

§ 225.137 Acquisitions of shares pursuant to section 4(c)(6) of the Bank Holding Company Act.

(a) The Board has received a request for an interpretation of section 4(c)(6) of the Bank Holding Company Act (''Act'')[1] in connection with a proposal under which a number of bank holding companies would purchase interests in an insurance company to be formed for the purpose of underwriting or reinsuring credit life and credit accident and health insurance sold in connection with extensions of credit by the stockholder bank holding companies and their affiliates.

(b) Each participating holding company would own no more than 5 percent of the outstanding voting shares of the company. However, the investment of each holding company would be represented by a separate class of voting security, so that each stockholder would own 100 percent of its respective class. The participating companies would execute a formal ''Agreement Among Stockholders'' under which each would agree to use its best efforts at all times to direct or recommend to customers and clients the placement of their life, accident and health insurance directly or indirectly with the company. Such credit-related insurance placed with the company would be identified in the records of the company as having been originated by the respective stockholder. A separate capital account would be maintained for each stockholder consisting of the original capital contribution increased or decreased from time to time by the net profit or loss resulting from the insurance business attributable to each stockholder. Thus, each stockholder would receive a return on its investment based upon the claims experience and profitability of the insurance business that it had itself generated. Dividends declared by the board of directors of the company would be payable to each stockholder only out of the earned surplus reflected in the respective stockholder's capital account.

(c) It has been requested that the Board issue an interpretation that section 4(c)(6) of the Act provides an exemption under which participating bank holding companies may acquire such interests in the company without prior approval of the Board.

(d) On the basis of a careful review of the documents submitted, in light of the purposes and provisions of the Act, the Board has concluded that section 4(c)(6) of the Act is inapplicable to this proposal and that a bank holding company must obtain the approval of the Board before participating in such a proposal in the manner described. The Board's conclusion is based upon the following considerations:

(1) Section 2(a)(2)(A) of the Act provides that a company is deemed to have control over a second company if it owns or controls ''25 per centum or more of any class of voting securities'' of the second company. In the case presented, the stock interest of each participant would be evidenced by a different class of stock and each would accordingly, own 100 percent of a class of voting securities of the company. Thus, each of the stockholders would be deemed to ''control'' the company and prior Board approval would be required

[1] It should be noted that every Board Order granting approval under section 4(c)(8) of the Act contains the following paragraph:

''This determination is subject . . . to the Board's authority to require such modification or termination of the activities of a holding company or any of its subsidiaries as the Board finds necessary to assure compliance with the provisions and purposes of the Act and the Board's regulations and orders issued thereunder, or to prevent evasion thereof.''

The Board believes that, even apart from this Interpretation, this language preserves the authority of the Board to require the revisions contemplated in this Interpretation.

for each stockholder's acquisition of stock in the company.

The Board believes that this application of section 2(a)(2)(A) of the Act is particularly appropriate on the facts presented here. The company is, in practical effect, a conglomeration of separate business ventures each owned 100 percent by a stockholder the value of whose economic interest in the company is determined by reference to the profits and losses attributable to its respective class of stock. Furthermore, it is the Board's opinion that this application of section 2(a)(2)(A) is not inconsistent with section 4(c)(6). Even assuming that section (4)(c)(6) is intended to refer to all outstanding voting shares, and not merely the outstanding shares of a particular class of securities, section 4(c)(6) must be viewed as permitting ownership of 5 percent of a company's voting stock only when that ownership does not constitute ''control'' as otherwise defined in the Act. For example, it is entirely possible that a company could exercise a controlling influence over the management and policies of a second company, and thus ''control'' that company under the Act's definitions, even though it held less than 5 percent of the voting stock of the second company. To view section 4(c)(6) as an unqualified exemption for holdings of less than 5 percent would thus create a serious gap in the coverage of the Act.

(2) The Board believes that section 4(c)(6) should properly be interpreted as creating an exemption from the general prohibitions in section 4 on ownership of stock in nonbank companies only for passive investments amounting to not more than 5 percent of a company's outstanding stock, and that the exemption was not intended to allow a group of holding companies, through concerted action, to engage in an activity as entrepreneurs. Section 4 of the Act, of course, prohibits not only owning stock in nonbank companies, but engaging in activities other than banking or those activities permitted by the Board under section 4(c)(8) as being closely related to banking. Thus, if a holding company may be deemed to be engaging in an activity through the medium of a company in which it owns less than 5 percent of the voting stock it may nevertheless require Board approval, despite the section 4(c)(6) exemption.

(e) To accept the argument that section 4(c)(6) is an unqualified grant of permission to a bank holding company to own 5 percent of the shares of any nonbanking company irrespective of the nature or extent of the holding company's participation in the affairs of the nonbanking company would, in the Board's view, create the potential for serious and widespread evasion of the Act's controls over nonbanking activities. Such a construction would allow a group of 20 bank holding companies—or even a single bank holding company and one or more nonbank companies—to engage in entrepreneurial joint ventures in businesses prohibited to bank holding companies, a result the Board believes to be contrary to the intent of Congress.

(f) In this proposal, each of the participating stockholders must be viewed as engaging in the business of insurance underwriting. Each stockholder would agree to channel to the company the insurance business it generates, and the value of the interest of each stockholder would be determined by reference to the profitability of the business generated by that stockholder itself. There is no sharing or pooling among stockholders of underwriting risks assumed by the company, and profit or loss from investments is allocated on the basis of each bank holding company's allocable underwriting profit or loss. The interest of each stockholder is thus clearly that of an entrepreneur rather than that of an investor.

(g) Accordingly, on the basis of the factual situation before the Board, and for the reasons summarized above, the Board has concluded that section 4(c)(6) of the Act cannot be interpreted to exempt the ownership of 5 percent of the voting stock of a company under the circumstances described, and that a bank holding company wishing to become a stockholder in a company under this proposal would be required to obtain the Board's approval to do so.

[42 FR 1263, Jan. 6, 1977; 42 FR 2951, Jan. 14, 1977]

§ 225.138 Statement of policy concerning divestitures by bank holding companies.

(a) From time to time the Board of Governors receives requests from companies subject to the Bank Holding Company Act, or other laws administered by the Board, to extend time periods specified either by statute or by Board order for the divestiture of assets held or activities engaged in by such companies. Such divestiture requirements may arise in a number of ways. For example, divestiture may be ordered by the Board in connection with an acquisition found to have been made in violation of law. In other cases the divestiture may be pursuant to a statutory requirement imposed at the time and amendment to the Act was adopted, or it may be required as a result of a foreclosure upon collateral held by the company or a bank subsidiary in connection with a debt previously contracted in good faith. Certain divestiture periods may be extended in the discretion of the Board, but in other cases the Board may be without statutory authority, or may have only limited authority, to extend a specified divestiture period.

(b) In the past, divestitures have taken many different forms, and the Board has followed a variety of procedures in enforcing divestiture requirements. Because divestitures may occur under widely disparate factual circumstances, and because such forced dispositions may have the potential for causing a serious adverse economic impact upon the divesting company, the Board believes it is important to maintain a large measure of flexibility in dealing with divestitures. For these reasons, there can be no fixed rule as to the type of divestiture that will be appropriate in all situations. For example, where divestiture has been ordered to terminate a control relationship created or maintained in violation of the Act, it may be necessary to impose conditions that will assure that the unlawful relationship has been fully terminated and that it will not arise in the future. In other circumstances, however, less stringent conditions may be appropriate.

(1) *Avoidance of delays in divestitures.* Where a specific time period has been fixed for accomplishing divestiture, the affected company should endeavor and should be encouraged to complete the divestiture as early as possible during the specific period. There will generally be substantial advantages to divesting companies in taking steps to plan for and accomplish divestitures well before the end of the divestiture period. For example, delays may impair the ability of the company to realize full value for the divested assets, for as the end of the divestiture period approaches the "forced sale" aspect of the divestiture may lead potential buyers to withhold firm offers and to bargain for lower prices. In addition, because some prospective purchasers may themselves require regulatory approval to acquire the divested property, delay by the divesting company may—by leaving insufficient time to obtain such approvals—have the effect of narrowing the range of prospective purchases. Thus, delay in planning for divestiture may increase the likelihood that the company will seek an extension of the time for divestiture if difficulty is encountered in securing a purchaser, and in certain situations, of course, the Board may be without statutory authority to grant extensions.

(2) *Submissions and approval of divestiture plans.* When a divestiture requirement is imposed, the company affected should generally be asked to submit a divestiture plan promptly for review and approval by the Reserve Bank or the Board. Such a requirement may be imposed pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act to issue such orders as may be necessary to enable the Board to administer and carry out the purposes of the Act and prevent evasions thereof. A divestiture plan should be as specific as possible, and should indicate the manner in which divestiture will be accomplished—for example, by a bulk sale of the assets to a third party, by "spinoff" or distribution of shares to the shareholders of the divesting company, or by termination of prohibited activities. In addition, the plan should specify the steps the company expects to take in effecting the divestiture and assuring its completeness, and should indicate the time schedule for taking such steps. In

appropriate circumstances, the divestiture plan should make provision for assuring that ''controlling influence'' relationships, such as management or financial interlocks, will not continue to exist.

(3) *Periodic progress reports.* A company subject to a divestiture requirement should generally be required to submit regular periodic reports detailing the steps it has taken to effect divestiture. Such a requirement may be imposed pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act, referred to above, as well as its authority under section 5(c) of the Act to require reports for the purpose of keeping the Board informed as to whether the Act and Board regulations and order thereunder are being complied with. Reports should set forth in detail such matters as the identities of potential buyers who have been approached by the company, the dates of discussions with potential buyers and the identities of the individuals involved in such discussions, the terms of any offers received, and the reasons for rejecting any offers. In addition, the reports should indicate whether the company has employed brokers, investment bankers or others to assist in the divestiture, or its reasons for not doing so, and should describe other efforts by the company to seek out possible purchasers. The purpose of requiring such reports is to insure that substantial and good faith efforts being made by the company to satisfy its divestiture obligations. The frequency of such reports may vary depending upon the nature of the divestiture and the period specified for divestiture. However, such reports should generally not be required less frequently than every three months, and may in appropriate cases be required on a monthly or even more frequent basis. Progress reports as well as divestiture plans should be afforded confidential treatment.

(4) *Extensions of divestiture periods.* Certain divestiture periods—such as December 31, 1980 deadline for divestitures required by the 1970 Amendments to the Bank Holding Company Act—are not extendable. In such cases it is imperative that divestiture be accomplished in a timely manner. In certain other cases, the Board may have discretion to extend a statutorily prescribed divestiture period within specified limits. For example, under section 4(c)(2) of the Act the Board may extend for three one-year periods the two-year period in which a bank subsidiary of a holding company is otherwise required to divest shares acquired in satisfaction of a debt previously contracted in good faith. In such cases, however, when the permissible extensions expire the Board no longer has discretion to grant further extensions. In still other cases, where a divestiture period is prescribed by the Board, in the exercise of its regulatory judgment, the Board may have broader discretion to grant extensions. Where extensions of specified divestiture periods are permitted by law, extensions should not be granted except under compelling circumstances. Neither unfavorable market conditions, nor the possibility that the company may incur some loss, should alone be viewed as constituting such circumstances—particularly if the company has failed to take earlier steps to accomplish a divestiture under more favorable circumstances. Normally, a request for an extension will not be considered unless the company has established that it has made substantial and continued good faith efforts to accomplish the divestiture within the prescribed period. Furthermore, requests for extensions of divestiture periods must be made sufficiently in advance of the expiration of the prescribed period both to enable the Board to consider the request in an orderly manner and to enable the company to effect a timely divestiture in the event the request for extension is denied. Companies subject to divestiture requirements should be aware that a failure to accomplish a divestiture within the prescribed period may in and of itself be viewed as a separate violation of the Act.

(5) *Use of trustees.* In appropriate cases a company subject to a divestiture requirement may be required to place the assets subject to divestiture with an independent trustee under instructions to accomplish a sale by a specified date, by public auction if necessary. Such a trustee may be given the responsibility for exercising the

voting rights with respect to shares being divested. The use of such a trustee may be particularly appropriate where the divestiture is intended to terminate a control relationship established or maintained in violation of law, or where the divesting company has demonstrated an inability or unwillingness to take timely steps to effect a divestiture.

(6) *Presumptions of control.* Bank holding companies contemplating a divestiture should be mindful of section 2(g)(3) of the Bank Holding Company Act, which creates a presumption of continued control over the transferred assets where the transferee is indebted to the transferor, or where certain interlocks exist, as well as § 225.2 of Regulation Y, which sets forth certain additional control presumptions. Where one of these presumptions has arisen with respect to divested assets, the divestiture will not be considered as complete until the presumption has been overcome. It should be understood that the inquiry into the termination of control relationships is not limited by the statutory and regulatory presumptions of control, and that the Board may conclude that a control relationship still exists even though the presumptions do not apply.

(7) *Role of the Reserve Banks.* The Reserve Banks have a responsibility for supervising and enforcing divestitures. Specifically, in coordination with Board staff they should review divestiture plans to assure that proposed divestitures will result in the termination of control relationships and will not create unsafe or unsound conditions in any bank or bank holding company; they should monitor periodic progress reports to assure that timely steps are being taken to effect divestitures; and they should prompt companies to take such steps when it appears that progress is not being made. Where Reserve Banks have delegated authority to extend divestiture periods, that authority should be exercised consistently with this policy statement.

[42 FR 10969, Feb. 25, 1977]

§ 225.139 Presumption of continued control under section 2(g)(3) of the Bank Holding Company Act.

(a) Section 2(g)(3) of the Bank Holding Company Act (the ''Act'') establishes a statutory presumption that where certain specified relationships exist between a transferor and transferee of shares, the transferor (if it is a bank holding company, or a company that would be such but for the transfer) continues to own or control indirectly the transferred shares.[1] This presumption arises by operation of law, as of the date of the transfer, without the need for any order or determination by the Board. Operation of the presumption may be terminated only by the issuance of a Board determination, after opportunity for hearing, ''that the transferor is not in fact capable of controlling the transferee.''[2]

(b) The purpose of section 2(g)(3) is to provide the Board an opportunity to assess the effectiveness of divestitures in certain situations in which there may be a risk that the divestiture will not result in the complete termination of a control relationship. By presuming control to continue as a matter of law, section 2(g)(3) operates to allow the effectiveness of the divestiture to be assessed before the divesting company is permitted to act on the assumption that the divestiture is complete. Thus, for example, if a holding company divests its banking interest under circumstances where the presumption of continued control arises, the divesting company must continue to consider itself bound by the Act until an appropriate order is entered by the Board dispelling the presumption. Section 2(g)(3) does not establish a substantive rule that invalidates transfers to which it applies, and in a great many cases the Board has acted favorably on applications to have the presumption dispelled. It merely provides a procedural opportunity for Board consideration of the effect of such transfers in advance

[1] The presumption arises where the transferee ''is indebted to the transferor, or has one or more officers, directors, trustees, or beneficiaries in common with or subject to control by the transferor.''

[2] The Board has delegated to its General Counsel the authority to issue such determinations, 12 CFR 265.2(b)(1).

of their being deemed effective. Whether or not the statutory presumption arises, the substantive test for assessing the effectiveness of a divestiture is the same—that is, the Board must be assured that all control relationships between the transferor and the transferred property have been terminated and will not be reestablished.[3]

(c) In the course of administering section 2(g)(3) the Board has had several occasions to consider the scope of that section. In addition, questions have been raised by and with the Board's staff as to coverage of the section. Accordingly, the Board believes it would be useful to set forth the following interpretations of section 2(g)(3):

(1) The terms *transferor* and *transferee*, as used in section 2(g)(3), include parents and subsidiaries of each. Thus, for example, where a transferee is indebted to a subsidiary of the transferor, or where a specified interlocking relationship exists between the transferor or transferee and a subsidiary of the other (or between subsidiaries of each), the presumption arises. Similarly, if a parent of the transferee is indebted to a parent of the transferor, the presumption arises. The presumption of continued control also arises where an interlock or debt relationship is retained between the divesting company and the company being divested, since the divested company will be or may be viewed as a *subsidiary* of the transferee or group of transferees.

(2) The terms *officers*, *directors*, and *trustees*, as used in section 2(g)(3), include persons performing functions normally associated with such positions (including general partners in a partnership and limited partners having a right to participate in the management of the affairs of the partnership) as well as persons holding such positions in an advisory or honorary capacity. The presumption arises not only where the transferee or transferred company has an officer, director or trustee *in common with* the transferor, but where the transferee himself holds such a position with the transferor.[4] It should be noted that where a transfer takes the form of a pro-rata distribution, or *spin-off*, of shares to a company's shareholders, officers and directors of the transferor company are likely to receive a portion of such shares. The presumption of continued control would, of course, attach to any shares transferred to officers and directors of the divesting company, whether by *spinoff* or outright sale. However, the presumption will be of legal significance—and will thus require an application under section 2(g)(3)—only where the total number of shares subject to the presumption exceeds one of the applicable thresholds in the Act. For example, where officers and directors of a one-bank holding company receive in the aggregate 25 percent or more of the stock of a bank subsidiary being divested by the holding company, the holding company would be presumed to continue to control the *divested* bank. In such a case it would be necessary for the divesting company to demonstrate that it no longer controls either the divested bank or the officer/director transferees. However, if officers and directors were to receive in the aggregate less than 25 percent of the bank's stock (and no other shares were subject to the presumption), section 2(g)(3) would not have the legal effect of presuming continued control of

[3] It should be noted, however, that the Board will require termination of any interlocking management relationships between the divesting company and the transferee or the divested company as a precondition of finding that a divestiture is complete. Similarly, the retention of an economic interest in the divested company that would create an incentive for the divesting company to attempt to influence the management of the divested company will preclude a finding that the divestiture is complete. (See the Board's Order in the matter of ''International Bank'', 1977 Federal Reserve Bulletin 1106, 1113.)

[4] It has been suggested that the words *in common with* in section 2(g)(3) evidence an intent to make the presumption applicable only where the transferee is a *company* having an interlock with the transferor. Such an interpretation would, in the Board's view, create an unwarranted gap in the coverage of section 2(g)(3). Furthermore, because the presumption clearly arises where the transferee is an individual who is indebted to the transferor such an interpretation would result in an illogical internal inconsistency in the statute.

the bank.[5] In the case of a divestiture of nonbank shares, an application under section 2(g)(3) would be required whenever officers and directors of the divesting company received in the aggregate more than 5 percent of the shares of the company being divested.

(3) Although section 2(g)(3) refers to transfers of *shares* it is not, in the Board's view, limited to disposition of corporate stock. General or limited partnership interests, for example, are included within the term *shares*. Furthermore, the transfer of all or substantially all of the assets of a company, or the transfer of such a significant volume of assets that the transfer may in effect constitute the disposition of a separate activity of the company, is deemed by the Board to involve a transfer of *shares* of that company.

(4) The term *indebtedness* giving rise to the presumption of continued control under section 2(g)(3) of the Act is not limited to debt incurred in connection with the transfer; it includes any debt outstanding at the time of transfer from the transferee to the transferor or its subsidiaries. However, the Board believes that not every kind of indebtedness was within the contemplation of the Congress when section 2(g)(3) was adopted. Routine business credit of limited amounts and loans for personal or household purposes are generally not the kinds of indebtedness that, standing alone, support a presumption that the creditor is able to control the debtor. Accordingly, the Board does not regard the presumption of section 2(g)(3) as applicable to the following categories of credit, provided the extensions of credit are not secured by the transferred property and are made in the ordinary course of business of the transferor (or its subsidiary) that is regularly engaged in the business of extending credit:

(i) Consumer credit extended for personal or household use to an individual transferee; (ii) student loans made for the education of the individual transferee or a spouse or child of the transferee; (iii) a home mortgage loan made to an individual transferee for the purchase of a residence for the individual's personal use and secured by the residence; and (iv) loans made to companies (as defined in section 2(b) of the Act) in an aggregate amount not exceeding ten per cent of the total purchase price (or if not sold, the fair market value) of the transferred property. The amounts and terms of the preceding categories of credit should not differ substantially from similar credit extended in comparable circumstances to others who are not transferees. It should be understood that, while the statutory presumption in situations involving these categories of credit may not apply, the Board is not precluded in any case from examining the facts of a particular transfer and finding that the divestiture of control was ineffective based on the facts of record.

(d) Section 2(g)(3) provides that a Board determination that a transferor is not in fact capable of controlling a transferee shall be made after opportunity for hearing. It has been the Board's routine practice since 1966 to publish notice in the FEDERAL REGISTER of applications filed under section 2(g)(3) and to offer interested parties an opportunity for a hearing. Virtually without exception no comments have been submitted on such applications by parties other than the applicant and, with the exception of one case in which the request was later withdrawn, no hearings have been requested in such cases. Because the Board believes that the hearing provision in section 2(g)(3) was intended as a protection for applicants who are seeking to have the presumption overcome by a Board order, a hearing would not be of use where an application is to be granted. In light of the experience indicating that the publication of FEDERAL REGISTER notice of such applications has not served a useful purpose, the Board has decided to alter its procedures in such cases. In the future, FEDERAL REGISTER notice of section 2(g)(3) applications will be published only in cases in which the Board's General Counsel, acting under delegated authority, has determined not to grant

[5] Of course, the fact that section 2(g)(3) would not operate to presume continued control would not necessarily mean that control had in fact been terminated if control could be exercised through other means.

such an application and has referred the matter to the Board for decision.[6]

(12 U.S.C. 1841, 1844)

[43 FR 6214, Feb. 14, 1978; 43 FR 15147, Apr. 11, 1978; 43 FR 15321, Apr. 12, 1978, as amended at 45 FR 8280, Feb. 7, 1980; 45 FR 11125, Feb. 20, 1980]

§ 225.140 Disposition of property acquired in satisfaction of debts previously contracted.

(a) The Board recently considered the permissibility, under section 4 of the Bank Holding Company Act, of a subsidiary of a bank holding company acquiring and holding assets acquired in satisfaction of a debt previously contracted in good faith (a ''dpc'' acquisition). In the situation presented, a lending subsidiary of a bank holding company made a ''dpc'' acquisition of assets and transferred them to a wholly-owned subsidiary of the bank holding company for the purpose of effecting an orderly divestiture. The question presented was whether such ''dpc'' assets could be held indefinitely by a bank holding company subsidiary as incidental to its permissible lending activity.

(b) While the Board believes that ''dpc'' acquisitions may be regarded as normal, necessary and incidental to the business of lending, the Board does not believe that the holding of assets acquired ''dpc'' without any time restrictions is appropriate from the standpoint of prudent banking and in light of the prohibitions in section 4 of the Act against engaging in nonbank activities. If a nonbanking subsidiary of a bank holding company were permitted, either directly or through a subsidiary, to hold ''dpc'' assets of substantial amount over an extended period of time, the holding of such property could result in an unsafe or unsound banking practice or in the holding company engaging in an impermissible activity in connection with the assets, rather than liquidating them.

(c) The Board notes that section 4(c)(2) of the Bank Holding Company Act provides an exemption from the prohibitions of section 4 of the Act for bank holding company subsidiaries to acquire *shares* ''dpc''. It also provides that such ''dpc'' shares may be held for a period of two years, subject to the Board's authority to grant three one-year extensions up to a maximum of five years.[1] Viewed in light of the Congressional policy evidenced by section 4(c)(2), the Board believes that a lending subsidiary of a bank holding company or the holding company itself, should be permitted, as an incident to permissible lending activities, to make acquisitions of ''dpc'' *assets*. Consistent with the principles underlying the provisions of section 4(c)(2) of the Act and as a matter of prudent banking practice, such assets may be held for no longer than five years from the date of acquisition. Within the divestiture period it is expected that the company will make good faith efforts to dispose of ''dpc'' shares or assets at the earliest practicable date. While no specific authorization is necessary to hold such assets for the five-year period, after two years from the date of acquisition of such assets, the holding company should report annually on its efforts to accomplish divestiture to its Reserve Bank. The Reserve Bank will monitor the efforts of the company to effect an orderly divestiture, and may order divestiture before the end of the five-year period if supervisory concerns warrant such action.

(d) The Board recognizes that there are instances where a company may encounter particular difficulty in attempting to effect an orderly divestiture of ''dpc'' real estate holdings within the divestiture period, notwithstanding its persistent good faith efforts to dispose of such property. In the Depository Institutions Deregulation

[6] It should be noted that in the event a third party should take exception to a Board order under section 2(g)(3) finding that control has been terminated, any rights such party might have would not be prejudiced by the order. If such party brought facts to the Board's attention indicating that control had not been terminated the Board would have ample authority to revoke its order and take necessary remedial action.

Orders issued under section 2(g)(3) are published in the Federal Reserve ''Bulletin.''

[1] The Board notes that where the dpc shares or other similar interests represent less than 5 percent of the total of such interests outstanding, they may be retained on the basis of section 4(c)(6), even if originally acquired dpc.

and Monetary Control Act of 1980, (Pub. L. 96–221) Congress, recognizing that real estate possesses unusual characteristics, amended the National Banking Act to permit national banks to hold real estate for five years and for an additional five-year period subject to certain conditions. Consistent with the policy underlying the recent Congressional enactment, and as a matter of supervisory policy, a bank holding company may be permitted to hold real estate acquired ''dpc'' beyond the initial five-year period provided that the value of the real estate on the books of the company has been written down to fair market value, the carrying costs are not significant in relation to the overall financial position of the company, and the company has made good faith efforts to effect divestiture. Companies holding real estate for this extended period are expected to make active efforts to dispose of it, and should keep the Reserve Bank advised on a regular basis concerning their ongoing efforts. Fair market value should be derived from appraisals, comparable sales or some other reasonable method. In any case, ''dpc'' real estate would not be permitted to be held beyond 10 years from the date of its acquisition.

(e) With respect to the transfer by a subsidiary of other ''dpc'' shares or assets to another company in the holding company system, including a section 4(c)(1)(D) liquidating subsidiary, or to the holding company itself, such transfers would not alter the original divestiture period applicable to such shares or assets at the time of their acquisition. Moreover, to ensure that assets are not carried at inflated values for extended periods of time, the Board expects, in the case of all such intracompany transfers, that the shares or assets will be transferred at a value no greater than the fair market value at the time of transfer and that the transfer will be made in a normal arms-length transaction.

(f) With regard to ''dpc'' assets acquired by a banking subsidiary of a holding company, so long as the assets continue to be held by the bank itself, the Board will regard them as being solely within the regulatory authority of the primary supervisor of the bank.

(12 U.S.C. 1843 (c)(1)(d), (c)(2), (c)(8), and 1844 (b); 12 U.S.C. 1818)

[45 FR 49905, July 28, 1980]

§ 225.141 Operations subsidiaries of a bank holding company.

In orders approving the retention by a bank holding company of a 4(c)(8) subsidiary, the Board has stated that it would permit, without any specific regulatory approval, the formation of a wholly owned subsidiary of an approved 4(c)(8) company to engage in activities that such a company could itself engage in directly through a division or department. (*Northwestern Financial Corporation*, 65 Federal Reserve Bulletin 566 (1979).) Section 4(a)(2) of the Act provides generally that a bank holding company may engage directly in the business of managing and controlling banks and permissible nonbank activities, and in furnishing services directly to its subsidiaries. Even though section 4 of the Act generally prohibits the acquisition of shares of nonbanking organizations, the Board does not believe that such prohibition should apply to the formation by a holding company of a wholly-owned subsidiary to engage in activities that it could engage in directly. Accordingly, as a general matter, the Board will permit without any regulatory approval a bank holding company to form a wholly-owned subsidiary to perform servicing activities for subsidiaries that the holding company itself could perform directly or through a department or a division under section 4(a)(2) of the Act. The Board believes that permitting this type of subsidiary is not inconsistent with the nonbanking prohibitions of section 4 of the Act, and is consistent with the authority in section 4(c)(1)(C) of the Act, which permits a bank holding company, without regulatory approval, to form a subsidiary to perform services for its *banking* subsidiaries. The Board notes, however, that a servicing subsidiary established by a bank holding company in reliance on this interpretation will be an affiliate of the subsidiary bank of the holding company for the purposes of the lending restrictions of section 23A of the Federal Reserve Act. (12 U.S.C. 371c)

(12 U.S.C. 1843(a)(2) and 1844(b))

[45 FR 54326, July 15, 1980]

§225.142 Statement of policy concerning bank holding companies engaging in futures, forward and options contracts on U.S. Government and agency securities and money market instruments.

(a) *Purpose of financial contract positions.* In supervising the activities of bank holding companies, the Board has adopted and continues to follow the principle that bank holding companies should serve as a source of strength for their subsidiary banks. Accordingly, the Board believes that any positions that bank holding companies or their nonbank subsidiaries take in financial contracts should reduce risk exposure, that is, not be speculative.

(b) *Establishment of prudent written policies, appropriate limitations and internal controls and audit programs.* If the parent organization or nonbank subsidiary is taking or intends to take positions in financial contracts, that company's board of directors should approve prudent written policies and establish appropriate limitations to insure that financial contract activities are performed in a safe and sound manner with levels of activity reasonably related to the organization's business needs and capacity to fulfill obligations. In addition, internal controls and internal audit programs to monitor such activity should be established. The board of directors, a duly authorized committee thereof or the internal auditors should review periodically (at least monthly) all financial contract positions to insure conformity with such policies and limits. In order to determine the company's exposure, all open positions should be reviewed and market values determined at least monthly, or more often, depending on volume and magnitude of positions.

(c) *Formulating policies and recording financial contracts.* In formulating its policies and procedures, the parent holding company may consider the interest rate exposure of its nonbank subsidiaries, but not that of its bank subsidiaries. As a matter of policy, the Board believes that any financial contracts executed to reduce the interest rate exposure of a bank affiliate of a holding company should be reflected on the books and records of the bank affiliate (to the extent required by the bank policy statements), rather than on the books and records of the parent company. If a bank has an interest rate exposure that management believes requires hedging with financial contracts, the bank should be the direct beneficiary of any effort to reduce that exposure. The Board also believes that final responsibility for financial contract transactions for the account of each affiliated bank should reside with the management of that bank.

(d) *Accounting.* The joint bank policy statements of March 12, 1980 include accounting guidelines for banks that engage in financial contract activities. Since the Financial Accounting Standards Board is presently considering accounting standards for contract activities, no specific accounting requirements for financial contracts entered into by parent bank holding companies and nonbank subsidiaries are being mandated at this time. The Board expects to review further developments in this area.

(e) *Board to monitor bank holding company transactions in financial contracts.* The Board intends to monitor closely bank holding company transactions in financial contracts to ensure that any such activity is consistent with maintaining a safe and sound banking system. In any cases where bank holding companies are found to be engaging in speculative practices, the Board is prepared to institute appropriate action under the Financial Institutions Supervisory Act of 1966, as amended.

(f) *Federal Reserve Bank notification.* Bank holding companies should furnish written notification to their District Federal Reserve Bank within 10 days after financial contract activities are begun by the parent or a nonbank subsidiary. Holding companies in which the parent or a nonbank subsidiary currently engage in financial contract activity should furnish notice by March 31, 1983.

(Secs. 5(b) and 8 of the Bank Holding Company Act (12 U.S.C. 1844 and 1847); sec. 8(b) of the Financial Institutions Supervisory Act (12 U.S.C. 1818(b))

[48 FR 7720, Feb. 24, 1983]

§ 225.143 Policy statement on nonvoting equity investments by bank holding companies.

(a) *Introduction.* (1) In recent months, a number of bank holding companies have made substantial equity investments in a bank or bank holding company (the ''acquiree'') located in states other than the home state of the investing company through acquisition of preferred stock or nonvoting common shares of the acquiree. Because of the evident interest in these types of investments and because they raise substantial questions under the Bank Holding Company Act (the ''Act''), the Board believes it is appropriate to provide guidance regarding the consistency of such arrangements with the Act.

(2) This statement sets out the Board's concerns with these investments, the considerations the Board will take into account in determining whether the investments are consistent with the Act, and the general scope of arrangements to be avoided by bank holding companies. The Board recognizes that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control in any particular case must take into account the effect of the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case. Nevertheless, the Board believes that the factors outlined in this statement provide a framework for guiding bank holding companies in complying with the requirements of the Act.

(b) *Statutory and regulatory provisions.* (1) Under section 3(a) of the Act, a bank holding company may not acquire direct or indirect ownership or control of more than 5 per cent of the voting shares of a bank without the Board's prior approval. (12 U.S.C. 1842(a)(3)). In addition, this section of the Act provides that a bank holding company may not, without the Board's prior approval, acquire control of a bank: That is, in the words of the statute, ''for any action to be taken that causes a bank to become a subsidiary of a bank holding company.'' (12 U.S.C. 1842(a)(2)). Under the Act, a bank is a subsidiary of a bank holding company if:

(i) The company directly or indirectly owns, controls, or holds with power to vote 25 per cent or more of the voting shares of the bank;

(ii) The company controls in any manner the election of a majority of the board of directors of the bank; or

(iii) The Board determines, after notice and opportunity for hearing, that the company has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the bank. (12 U.S.C. 1841(d)).

(2) In intrastate situations, the Board may approve bank holding company acquisitions of additional banking subsidiaries. However, where the acquiree is located outside the home state of the investing bank holding company, section 3(d) of the Act prevents the Board from approving any application that will permit a bank holding company to ''acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional bank.'' (12 U.S.C. 1842(d)(1)).

(c) *Review of agreements.* (1) In apparent expectation of statutory changes that might make interstate banking permissible, bank holding companies have sought to make substantial equity investments in other bank holding companies across state lines, but without obtaining more than 5 per cent of the voting shares or control of the acquiree. These investments involve a combination of the following arrangements:

(i) Options on, warrants for, or rights to convert nonvoting shares into substantial blocks of voting securities of the acquiree bank holding company or its subsidiary bank(s);

(ii) Merger or asset acquisition agreements with the out-of-state bank or bank holding company that are to be consummated in the event interstate banking is permitted;

(iii) Provisions that limit or restrict major policies, operations or decisions of the acquiree; and

(iv) Provisions that make acquisition of the acquiree or its subsidiary bank(s) by a third party either impossible or economically impracticable.

The various warrants, options, and rights are not exercisable by the investing bank holding company unless interstate banking is permitted, but may be transferred by the investor either immediately or after the passage of a period of time or upon the occurrence of certain events.

(2) After a careful review of a number of these agreements, the Board believes that investments in nonvoting stock, absent other arrangements, can be consistent with the Act. Some of the agreements reviewed appear consistent with the Act since they are limited to investments of relatively moderate size in nonvoting equity that may become voting equity only if interstate banking is authorized.

(3) However, other agreements reviewed by the Board raise substantial problems of consistency with the control provisions of the Act because the investors, uncertain whether or when interstate banking may be authorized, have evidently sought to assure the soundness of their investments, prevent takeovers by others, and allow for sale of their options, warrants, or rights to a person of the investor's choice in the event a third party obtains control of the acquiree or the investor otherwise becomes dissatisfied with its investment. Since the Act precludes the investors from protecting their investments through ownership or use of voting shares or other exercise of control, the investors have substituted contractual agreements for rights normally achieved through voting shares.

(4) For example, various covenants in certain of the agreements seek to assure the continuing soundness of the investment by substantially limiting the discretion of the acquiree's management over major policies and decisions, including restrictions on entering into new banking activities without the investor's approval and requirements for extensive consultations with the investor on financial matters. By their terms, these covenants suggest control by the investing company over the management and policies of the acquiree.

(5) Similarly, certain of the agreements deprive the acquiree bank holding company, by covenant or because of an option, of the right to sell, transfer, or encumber a majority or all of the voting shares of its subsidiary bank(s) with the aim of maintaining the integrity of the investment and preventing takeovers by others. These long-term restrictions on voting shares fall within the presumption in the Board's Regulation Y that attributes control of shares to any company that enters into any agreement placing long-term restrictions on the rights of a holder of voting securities. (12 CFR 225.2(b)(4)).

(6) Finally, investors wish to reserve the right to sell their options, warrants or rights to a person of their choice to prevent being locked into what may become an unwanted investment. The Board has taken the position that the ability to control the ultimate disposition of voting shares to a person of the investor's choice and to secure the economic benefits therefrom indicates control of the shares under the Act.[1] Moreover, the ability to transfer rights to large blocks of voting shares, even if nonvoting in the hands of the investing company, may result in such a substantial position of leverage over the management of the acquiree as to involve a structure that inevitably results in control prohibited by the Act.

(d) *Provisions that avoid control.* (1) In the context of any particular agreement, provisions of the type described above may be acceptable if combined with other provisions that serve to preclude control. The Board believes that such agreements will not be consistent with the Act unless provisions are included that will preserve management's discretion over the policies and decisions of the acquiree and avoid control of voting shares.

(2) As a first step towards avoiding control, covenants in any agreement

[1] *See* Board letter dated March 18, 1982, to C. A. Cavendes, Sociedad Financiera.

should leave management free to conduct banking and permissible nonbanking activities. Another step to avoid control is the right of the acquiree to ''call'' the equity investment and options or warrants to assure that covenants that may become inhibiting can be avoided by the acquiree. This right makes such investments or agreements more like a loan in which the borrower has a right to escape covenants and avoid the lender's influence by prepaying the loan.

(3) A measure to avoid problems of control arising through the investor's control over the ultimate disposition of rights to substantial amounts of voting shares of the acquiree would be a provision granting the acquiree a right of first refusal before warrants, options or other rights may be sold and requiring a public and dispersed distribution of these rights if the right of first refusal is not exercised.

(4) In this connection, the Board believes that agreements that involve rights to less than 25 percent of the voting shares, with a requirement for a dispersed public distribution in the event of sale, have a much greater prospect of achieving consistency with the Act than agreements involving a greater percentage. This guideline is drawn by analogy from the provision in the Act that ownership of 25 percent or more of the voting securities of a bank constitutes control of the bank.

(5) The Board expects that one effect of this guideline would be to hold down the size of the nonvoting equity investment by the investing company relative to the acquiree's total equity, thus avoiding the potential for control because the investor holds a very large proportion of the acquiree's total equity. Observance of the 25 percent guideline will also make provisions in agreements providing for a right of first refusal or a public and widely dispersed offering of rights to the acquiree's shares more practical and realistic.

(6) Finally, certain arrangements should clearly be avoided regardless of other provisions in the agreement that are designed to avoid control. These are:

(i) Agreements that enable the investing bank holding company (or its designee) to direct in any manner the voting of more than 5 per cent of the voting shares of the acquiree;

(ii) Agreements whereby the investing company has the right to direct the acquiree's use of the proceeds of an equity investment by the investing company to effect certain actions, such as the purchase and redemption of the acquiree's voting shares; and

(iii) The acquisition of more than 5 per cent of the voting shares of the acquiree that ''simultaneously'' with their acquisition by the investing company become nonvoting shares, remain nonvoting shares while held by the investor, and revert to voting shares when transferred to a third party.

(e) *Review by the Board.* This statement does not constitute the exclusive scope of the Board's concerns, nor are the considerations with respect to control outlined in this statement an exhaustive catalog of permissible or impermissible arrangements. The Board has instructed its staff to review agreements of the kind discussed in this statement and to bring to the Board's attention those that raise problems of consistency with the Act. In this regard, companies are requested to notify the Board of the terms of such proposed merger or asset acquisition agreements or nonvoting equity investments prior to their execution or consummation.

[47 FR 30966, July 16, 1982]

§ 225.145 Limitations established by the Competitive Equality Banking Act of 1987 on the activities and growth of nonbank banks.

(a) *Introduction.* Effective August 10, 1987, the Competitive Equality Banking Act of 1987 (''CEBA'') redefined the term ''bank'' in the Bank Holding Company Act (''BHC Act'' or ''Act'') to include any bank the deposits of which are insured by the Federal Deposit Insurance Corporation as well as any other institution that accepts demand or checkable deposit accounts and is engaged in the business of making commercial loans. 12 U.S.C. 1841(c). CEBA also contained a grandfather provision for certain companies affected by this redefinition. CEBA amended section 4 of the BHC Act to permit a company that on March 5, 1987, controlled a nonbank bank (an institution that became a bank as a result of enactment of CEBA) and that was not a bank holding company on August 9, 1987, to retain its nonbank bank and not be treated as a bank holding company for purposes of the BHC Act if the company and its subsidiary nonbank bank observe certain limitations imposed by CEBA.[1] Certain of these limitations are codified in section 4(f)(3) of the BHC Act and generally restrict nonbank banks from commencing new activities or certain cross-marketing activities with affiliates after March 5, 1987, or permitting overdrafts for affiliates or incurring overdrafts on behalf of affiliates at a Federal Reserve Bank. 12 U.S.C. 1843(f)(3).[2] The Board's views regarding the meaning and scope of these limitations are set forth below and in provisions of the Board's Regulation Y (12 CFR 225.52).

(b) *Congressional findings.* (1) At the outset, the Board notes that the scope and application of the Act's limitations on nonbank banks must be guided by the Congressional findings set out in section 4(f)(3) of the BHC Act. Congress was aware that these nonbank banks had been acquired by companies that engage in a wide range of nonbanking activities, such as retailing and general securities activities that are forbidden to bank holding companies under section 4 of the BHC Act. In section 4(f)(3), Congress found that nonbank banks controlled by grandfathered nonbanking companies may, because of their relationships with affiliates, be involved in conflicts of interest, concentration of resources, or other effects adverse to bank safety and soundness. Congress also found that nonbank banks may be able to compete unfairly against banks controlled by bank holding companies by combining banking services with financial services not permissible for bank holding companies. Section 4(f)(3) states that the purpose of the nonbank bank limitations is to minimize any such potential adverse effects or inequities by restricting the activities of nonbank banks until further Congressional action in the area of bank powers could be undertaken. Similarly, the Senate Report accompanying CEBA states that the restrictions CEBA places on nonbank banks "will help prevent existing nonbank banks from changing their basic character * * * while Congress considers proposals for comprehensive legislation; from drastically eroding the separation of banking and commerce; and from increasing the potential for unfair competition, conflicts of interest, undue concentration of resources, and other adverse effects." S. Rep. No. 100–19, 100th Cong., 1st Sess. 12 (1987). *See also* H. Rep. No. 100–261, 100th Cong., 1st Sess. 124 (1987) (the "Conference Report").

(2) Thus, Congress explicitly recognized in the statute itself that nonbanking companies controlling grandfathered nonbank banks, which include the many of the nation's largest commercial and financial organizations, were being accorded a significant competitive advantage that could not be matched by bank holding companies because of the general prohibition against nonbanking activities in section 4 of the BHC Act. Congress recognized that this inequality in regulatory approach could inflict serious competitive harm on regulated bank holding companies as the grandfathered entities sought to exploit potential synergies between banking and commercial products and services. *See* Conference Report at 125–126. The basic and stated purpose of the restrictions on grandfathered nonbank banks is to minimize these potential anticompetitive effects.

[1] 12 U.S.C. 1843(f). Such a company is treated as a bank holding company, however, for purposes of the anti-tying provisions in section 106 of the BHC Act Amendments of 1970 (12 U.S.C. 1971 *et seq.*) and the insider lending limitations of section 22(h) of the Federal Reserve Act (12 U.S.C. 375b). The company is also subject to certain examination and enforcement provisions to assure compliance with CEBA.

[2] CEBA also prohibits, with certain limited exceptions, a company controlling a grandfathered nonbank bank from acquiring control of an additional bank or thrift institution or acquiring, directly or indirectly after March 5, 1987, more than 5 percent of the assets or shares of a bank or thrift institution. 12 U.S.C. 1843(f)(2).

(3) The Board believes that the specific CEBA limitations should be implemented in light of these Congressional findings and the legislative intent reflected in the plain meaning of the terms used in the statute. In those instances when the language of the statute did not provide clear guidance, legislative materials and the Congressional intent manifested in the overall statutory structure were considered. The Board also notes that prior precedent requires that grandfather exceptions in the BHC Act, such as the nonbank bank limitations and particularly the exceptions thereto, are to be interpreted narrowly in order to ensure the proper implementation of Congressional intent.[3]

(c) *Activity limitation*—(1) *Scope of activity*. (i) The first limitation established under section 4(f)(3) provides that a nonbank bank shall not ''engage in any activity in which such bank was not lawfully engaged as of March 5, 1987.'' The term *activity* as used in this provision of CEBA is not defined. The structure and placement of the CEBA activity restriction within section 4 of the BHC Act and its legislative history do, however, provide direction as to certain transactions that Congress intended to treat as separate activities, thereby providing guidance as to the meaning Congress intended to ascribe to the term generally. First, it is clear that the term *activity* was not meant to refer to banking as a single activity. To the contrary, the term must be viewed as distinguishing between deposit taking and lending activities and treating demand deposit-taking as a separate activity from general deposit-taking and commercial lending as separate from the general lending category.

(ii) Under the activity limitation, a nonbank bank may engage only in activities in which it was ''lawfully engaged'' as of March 5, 1987. As of that date, a nonbank bank could not have been engaged in both demand deposit-taking and commercial lending activity without placing it and its parent holding company in violation of the BHC Act. Thus, under the activity limitations, a nonbank bank could not after March 5, 1987, commence the demand deposit-taking or commercial lending activity that it did not conduct as of March 5, 1987. The debates and Senate and Conference Reports on CEBA confirm that Congress intended the activity limitation to prevent a grandfathered nonbank bank from converting itself into a full-service bank by both offering demand deposits and engaging in the business of making commercial loans.[4] Thus, these types of transactions provide a clear guide as to the type of banking transactions that would constitute activities under CEBA and the degree of specificity intended by Congress in interpreting that term.

(iii) It is also clear that the activity limitation was not intended simply to prevent a nonbank bank from both accepting demand deposits and making commercial loans; it has a broader scope and purpose. If Congress had meant the term to refer to just these two activities, it would have used the restriction it used in another section of CEBA dealing with nonbank banks owned by bank holding companies which has this result, *i.e.*, the nonbank bank could not engage in any activity that would have caused it to become a bank under the prior bank definition in the Act. *See* 12 U.S.C. 1843(g)(1)(A). Indeed, an earlier version of CEBA under consideration by the Senate Banking Committee contained such a provision for nonbank banks owned by commercial holding companies, which was deleted in favor of the broader activity limitation actually enacted. Committee Print No. 1, (Feb. 17, 1987). In this regard, both the Senate Report and Conference Report refer to demand deposit-taking and commercial lending as examples of activities that could be affected by the activity limitation, not

[3] *E.g., Maryland National Corporation*, 73 Federal Reserve Bulletin 310, 313–314 (1987). *Cf., Spokane & Inland Empire Railroad Co.* v. *United States*, 241 U.S. 344, 350 (1915).

[4] Conference Report at 124–25; S. Rep. No. 100–19 at 12, 32; H. Rep. No. 99–175, 99th Cong., 1st Sess. 3 (1985) (''the activities limitation is to prevent an institution engaged in a limited range of functions from expanding into new areas and becoming, in essence, a full-service bank''); 133 Cong. Rec. S4054 (daily ed. March 27, 1987); (Comments of Senator Proxmire).

as the sole activities to be limited by the provision.[5]

(iv) Finally, additional guidance as to the meaning of the term *activity* is provided by the statutory context in which the term appears. The activity limitation is contained in section 4 of the BHC Act, which regulates the investments and activities of bank holding companies and their nonbank subsidiaries. The Board believes it reasonable to conclude that by placing the CEBA activity limitation in section 4 of the BHC Act, Congress meant that Board and judicial decisions regarding the meaning of the term *activity* in that section be looked to for guidance. This is particularly appropriate given the fact that grandfathered nonbank banks, whether owned by bank holding companies or unregulated holding companies, were treated as nonbank companies and not banks before enactment of CEBA.

(v) This interpretation of the term activity draws support from comments by Senator Proxmire during the Senate's consideration of the provision that the term was not intended to apply ''on a product-by-product, customer-by-customer basis.'' 133 Cong. Rec. S4054–5 (daily ed. March 27, 1987). This is the same manner in which the Board has interpreted the term activity in the nonbanking provision of section 4 as referring to generic categories of activities, not to discrete products and services.

(vi) Accordingly, consistent with the terms and purposes of the legislation and the Congressional intent to minimize unfair competition and the other adverse effects set out in the CEBA findings, the Board concludes that the term *activity* as used in section 4(f)(3) means any line of banking or nonbanking business. This definition does not, however, envision a product-by-product approach to the activity limitation. The Board believes it would be helpful to describe the application of the activity limitation in the context of the following major categories of activities: deposit-taking, lending, trust, and other activities engaged in by banks.

[5] Conference Report at 124–125; S. Rep. No. 100–19 at 32.

(2) *Deposit-taking activities.* (i) With respect to deposit-taking, the Board believes that the activity limitation in section 4(f)(3) generally refers to three types of activity: demand deposit-taking; non-demand deposit-taking with a third party payment capability; and time and savings deposit-taking without third party payment powers. As previously discussed, it is clear from the terms and intent of CEBA that the activity limitation would prevent, and was designed to prevent, nonbank banks that prior to the enactment of CEBA had refrained from accepting demand deposits in order to avoid coverage as a *bank* under the BHC Act, from starting to take these deposits after enactment of CEBA and thus becoming full-service banks. Accordingly, CEBA requires that the taking of demand deposits be treated as a separate activity.

(ii) The Board also considers nondemand deposits withdrawable by check or other similar means for payment to third parties or others to constitute a separate line of business for purposes of applying the activity limitation. In this regard, the Board has previously recognized that this line of businesss constitutes a permissible but separate activity under section 4 of the BHC Act. Furthermore, the offering of accounts with transaction capability requires different expertise and systems than non-transaction deposit-taking and represented a distinct new activity that traditionally separated banks from thrift and similar institutions.

(iii) Support for this view may also be found in the House Banking Committee report on proposed legislation prior to CEBA that contained a similar prohibition on new activities for nonbank banks. In discussing the activity limitation, the report recognized a distinction between demand deposits and accounts with transaction capability and those without transaction capability:

With respect to deposits, the Committee recognizes that it is legitimate for an institution currently involved in offering demand deposits or other third party transaction accounts to make use of new technologies that are in the process of replacing the existing check-based, paper payment system. Again, however, the Committee does not believe that technology should be used as a lever for an institution that was only incidentally involved in the payment system to transform itself into a significant offeror of transaction account capability.[6]

(iv) Finally, this distinction between demand and nondemand checkable accounts and accounts not subject to withdrawal by check was specifically recognized by Congress in the redefinition of the term *bank* in CEBA to include an institution that takes demand deposits or ''deposits that the depositor may withdraw by check or other means for payment to third parties or others'' as well as in various exemptions from that definition for trust companies, credit card banks, and certain industrial banks.[7]

(v) Thus, an institution that as of March 5, 1987, offered only time and savings accounts that were not withdrawable by check for payment to third parties could not thereafter begin offering accounts with transaction capability, for example, NOW accounts or other types of transaction accounts.

(3) *Lending.* As noted, the CEBA activity limitation does not treat lending as a single activity; it clearly distinguishes between commercial and other types of lending. This distinction is also reflected in the definition of *bank* in the BHC Act in effect both prior to and after enactment of CEBA as well as in various of the exceptions from this definition. In addition, commercial lending is a specialized form of lending involving different techniques and analysis from other types of lending. Based upon these factors, the Board would view commercial lending as a separate and distinct activity for purposes of the activity limitation in section 4(f)(3). The Board's decisions under section 4 of the BHC Act have not generally differentiated between types of commercial lending, and thus the Board would view commercial lending as a single activity for purposes of CEBA. Thus, a nonbank bank that made commercial loans as of March 5, 1987, could make any type of commercial loan thereafter.

(i) *Commercial lending.* For purposes of the activity limitation, a commercial loan is defined in accordance with the Supreme Court's decision in *Board of Governors* v. *Dimension Financial Corporation*, 474 U.S. 361 (1986), as a direct loan to a business customer for the purpose of providing funds for that customer's business. In this regard, the Board notes that whether a particular transaction is a commercial loan must be determined not from the face of the instrument, but from the application of the definition of commercial loan in the *Dimension* decision to that transaction. Thus, certain transactions of the type mentioned in the Board's ruling at issue in *Dimension* and in the Senate and Conference Reports in the CEBA legislation[8] would be commercial loans if they meet the test for commercial loans established in *Dimension*. Under this test, a commercial loan would not include, for example, an open-market investment in a commercial entity that does not involve a borrower-lender relationship or negotiation of credit terms, such as a money market transaction.

(ii) *Other lending.* Based upon the guidance in the Act as to the degree of specificity required in applying the activity limitation with respect to lending, the Board believes that, in addition to commercial lending, there are three other types of lending activities: consumer mortgage lending, consumer credit card lending, and other consumer lending. Mortgage lending and credit card lending are recognized, discrete lines of banking and business activity, involving techniques and processes that are different from and more specialized than those required for general consumer lending. For example, these activities are, in many cases, conducted by specialized institutions, such as mortgage companies and credit card institutions, or through separate organizational structures within an institution, particularly in the case of mortgage lending. Additionally, the Board's decisions under section 4 of the Act have recognized mortgage banking and credit card lending as separate activities for bank holding companies.

[6] H. Rep. No. 99–175, 99th Cong., 1st Sess. 13 (1985).

[7] See 12 U.S.C. 1841(c)(2) (D), (F), (H), and (I).

[8] S. Rep. No. 100–19 at 31; Conference Report at 123.

The Board's Regulation Y reflects this specialization, noting as examples of permissible lending activity: consumer finance, credit card and mortgage lending. 12 CFR 225.25(b)(1). Finally, CEBA itself recognizes the specialized nature of credit card lending by exempting an institution specializing in that activity from the bank definition. For purpose of the activity limitation, a consumer mortgage loan will mean any loan to an individual that is secured by real estate and that is not a commercial loan. A credit card loan would be any loan made to an individual by means of a credit card that is not a commercial loan.

(4) *Trust activities.* Under section 4 of the Act, the Board has historically treated trust activities as a single activity and has not differentiated the function on the basis of whether the customer was an individual or a business. *See* 12 CFR 225.25(b)(3). Similarly, the trust company exemption from the bank definition in CEBA makes no distinction between various types of trust activities. Accordingly, the Board would view trust activities as a separate activity without additional differentiation for purposes of the activity limitation in section 4(f)(3).

(5) *Other activities.* With respect to activities other than the various traditional deposit-taking, lending or trust activities, the Board believes it appropriate, for the reasons discussed above, to apply the activity limitation in section 4(f)(3) as the term *activity* generally applies in other provisions of section 4 of the BHC Act. Thus, a grandfathered nonbank bank could not, for example, commence after March 5, 1987, any of the following activities (unless it was engaged in such an activity as of that date): discount securities brokerage, full-service securities brokerage investment advisory services, underwriting or dealing in government securities as permissible for member banks, foreign exchange transaction services, real or personal property leasing, courier services, data processing for third parties, insurance agency activities,[9] real estate development, real estate brokerage, real estate syndication, insurance underwriting, management consulting, futures commission merchant, or activities of the general type listed in §225.25(b) of Regulation Y.

(6) *Meaning of engaged in.* In order to be *engaged in* an activity, a nonbank bank must demonstrate that it had a program in place to provide a particular product or service included within the grandfathered activity to a customer and that it was in fact offering the product or service to customers as of March 5, 1987. Thus, a nonbank bank is not engaged in an activity as of March 5, 1987, if the product or service in question was in a planning state as of that date and had not been offered or delivered to a customer. Consistent with prior Board interpretations of the term activity in the grandfather provisions of section 4, the Board does not believe that a company may be engaged in an activity on the basis of a single isolated transaction that was not part of a program to offer the particular product or to conduct in the activity on an ongoing basis. For example, a nonbank bank that held an interest in a single real estate project would not thereby be engaged in real estate development for purposes of this provision, unless evidence was presented indicating the interest was held under a program to commence a real estate development business.

(7) *Meaning of as of* The Board believes that the grandfather date ''as of March 5, 1987'' as used throughout section 4(f)(3) should refer to activities engaged in on March 5, 1987, or a reasonably short period preceding this date not exceeding 13 months. 133 Cong. Rec. S3957 (daily ed. March 26, 1987). (Remarks of Senators Dodd and Proxmire). Activities that the institution had terminated prior to March 5, 1988, however, would not be considered to have been conducted or engaged in *as of* March 5. For example, if within 13 months of March 5, 1987, the nonbank bank had terminated its commercial lending activity in order to avoid the

[9] In this area, section 4 of the Act does not treat all insurance agency activities as a single activity. Thus, for example, the Act treats the sale of credit-related life, accident and health insurance as a separate activity from general insurance agency activities. See 12 U.S.C. 1843(c)(8).

bank definition in the Act, the nonbank bank could not recommence that activity after enactment of CEBA.

(d) *Cross-marketing limitation*—(1) *In general*. Section 4(f)(3) also limits cross-marketing activities by nonbank banks and their affiliates. Under this provision, a nonbank bank may not offer or market a product or service of an affiliate unless the product or service may be offered by bank holding companies generally under section 4(c)(8) of the BHC Act. In addition, a nonbank bank may not permit any of its products or services to be offered or marketed by or through a nonbank affiliate unless the affiliate engages only in activities permissible for a bank holding company under section 4(c)(8). These limitations are subject to an exception for products or services that were being so offered or marketed as of March 5, 1987, but only in the same manner in which they were being offered or marketed as of that date.

(2) *Examples of impermissible cross-marketing*. The Conference Report illustrates the application of this limitation to the following two covered transactions: (i) products and services of an affiliate that bank holding companies may not offer under the BHC Act, and (ii) products and services of the nonbank bank. In the first case, the restrictions would prohibit, for example, a company from marketing life insurance or automotive supplies through its affiliate nonbank bank because these products are not generally permissible under the BHC Act. Conference Report at 126. In the second case, a nonbank bank may not permit its products or services to be offered or marketed through a life insurance affiliate or automobile parts retailer because these affiliates engage in activities prohibited under the BHC Act. *Id.*

(3) *Permissible cross-marketing*. On the other hand, a nonbank bank could offer to its customers consumer loans from an affiliated mortgage banking or consumer finance company. These affiliates could likewise offer their customers the nonbank bank's products or services provided the affiliates engaged only in activities permitted for bank holding companies under the closely-related-to-banking standard of section 4(c)(8) of the BHC Act. If the affiliate is engaged in both permissible and impermissible activities within the meaning of section 4(c)(8) of the BHC Act, however, the affiliate could not offer or market the nonbank bank's products or services.

(4) *Product approach to cross-marketing restriction*. (i) Unlike the activity restrictions, the cross-marketing restrictions of CEBA apply by their terms to individual products and services. Thus, an affiliate of a nonbank bank that was engaged in activities that are not permissible for bank holding companies and that was marketing a particular product or service of a nonbank bank on the grandfather date could continue to market that product and, as discussed below, could change the terms and conditions of the loan. The nonbank affiliate could not, however, begin to offer or market another product or service of the nonbank bank.

(ii) The Board believes that the term *product or service* must be interpreted in light of its accepted ordinary commercial usage. In some instances, commercial usage has identified a group of products so closely related that they constitute a product line (*e.g.*, certificates of deposit) and differences in versions of the product (*e.g.*, a one-year certificate of deposit) simply represent a difference in the terms of the product.[10] This approach is consistent with the treatment in CEBA's legislative history of certificates of deposit as a product line rather than each particular type of CD as a separate product.[11]

(iii) In the area of consumer lending, the Board believes the following provide examples of different consumer loan products: mortgage loans to finance the purchase of the borrower's

[10] American Bankers Association, *Banking Terminology* (1981).

[11] During the Senate debates on CEBA, Senator Proxmire in response to a statement from Senator Cranston that the joint-marketing restrictions do not lock into place the specific terms or conditions of the particular grandfathered product or service, stated:

That is correct. For example, if a nonbank bank was jointly marketing on March 5, 1987, a 3 year, $5,000 certificate of deposit, this bill would not prohibit offering in the same manner a 1 year, $2,000 certificate of deposit with a different interest rate. 133 Cong. Rec. S3959 (daily ed. March 26, 1987).

residence, unsecured consumer loans, consumer installment loans secured by the personal property to be purchased (*e.g.* automobile, boat or home appliance loans), or second mortgage loans.[12] Under this interpretation, a nonbank bank that offered automobile loans through a nonbank affiliate on the grandfather date could market boat loans, appliance loans or any type of secured consumer installment loan through that affiliate. It could not, however, market unsecured consumer loans, home mortgage loans or other types of consumer loans.

(iv) In other areas, the Board believes that the determination as to what constitutes a product or service should be made on a case-by-case basis consistent with the principles that the terms *product or service* must be interpreted in accordance with their ordinary commercial usage and must be narrower in scope than the definition of activity. Essentially, the concept applied in this analysis is one of permitting the continuation of the specific product marketing activity that was undertaken as of March 5, 1987. Thus, for example, while insurance underwriting may constitute a separate activity under CEBA, a nonbank bank could not market a life insurance policy issued by the affiliate if on the grandfather date it had only marketed homeowners' policies issued by the affiliate.

(5) *Change in terms and conditions permitted.* (i) The cross-marketing restrictions would not limit the ability of the institution to change the specific terms and conditions of a particular grandfathered product or service. The Conference Report indicates a legislative intent not to lock into place the specific terms or conditions of a grandfathered product or service. Conference Report at 126. For example, a nonbank bank marketing a three-year, $5,000 certificate of deposit through an affiliate under the exemption could offer a one-year $2,000 certificate of deposit with a different interest rate after the grandfather date. *See* footnote 11 above. Modifications that alter the type of product, however, are not permitted. Thus, a nonbank bank that marketed through affiliates on March 5, 1987, only certificates of deposit could not commence marketing MMDA's or NOW accounts after the grandfather date.

(ii) General changes in the character of the product or service as the result of market or technological innovation are similarly permitted to the extent that they do not transform a grandfathered product into a new product. Thus, an unsecured line of credit could not be modified to include a lien on the borrower's residence without becoming a new product.

(6) *Meaning of offer or market.* In the Board's opinion, the terms *offer or market* in the cross-marketing restrictions refer to the presentation to a customer of an institution's products or service through any type of program, including telemarketing, advertising brochures, direct mailing, personal solicitation, customer referrals, or joint-marketing agreements or presentations. An institution must have offered or actually marketed the product or service on March 5 or shortly before that date (as discussed above) to qualify for the grandfather privilege. Thus, if the cross-marketing program was in the planning stage on March 5, 1987, the program would not quality for grandfather treatment under CEBA.

(7) *Limitations on cross-marketing to in the same manner.* (i) The cross-marketing restriction in section 4(f)(3) contains a grandfather provision that permits products or services that would otherwise be prohibited from being offered or marketed under the provision to continue to be offered or marketed by a particular entity if the products or services were being so offered or marketed as of March 5, 1987, but "only in the same manner in which they were being offered or marketed as of that date." Thus, to qualify for the grandfather provision, the manner of offering or marketing the otherwise prohibited product or service must remain the same as on the grandfather date.

[12] In this regard, the Supreme Court in *United States* v. *Philadelphia National Bank*, noted that "the principal banking products are of course various types of credit, for example: unsecured personal and business loans, mortgage loans, loans secured by securities or accounts receivable, automobile installment and consumer goods, installment loans, tuition financing, bank credit cards, revolving credit funds." 374 U.S. 321, 326 n.5 (1963).

(ii) In interpreting this provision, the Board notes that Congress designed the joint-marketing restrictions to prevent the significant risk to the public posed by the conduct of such activities by insured banks affiliated with companies engaged in general commerce, to ensure objectivity in the credit-granting process and to ''minimize the unfair competitive advantage that grandfathered commercial companies owning nonbank banks might otherwise engage over regulated bank holding companies and our competing commercial companies that have no subsidiary bank.'' Conference Report at 125–126. The Board believes that determinations regarding the manner of cross-marketing of a particular product or service may best be accomplished by applying the limitation to the particular facts in each case consistent with the stated purpose of this provision of CEBA and the general principle that grandfather restrictions and exceptions to general prohibitions must be narrowly construed in order to prevent the exception from nullifying the rule. Essentially, as in the scope of the term ''product or service'', the guiding principle of Congressional intent with respect to this term is to permit only the continuation of the specific types of cross-marketing activity that were undertaken as of March 5, 1987.

(8) *Eligibility for cross-marketing grandfather exemption.* The Conference Report also clarifies that entitlement to an exemption to continue to cross-market products and services otherwise prohibited by the statute applies only to the specific company that was engaged in the activity as of March 5, 1987. Conference Report at 126. Thus, an affiliate that was not engaged in cross-marketing products or services as of the grandfather date may not commence these activities under the exemption even if such activities were being conducted by another affiliate. *Id.*; *see also* S. Rep. No. 100–19 at 33–34.

(e) *Eligibility for grandfathered nonbank bank status.* In reviewing the reports required by CEBA, the Board notes that a number of institutions that had not commenced business operations on August 10, 1987, the date of enactment of CEBA, claimed grandfather privileges under section 4(f)(3) of CEBA. To qualify for grandfather privileges under section 4(f)(3), the institution must have ''bec[o]me a bank as a result of the enactment of [CEBA]'' and must have been controlled by a nonbanking company on March 5, 1987. 12 U.S.C. 1843(f)(1)(A). An institution that did not have FDIC insurance on August 10, 1987, and that did not accept demand deposits or transaction accounts or engage in the business of commercial lending on that date, would not have become a *bank* as a result of enactment of CEBA. Thus, institutions that had not commenced operations on August 10, 1987, could not qualify for grandfather privileges under section 4(f)(3) of CEBA. This view is supported by the activity limitations of section 4(f)(3), which, as noted, limit the activities of grandfathered nonbank banks to those in which they were lawfully engaged as of March 5, 1987. A nonbank bank that had not commenced conducting business activities on March 5, 1987, could not after enactment of CEBA engage in any activities under this provision.

[Reg. Y, 53 FR 37746, Sept. 28, 1988, as amended by Reg. Y, 62 FR 9343, Feb. 28, 1997]

Subpart J—Merchant Banking Investments

SOURCE: Reg. Y, 66 FR 8484, Jan. 31, 2001, unless otherwise noted.

§ 225.170 What type of investments are permitted by this subpart, and under what conditions may they be made?

(a) *What types of investments are permitted by this subpart?* Section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) and this subpart authorize a financial holding company, directly or indirectly and as principal or on behalf of one or more persons, to acquire or control any amount of shares, assets or ownership interests of a company or other entity that is engaged in any activity not otherwise authorized for the financial holding company under section 4 of the Bank Holding Company Act. For purposes of this subpart, shares, assets or ownership interests acquired or controlled under section 4(k)(4)(H) and this subpart are referred to as "merchant banking investments." A financial holding company may not directly or indirectly acquire or control any merchant banking investment except in compliance with the requirements of this subpart.

(b) *Must the investment be a bona fide merchant banking investment?* The acquisition or control of shares, assets or ownership interests under this subpart is not permitted unless it is part of a bona fide underwriting or merchant or investment banking activity.

(c) *What types of ownership interests may be acquired?* Shares, assets or ownership interests of a company or other entity include any debt or equity security, warrant, option, partnership interest, trust certificate or other instrument representing an ownership interest in the company or entity, whether voting or nonvoting.

(d) *Where in a financial holding company may merchant banking investments be made?* A financial holding company and any subsidiary (other than a depository institution or subsidiary of a depository institution) may acquire or control merchant banking investments. A financial holding company and its subsidiaries may not acquire or control merchant banking investments on behalf of a depository institution or subsidiary of a depository institution.

(e) *May assets other than shares be held directly?* A financial holding company may not under this subpart acquire or control assets, other than debt or equity securities or other ownership interests in a company, unless:

(1) The assets are held by or promptly transferred to a portfolio company;

(2) The portfolio company maintains policies, books and records, accounts, and other indicia of corporate, partnership or limited liability organization and operation that are separate from the financial holding company and limit the legal liability of the financial holding company for obligations of the portfolio company; and

(3) The portfolio company has management that is separate from the financial holding company to the extent required by §225.171.

(f) *What type of affiliate is required for a financial holding company to make merchant banking investments?* A financial holding company may not acquire or control merchant banking investments under this subpart unless the financial holding company qualifies under at least one of the following paragraphs:

(1) *Securities affiliate.* The financial holding company is or has an affiliate that is registered under the Securities Exchange Act of 1934 (15 U.S.C. 78c, 78o, 78o–4) as:

(i) A broker or dealer; or

(ii) A municipal securities dealer, including a separately identifiable department or division of a bank that is registered as a municipal securities dealer.

(2) *Insurance affiliate with an investment adviser affiliate.* The financial holding company controls:

(i) An insurance company that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance), or providing and issuing annuities; and

(ii) A company that:

(A) Is registered with the Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940 (15 U.S.C. 80b–1 *et seq.*); and

(B) Provides investment advice to an insurance company.

§ 225.171 What are the limitations on managing or operating a portfolio company held as a merchant banking investment?

(a) *May a financial holding company routinely manage or operate a portfolio company?* Except as permitted in paragraph (e) of this section, a financial holding company may not routinely manage or operate any portfolio company.

(b) *When does a financial holding company routinely manage or operate a company?*—(1) *Examples of routine management or operation*—(i) *Executive officer interlocks at the portfolio company.* A financial holding company routinely manages or operates a portfolio company if any director, officer or employee of the financial holding company serves as or has the responsibilities of an executive officer of the portfolio company.

(ii) Interlocks by executive officers of the financial holding company. (A) *Prohibition.* A financial holding company routinely manages or operates a portfolio company if any executive officer of the financial holding company serves as or has the responsibilities of an officer or employee of the portfolio company.

(B) *Definition.* For purposes of paragraph (b)(1)(ii)(A) of this section, the term ''financial holding company'' includes the financial holding company and only the following subsidiaries of the financial holding company:

(*1*) A securities broker or dealer registered under the Securities Exchange Act of 1934;

(*2*) A depository institution;

(*3*) An affiliate that engages in merchant banking activities under this subpart or insurance company investment activities under section 4(k)(4)(I) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(I));

(*4*) A small business investment company (as defined in section 302(b) of the Small Business Investment Act of 1958 (15 U.S.C. 682(b)) controlled by the financial holding company or by any depository institution controlled by the financial holding company; and

(*5*) Any other affiliate that engages in significant equity investment activities that are subject to a special capital charge under the capital adequacy rules or guidelines of the Board.

(iii) *Covenants regarding ordinary course of business.* A financial holding company routinely manages or operates a portfolio company if any covenant or other contractual arrangement exists between the financial holding company and the portfolio company that would restrict the portfolio company's ability to make routine business decisions, such as entering into transactions in the ordinary course of business or hiring officers or employees other than executive officers.

(2) *Presumptions of routine management or operation.* A financial holding company is presumed to routinely manage or operate a portfolio company if:

(i) Any director, officer, or employee of the financial holding company serves as or has the responsibilities of an officer (other than an executive officer) or employee of the portfolio company; or

(ii) Any officer or employee of the portfolio company is supervised by any director, officer, or employee of the financial holding company (other than in that individual's capacity as a director of the portfolio company).

(c) *How may a financial holding company rebut a presumption that it is routinely managing or operating a portfolio company?* A financial holding company may rebut a presumption that it is routinely managing or operating a portfolio company under paragraph (b)(2) of this section by presenting information to the Board demonstrating to the Board's satisfaction that the financial holding company is not routinely managing or operating the portfolio company.

(d) *What arrangements do not involve routinely managing or operating a portfolio company?*—(1) *Director representation at portfolio companies.* A financial holding company may select any or all of the directors of a portfolio company or have one or more of its directors, officers, or employees serve as directors of a portfolio company if:

(i) The portfolio company employs officers and employees responsible for routinely managing and operating the company; and

(ii) The financial holding company does not routinely manage or operate the portfolio company, except as permitted in paragraph (e) of this section.

(2) *Covenants or other provisions regarding extraordinary events.* A financial holding company may, by virtue of covenants or other written agreements with a portfolio company, restrict the ability of the portfolio company, or require the portfolio company to consult with or obtain the approval of the financial holding company, to take actions outside of the ordinary course of the business of the portfolio company. Examples of the types of actions that may be subject to these types of covenants or agreements include, but are not limited to, the following:

(i) The acquisition of significant assets or control of another company by the portfolio company or any of its subsidiaries;

(ii) Removal or selection of an independent accountant or auditor or investment banker by the portfolio company;

(iii) Significant changes to the business plan or accounting methods or policies of the portfolio company;

(iv) Removal or replacement of any or all of the executive officers of the portfolio company;

(v) The redemption, authorization or issuance of any equity or debt securities (including options, warrants or convertible shares) of the portfolio company or any borrowing by the portfolio company outside of the ordinary course of business;

(vi) The amendment of the articles of incorporation or by-laws (or similar governing documents) of the portfolio company; and

(vii) The sale, merger, consolidation, spin-off, recapitalization, liquidation, dissolution or sale of substantially all of the assets of the portfolio company or any of its significant subsidiaries.

(3) *Providing advisory and underwriting services to, and having consultations with, a portfolio company.* A financial holding company may:

(i) Provide financial, investment and management consulting advice to a portfolio company in a manner consistent with and subject to any restrictions on such activities contained in §§ 225.28(b)(6) or 225.86(b)(1) of this part (12 CFR 225.28(b)(6) and 225.86(b)(1));

(ii) Provide assistance to a portfolio company in connection with the underwriting or private placement of its securities, including acting as the underwriter or placement agent for such securities; and

(iii) Meet with the officers or employees of a portfolio company to monitor or provide advice with respect to the portfolio company's performance or activities.

(e) *When may a financial holding company routinely manage or operate a portfolio company?*—(1) *Special circumstances required.* A financial holding company may routinely manage or operate a portfolio company only when intervention by the financial holding company is necessary or required to obtain a reasonable return on the financial holding company's investment in the portfolio company upon resale or other disposition of the investment, such as to avoid or address a significant operating loss or in connection with a loss of senior management at the portfolio company.

(2) *Duration Limited.* A financial holding company may routinely manage or operate a portfolio company only for the period of time as may be necessary to address the cause of the financial holding company's involvement, to obtain suitable alternative management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return upon the resale or disposition of the investment.

(3) *Notice required for extended involvement.* A financial holding company may not routinely manage or operate a portfolio company for a period greater than nine months without prior written notice to the Board.

(4) *Documentation required.* A financial holding company must maintain and make available to the Board upon request a written record describing its involvement in routinely managing or operating a portfolio company.

(f) *May a depository institution or its subsidiary routinely manage or operate a portfolio company?*—(1) *In general.* A depository institution and a subsidiary of a depository institution may not routinely manage or operate a portfolio company in which an affiliated company owns or controls an interest under this subpart.

(2) *Definition applying provisions governing routine management or operation.* For purposes of this section other than paragraph (e) and for purposes of § 225.173(d), a financial holding company includes a depository institution controlled by the financial holding company and a subsidiary of such a depository institution.

(3) *Exception for certain subsidiaries of depository institutions.* For purposes of paragraph (e) of this section, a financial holding company includes a financial subsidiary held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the Federal Deposit Insurance Act (12 U.S.C. 1831w), and a subsidiary that is a small business investment company and that is held in accordance with the Small Business Investment Act (15 U.S.C. 661 *et seq.*), and such a subsidiary may, in accordance with the limitations set forth in this section, routinely manage or operate a portfolio company in

which an affiliated company owns or controls an interest under this subpart.

§ 225.172 What are the holding periods permitted for merchant banking investments?

(a) *Must investments be made for resale?* A financial holding company may own or control shares, assets and ownership interests pursuant to this subpart only for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the financial holding company's merchant banking investment activities.

(b) *What period of time is generally permitted for holding merchant banking investments?*—(1) *In general.* Except as provided in this section or § 225.173, a financial holding company may not, directly or indirectly, own, control or hold any share, asset or ownership interest pursuant to this subpart for a period that exceeds 10 years.

(2) *Ownership interests acquired from or transferred to companies held under this subpart.* For purposes of paragraph (b)(1) of this section, shares, assets or ownership interests—

(i) Acquired by a financial holding company from a company in which the financial holding company held an interest under this subpart will be considered to have been acquired by the financial holding company on the date that the share, asset or ownership interest was acquired by the company; and

(ii) Acquired by a company from a financial holding company will be considered to have been acquired by the company on the date that the share, asset or ownership interest was acquired by the financial holding company if—

(A) The financial holding company held the share, asset, or ownership interest under this subpart; and

(B) The financial holding company holds an interest in the acquiring company under this subpart.

(3) *Interests previously held by a financial holding company under limited authority.* For purposes of paragraph (b)(1) of this section, any shares, assets, or ownership interests previously owned or controlled, directly or indirectly, by a financial holding company under any other provision of the Federal banking laws that imposes a limited holding period will if acquired under this subpart be considered to have been acquired by the financial holding company under this subpart on the date the financial holding company first acquired ownership or control of the shares, assets or ownership interests under such other provision of law. For purposes of this paragraph (b)(3), a financial holding company includes a depository institution controlled by the financial holding company and any subsidiary of such a depository institution.

(4) *Approval required to hold interests held in excess of time limit.* A financial holding company may seek Board approval to own, control or hold shares, assets or ownership interests of a company under this subpart for a period that exceeds the period specified in paragraph (b)(1) of this section. A request for approval must:

(i) Be submitted to the Board at least 90 days prior to the expiration of the applicable time period;

(ii) Provide the reasons for the request, including information that addresses the factors in paragraph (b)(5) of this section; and

(iii) Explain the financial holding company's plan for divesting the shares, assets or ownership interests.

(5) *Factors governing Board determinations.* In reviewing any proposal under paragraph (b)(4) of this section, the Board may consider all the facts and circumstances related to the investment, including:

(i) The cost to the financial holding company of disposing of the investment within the applicable period;

(ii) The total exposure of the financial holding company to the company and the risks that disposing of the investment may pose to the financial holding company;

(iii) Market conditions;

(iv) The nature of the portfolio company's business;

(v) The extent and history of involvement by the financial holding company in the management and operations of the company; and

(vi) The average holding period of the financial holding company's merchant banking investments.

(6) *Restrictions applicable to investments held beyond time period.* A financial holding company that directly or indirectly owns, controls or holds any share, asset or ownership interest of a company under this subpart for a total period that exceeds the period specified in paragraph (b)(1) of this section must—

(i) For purposes of determining the financial holding company's regulatory capital, apply to the financial holding company's adjusted carrying value of such shares, assets, or ownership interests a capital charge determined by the Board that must be:

(A) Higher than the maximum marginal Tier 1 capital charge applicable under the Board's capital adequacy rules or guidelines (*see* 12 CFR 225 appendix A) to merchant banking investments held by that financial holding company; and

(B) In no event less than 25 percent of the adjusted carrying value of the investment; and

(ii) Abide by any other restrictions that the Board may impose in connection with granting approval under paragraph (b)(4) of this section.

§225.173 How are investments in private equity funds treated under this subpart?

(a) *What is a private equity fund?* For purposes of this subpart, a ''private equity fund'' is any company that:

(1) Is formed for the purpose of and is engaged exclusively in the business of investing in shares, assets, and ownership interests of financial and nonfinancial companies for resale or other disposition;

(2) Is not an operating company;

(3) No more than 25 percent of the total equity of which is held, owned or controlled, directly or indirectly, by the financial holding company and its directors, officers, employees and principal shareholders;

(4) Has a maximum term of not more than 15 years; and

(5) Is not formed or operated for the purpose of making investments inconsistent with the authority granted under section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) or evading the limitations governing merchant banking investments contained in this subpart.

(b) *What form may a private equity fund take?* A private equity fund may be a corporation, partnership, limited liability company or other type of company that issues ownership interests in any form.

(c) *What is the holding period permitted for interests in private equity funds?*—(1) *In general.* A financial holding company may own, control or hold any interest in a private equity fund under this subpart and any interest in a portfolio company that is owned or controlled by a private equity fund in which the financial holding company owns or controls any interest under this subpart for the duration of the fund, up to a maximum of 15 years.

(2) *Request to hold interest for longer period.* A financial holding company may seek Board approval to own, control or hold an interest in or held through a private equity fund for a period longer than the duration of the fund in accordance with §225.172(b) of this subpart.

(3) *Application of rules.* The rules described in §225.172(b)(2) and (3) governing holding periods of interests acquired, transferred or previously held by a financial holding company apply to interests in, held through, or acquired from a private equity fund.

(d) *How do the restrictions on routine management and operation apply to private equity funds and investments held through a private equity fund?*—(1) *Portfolio companies held through a private equity fund.* A financial holding company may not routinely manage or operate a portfolio company that is owned or controlled by a private equity fund in which the financial holding company owns or controls any interest under this subpart, except as permitted under §225.171(e).

(2) *Private equity funds controlled by a financial holding company.* A private equity fund that is controlled by a financial holding company may not routinely manage or operate a portfolio company, except as permitted under §225.171(e).

(3) *Private equity funds that are not controlled by a financial holding company.* A private equity fund may routinely manage or operate a portfolio

company so long as no financial holding company controls the private equity fund or as permitted under § 225.171(e).

(4) *When does a financial holding company control a private equity fund?* A financial holding company controls a private equity fund for purposes of this subpart if the financial holding company, including any director, officer, employee or principal shareholder of the financial holding company:

(i) Serves as a general partner, managing member, or trustee of the private equity fund (or serves in a similar role with respect to the private equity fund);

(ii) Owns or controls 25 percent or more of any class of voting shares or similar interests in the private equity fund;

(iii) In any manner selects, controls or constitutes a majority of the directors, trustees or management of the private equity fund; or

(iv) Owns or controls more than 5 percent of any class of voting shares or similar interests in the private equity fund and is the investment adviser to the fund.

§ 225.174 What aggregate thresholds apply to merchant banking investments?

(a) *In general.* A financial holding company may not, without Board approval, directly or indirectly acquire any additional shares, assets or ownership interests under this subpart or make any additional capital contribution to any company the shares, assets or ownership interests of which are held by the financial holding company under this subpart if the aggregate carrying value of all merchant banking investments held by the financial holding company under this subpart exceeds:

(1) 30 percent of the Tier 1 capital of the financial holding company; or

(2) After excluding interests in private equity funds, 20 percent of the Tier 1 capital of the financial holding company.

(b) *How do these thresholds apply to a private equity fund?* Paragraph (a) of this section applies to the interest acquired or controlled by the financial holding company under this subpart in a private equity fund. Paragraph (a) of this section does not apply to any interest in a company held by a private equity fund or to any interest held by a person that is not affiliated with the financial holding company.

(c) *How long do these thresholds remain in effect?* This § 225.174 shall cease to be effective on the date that a final rule issued by the Board that specifically addresses the appropriate regulatory capital treatment of merchant banking investments becomes effective.

§ 225.175 What risk management, record keeping and reporting policies are required to make merchant banking investments?

(a) *What internal controls and records are necessary?*—(1) *General.* A financial holding company, including a private equity fund controlled by a financial holding company, that makes investments under this subpart must establish and maintain policies, procedures, records and systems reasonably designed to conduct, monitor and manage such investment activities and the risks associated with such investment activities in a safe and sound manner, including policies, procedures, records and systems reasonably designed to:

(i) Monitor and assess the carrying value, market value and performance of each investment and the aggregate portfolio;

(ii) Identify and manage the market, credit, concentration and other risks associated with such investments;

(iii) Identify, monitor and assess the terms, amounts and risks arising from transactions and relationships (including contingent fees or contingent interests) with each company in which the financial holding company holds an interest under this subpart;

(iv) Ensure the maintenance of corporate separateness between the financial holding company and each company in which the financial holding company holds an interest under this subpart and protect the financial holding company and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of each such company; and

(v) Ensure compliance with this part and any other provisions of law governing transactions and relationships with companies in which the financial holding company holds an interest under this subpart (*e.g.*, fiduciary principles or sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c–1), if applicable).

(2) *Availability of records.* A financial holding company must make the policies, procedures and records required by paragraph (a)(1) of this section available to the Board or the appropriate Reserve Bank upon request.

(b) *What periodic reports must be filed?* A financial holding company must provide reports to the appropriate Reserve Bank in such format and at such times as the Board may prescribe.

(c) *Is notice required for the acquisition of companies?*—(1) *Fulfillment of statutory notice requirement.* Except as required in paragraph (c)(2) of this section, no post-acquisition notice under section 4(k)(6) of the Bank Holding Company Act (12 U.S.C. 1843(k)(6)) is required by a financial holding company in connection with an investment made under this subpart if the financial holding company has previously filed a notice under § 225.87 indicating that it had commenced merchant banking investment activities under this subpart.

(2) *Notice of large individual investments.* A financial holding company must provide written notice to the Board on the appropriate form within 30 days after acquiring more than 5 percent of the voting shares, assets or ownership interests of any company under this subpart, including an interest in a private equity fund, at a total cost to the financial holding company that exceeds the lesser of 5 percent of the Tier 1 capital of the financial holding company or $200 million.

§ 225.176 How do the statutory cross marketing and sections 23A and B limitations apply to merchant banking investments?

(a) *Are cross marketing activities prohibited?*—(1) *In general.* A depository institution, including a subsidiary of a depository institution, controlled by a financial holding company may not:

(i) Offer or market, directly or through any arrangement, any product or service of any company if more than 5 percent of the company's voting shares, assets or ownership interests are owned or controlled by the financial holding company pursuant to this subpart; or

(ii) Allow any product or service of the depository institution, including any product or service of a subsidiary of the depository institution, to be offered or marketed, directly or through any arrangement, by or through any company described in paragraph (a)(1)(i) of this section.

(2) *How are certain subsidiaries treated?* For purposes of paragraph (a)(1) of this section, a subsidiary of a depository institution does not include a financial subsidiary held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the Federal Deposit Insurance Act. (12 U.S.C. 1831w), any company held by a company owned in accordance with section 25 or 25A of the Federal Reserve Act (12 U.S.C. 601 *et seq.*; 12 U.S.C. 611 *et seq.*), or any company held by a small business investment company owned in accordance with the Small Business Investment Act of 1958 (15 U.S.C. 661 *et seq.*).

(3) *How do the cross marketing restrictions apply to private equity funds?* The restriction contained in paragraph (a)(1) of this section does not apply to:

(i) Portfolio companies held by a private equity fund that the financial holding company does not control; or

(ii) The sale, offer or marketing of any interest in a private equity fund, whether or not controlled by the financial holding company.

(b) *When are companies held under section 4(k)(4)(H) affiliates under sections 23A and B?*—(1) *Rebuttable presumption of control.* The following rebuttable presumption of control shall apply for purposes of sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c-1): if a financial holding company directly or indirectly owns or controls more than 15 percent of the total equity of a company pursuant to this subpart, the company shall be presumed to be an affiliate of any member bank that is affiliated with the financial holding company.

(2) *Request to rebut presumption.* A financial holding company may rebut

this presumption by providing information acceptable to the Board demonstrating that the financial holding company does not control the company.

(3) *Presumptions that control does not exist.* Absent evidence to the contrary, the presumption in paragraph (b)(1) of this section will be considered to have been rebutted without Board approval under paragraph (b)(2) of this section if any one of the following requirements are met:

(i) No officer, director or employee of the financial holding company serves as a director, trustee, or general partner (or individual exercising similar functions) of the company;

(ii) A person that is not affiliated or associated with the financial holding company owns or controls a greater percentage of the equity capital of the portfolio company than the amount owned or controlled by the financial holding company, and no more than one officer or employee of the holding company serves as a director or trustee (or individual exercising similar functions) of the company; or

(iii) A person that is not affiliated or associated with the financial holding company owns or controls more than 50 percent of the voting shares of the portfolio company, and officers and employees of the holding company do not constitute a majority of the directors or trustees (or individuals exercising similar functions) of the company.

(4) *Convertible instruments.* For purposes of paragraph (b)(1) of this section, equity capital includes options, warrants and any other instrument convertible into equity capital.

(5) *Application of presumption to private equity funds.* A financial holding company will not be presumed to own or control the equity capital of a company for purposes of paragraph (b)(1) of this section solely by virtue of an investment made by the financial holding company in a private equity fund that owns or controls the equity capital of the company unless the financial holding company controls the private equity fund as described in §225.173(d)(4).

(6) *Application of sections 23A and B to U.S. branches and agencies of foreign banks.* Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c–1) shall apply to all covered transactions between each U.S. branch and agency of a foreign bank that acquires or controls, or that is affiliated with a company that acquires or controls, merchant banking investments and—

(i) Any portfolio company that the foreign bank or affiliated company controls or is presumed to control under paragraph (b)(1) of this section; and

(ii) Any company that the foreign bank or affiliated company controls or is presumed to control under paragraph (b)(1) of this section if the company is engaged in acquiring or controlling merchant banking investments and the proceeds of the covered transaction are used for the purpose of funding the company's merchant banking investment activities.

§ 225.177 Definitions.

(a) *What do references to a financial holding company include?*—(1) Except as otherwise expressly provided, the term ''financial holding company'' as used in this subpart means the financial holding company and all of its subsidiaries, including a private equity fund or other fund controlled by the financial holding company.

(2) Except as otherwise expressly provided, the term ''financial holding company'' does not include a depository institution or subsidiary of a depository institution or any portfolio company controlled directly or indirectly by the financial holding company.

(b) *What do references to a depository institution include?* For purposes of this subpart, the term ''depository institution'' includes a U.S. branch or agency of a foreign bank.

(c) *What is a portfolio company?* A portfolio company is any company or entity:

(1) That is engaged in any activity not authorized for the financial holding company under section 4 of the Bank Holding Company Act (12 U.S.C. 1843); and

(2) Any shares, assets or ownership interests of which are held, owned or controlled directly or indirectly by the financial holding company pursuant to

this subpart, including through a private equity fund that the financial holding company controls.

(d) *Who are the executive officers of a company?*—(1) An executive officer of a company is any person who participates or has the authority to participate (other than in the capacity as a director) in major policymaking functions of the company, whether or not the officer has an official title, the title designates the officer as an assistant, or the officer serves without salary or other compensation.

(2) The term ''executive officer'' does not include—

(i) Any person, including a person with an official title, who may exercise a certain measure of discretion in the performance of his duties, including the discretion to make decisions in the ordinary course of the company's business, but who does not participate in the determination of major policies of the company and whose decisions are limited by policy standards fixed by senior management of the company; or

(ii) Any person who is excluded from participating (other than in the capacity of a director) in major policymaking functions of the company by resolution of the board of directors or by the bylaws of the company and who does not in fact participate in such policymaking functions.

CONDITIONS TO ORDERS

Subpart K—Proprietary Trading and Relationships With Hedge Funds and Private Equity Funds

SOURCE: 76 FR 8275, Feb. 14, 2011, unless otherwise noted.

§225.180 Definitions.

For purposes of this subpart:

(a) *Banking entity* means—

(1) Any insured depository institution;

(2) Any company that controls an insured depository institution;

(3) Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and

(4) Any affiliate or subsidiary of any of the foregoing entities.

(b) *Hedge fund* and *private equity fund* mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*), but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in section 13(b)(2) of the Bank Holding Company Act (12 U.S.C. 1851(b)(2)), determine.

(c) *Insured depository institution* has the same meaning as given that term in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813), except that for purposes of this subpart the term shall not include an institution that functions solely in a trust or fiduciary capacity if—

(1) All or substantially all of the deposits of such institution are in trust funds and are received in a bona fide fiduciary capacity;

(2) No deposits of such institution which are insured by the Federal Deposit Insurance Corporation are offered or marketed by or through an affiliate of such institution;

(3) Such institution does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others or make commercial loans; and

(4) Such institution does not—

(i) Obtain payment or payment related services from any Federal Reserve bank, including any service referred to in section 11A of the Federal Reserve Act (12 U.S.C. 248a); or

(ii) Exercise discount or borrowing privileges pursuant to section 19(b)(7) of the Federal Reserve Act (12 U.S.C. 416(b)(7)).

(d) *Nonbank financial company supervised by the Board* means a nonbank financial company supervised by the Board of Governors, as defined in section 102 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (12 U.S.C. 5311).

(e) *Board* means the Board of Governors of the Federal Reserve System.

(f) *Illiquid fund* means a hedge fund or private equity fund that:

(1) As of May 1, 2010—

(i) Was principally invested in illiquid assets; or

(ii) Was invested in, and contractually committed to principally invest in, illiquid assets; and

(2) Makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

(g) *Illiquid assets* means any real property, security, obligation, or other asset that—

(1) Is not a liquid asset;

(2) Because of statutory or regulatory restrictions applicable to the hedge fund, private equity fund or asset, cannot be offered, sold, or otherwise transferred by the hedge fund or private equity fund to a person that is unaffiliated with the relevant banking entity; or

(3) Because of contractual restrictions applicable to the hedge fund, private equity fund or asset, cannot be offered, sold, or otherwise transferred by the hedge fund or private equity fund for a period of 3 years or more to a person that is unaffiliated with the relevant banking entity.

(h) *Liquid asset* means:

(1) Cash or cash equivalents;

(2) An asset that is traded on a recognized, established exchange, trading facility or other market on which there exist independent, bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for the particular asset almost instantaneously;

(3) An asset for which there are bona fide, competitive bid and offer quotations in a recognized inter-dealer quotation system or similar system or for which multiple dealers furnish bona fide, competitive bid and offer quotations to other brokers and dealers on request;

(4) An asset the price of which is quoted routinely in a widely disseminated publication that is readily available to the general public or through an electronic service that provides indicative data from real-time financial networks;

(5) An asset with an initial term of one year or less and the payments on which at maturity may be settled, closed-out, or paid in cash or one or more other liquid assets described in paragraphs (h)(1), (2), (3), or (4); and

(6) Any other asset that the Board determines, based on all the facts and circumstances, is a liquid asset.

(i) *Principally invested* and related definitions. A hedge fund or private equity fund:

(1) Is *principally invested* in illiquid assets if at least 75 percent of the fund's consolidated total assets are—

(i) Illiquid assets; or

(ii) Risk-mitigating hedges entered into in connection with and related to individual or aggregated positions in, or holdings of, illiquid assets;

(2) Is *contractually committed to principally invest* in illiquid assets if the fund's organizational documents, other documents that constitute a contractual obligation of the fund, or written representations contained in the fund's offering materials distributed to potential investors provide for the fund to be principally invested in assets described in paragraph (i)(1) at all times other than during temporary periods, such as the period prior to the initial receipt of capital contributions from investors or the period during which the fund's investments are being liquidated and capital and profits are being returned to investors; and

(3) Has an *investment strategy to principally invest* in illiquid assets if the fund—

(i) Markets or holds itself out to investors as intending to principally invest in assets described in paragraph (i)(1) of this section; or

(ii) Has a documented investment policy of principally investing in assets described in paragraph (i)(1) of this section.

§ 225.181 Conformance Period for Banking Entities Engaged in Prohibited Proprietary Trading or Private Fund Activities.

(a) *Conformance Period*—(1) *In general*. Except as provided in paragraph (b)(2) or (3) of this section, a banking entity shall bring its activities and investments into compliance with the requirements of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart no later than 2 years after the earlier of:

(i) July 21, 2012; or

(ii) Twelve months after the date on which final rules adopted under section 13(b)(2) of the Bank Holding Company Act (12 U.S.C. 1851(b)(2)) are published in the FEDERAL REGISTER.

(2) *New banking entities.*—A company that was not a banking entity, or a subsidiary or affiliate of a banking entity, as of July 21, 2010, and becomes a banking entity, or a subsidiary or affiliate of a banking entity, after that date shall bring its activities and investments into compliance with the requirements of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart before the later of—

(i) The conformance date determined in accordance with paragraph (a)(1) of this section; or

(ii) Two years after the date on which the company becomes a banking entity or a subsidiary or affiliate of a banking entity.

(3) *Extended conformance period.* The Board may extend the two-year period under paragraph (a)(1) or (2) of this section by not more than three separate one-year periods, if, in the judgment of the Board, each such one-year extension is consistent with the purposes of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart and would not be detrimental to the public interest.

(b) *Illiquid funds*—(1) *Extended transition period.* The Board may further extend the period provided by paragraph (a) of this section during which a banking entity may acquire or retain an equity, partnership, or other ownership interest in, or otherwise provide additional capital to, a private equity fund or hedge fund if—

(i) The fund is an illiquid fund; and

(ii) The acquisition or retention of such interest, or provision of additional capital, is necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010.

(2) *Duration limited.* The Board may grant a banking entity only one extension under paragraph (b)(1) of this section and such extension—

(i) May not exceed 5 years beyond any conformance period granted under paragraph (a)(3) of this section; and

(ii) Shall terminate automatically on the date during any such extension on which the banking entity is no longer under a contractual obligation described in paragraph (b)(1)(ii).

(3) *Contractual obligation.* For purposes of this paragraph (b)—

(i) A banking entity has a contractual obligation to take or retain an equity, partnership, or other ownership interest in an illiquid fund if the banking entity is prohibited from redeeming all of its equity, partnership, or other ownership interests in the fund, and from selling or otherwise transferring all such ownership interests to a person that is not an affiliate of the banking entity—

(A) Under the terms of the banking entity's equity, partnership, or other ownership interest in the fund or the banking entity's other contractual arrangements with the fund or unaffiliated investors in the fund; or

(B) If the banking entity is the sponsor of the fund, under the terms of a written representation made by the banking entity in the fund's offering materials distributed to potential investors;

(ii) A banking entity has a contractual obligation to provide additional capital to an illiquid fund if the banking entity is required to provide additional capital to such fund—

(A) Under the terms of its equity, partnership or other ownership interest in the fund or the banking entity's other contractual arrangements with the fund or unaffiliated investors in the fund; or

(B) If the banking entity is the sponsor of the fund, under the terms of a written representation made by the banking entity in the fund's offering materials distributed to potential investors; and

(iii) A banking entity shall be considered to have a contractual obligation for purposes of paragraph (b)(3)(i) or (ii) of this section only if—

(A) The obligation may not be terminated by the banking entity or any of its subsidiaries or affiliates under the terms of its agreement with the fund; and

(B) In the case of an obligation that may be terminated with the consent of other persons, the banking entity and its subsidiaries and affiliates have used their reasonable best efforts to obtain such consent and such consent has been denied.

(c) *Approval Required to Hold Interests in Excess of Time Limit.* The conformance period in paragraph (a) of this section may be extended in accordance with paragraph (a)(3) or (b) of this section only with the approval of the Board. A banking entity that seeks the Board's approval for an extension of the conformance period under paragraph (a)(3) or for an extended transition period under paragraph (b)(1) must—

(1) Submit a request in writing to the Board at least 180 days prior to the expiration of the applicable time period;

(2) Provide the reasons why the banking entity believes the extension should be granted, including information that addresses the factors in paragraph (d)(1) of this section; and

(3) Provide a detailed explanation of the banking entity's plan for divesting or conforming the activity or investment(s).

(d) *Factors governing Board determinations*—(1) *Extension requests generally.* In reviewing any application by a specific company for an extension under paragraph (a)(3) or (b)(1) of this section, the Board may consider all the facts and circumstances related to the activity, investment, or fund, including, to the extent relevant—

(i) Whether the activity or investment—

(A) Involves or results in material conflicts of interest between the banking entity and its clients, customers or counterparties;

(B) Would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;

(C) Would pose a threat to the safety and soundness of the banking entity; or

(D) Would pose a threat to the financial stability of the United States;

(ii) Market conditions;

(iii) The nature of the activity or investment;

(iv) The date that the banking entity's contractual obligation to make or retain an investment in the fund was incurred and when it expires;

(v) The contractual terms governing the banking entity's interest in the fund;

(vi) The degree of control held by the banking entity over investment decisions of the fund;

(vii) The types of assets held by the fund, including whether any assets that were illiquid when first acquired by the fund have become liquid assets, such as, for example, because any statutory, regulatory, or contractual restrictions on the offer, sale, or transfer of such assets have expired;

(viii) The date on which the fund is expected to wind up its activities and liquidate, or its investments may be redeemed or sold;

(ix) The total exposure of the banking entity to the activity or investment and the risks that disposing of, or maintaining, the investment or activity may pose to the banking entity or the financial stability of the United States;

(x) The cost to the banking entity of divesting or disposing of the activity or investment within the applicable period;

(xi) Whether the divestiture or conformance of the activity or investment would involve or result in a material conflict of interest between the banking entity and unaffiliated clients, customers or counterparties to which it owes a duty;

(xii) The banking entity's prior efforts to divest or conform the activity or investment(s), including, with respect to an illiquid fund, the extent to which the banking entity has made efforts to terminate or obtain a waiver of its contractual obligation to take or retain an equity, partnership, or other ownership interest in, or provide additional capital to, the illiquid fund; and

(xiii) Any other factor that the Board believes appropriate.

(2) *Timing of Board review.* The Board will seek to act on any request for an extension under paragraph (a)(3) or (b)(1) of this section no later than 90 calendar days after the receipt of a complete record with respect to such request.

(3) *Consultation.* In the case of a banking entity that is primarily supervised by another Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, the Board will consult with such agency prior to the

approval of a request by the banking entity for an extension under paragraph (a)(3) or (b)(1) of this section.

(e) *Authority to impose restrictions on activities or investments during any extension period*—(1) *In general.* The Board may impose such conditions on any extension approved under paragraph (a)(3) or (b)(1) of this section as the Board determines are necessary or appropriate to protect the safety and soundness of the banking entity or the financial stability of the United States, address material conflicts of interest or other unsound banking practices, or otherwise further the purposes of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart.

(2) *Consultation.* In the case of a banking entity that is primarily supervised by another Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, the Board will consult with such agency prior to imposing conditions on the approval of a request by the banking entity for an extension under paragraph (a)(3) or (b)(1) of this section.

§ 225.182 Conformance Period for Nonbank Financial Companies Supervised by the Board Engaged in Proprietary Trading or Private Fund Activities.

(a) *Divestiture Requirement.* A nonbank financial company supervised by the Board shall come into compliance with all applicable requirements of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart, including any capital requirements or quantitative limitations adopted thereunder and applicable to the company, not later than 2 years after the date the company becomes a nonbank financial company supervised by the Board.

(b) *Extensions.* The Board may, by rule or order, extend the two-year period under paragraph (a) by not more than three separate one-year periods, if, in the judgment of the Board, each such one-year extension is consistent with the purposes of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart and would not be detrimental to the public interest.

(c) *Approval Required to Hold Interests in Excess of Time Limit.* A nonbank financial company supervised by the Board that seeks the Board's approval for an extension of the conformance period under paragraph (b) of this section must—

(1) Submit a request in writing to the Board at least 180 days prior to the expiration of the applicable time period;

(2) Provide the reasons why the nonbank financial company supervised by the Board believes the extension should be granted; and

(3) Provide a detailed explanation of the company's plan for conforming the activity or investment(s) to any applicable requirements established under section 13(a)(2) or (f)(4) of the Bank Holding Company Act (12 U.S.C. 1851(a)(2) and (f)(4)).

(d) *Factors governing Board determinations*—(1) *In general.* In reviewing any application for an extension under paragraph (b) of this section, the Board may consider all the facts and circumstances related to the nonbank financial company and the request including, to the extent determined relevant by the Board, the factors described in § 225.181(d)(1).

(2) *Timing.* The Board will seek to act on any request for an extension under paragraph (b) of this section no later than 90 calendar days after the receipt of a complete record with respect to such request.

(f) *Authority to impose restrictions on activities or investments during any extension period.* The Board may impose conditions on any extension approved under paragraph (b) of this section as the Board determines are necessary or appropriate to protect the safety and soundness of the nonbank financial company or the financial stability of the United States, address material conflicts of interest or other unsound practices, or otherwise further the purposes of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart.

Subpart L—Conditions to Orders

SOURCE: 76 FR 8275, Feb. 14, 2011, unless otherwise noted.

§ 225.200 Conditions to Board's section 20 orders.

(a) *Introduction.* Under section 20 of the Glass-Steagall Act (12 U.S.C. 377) and section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. 1843(c)(8)), a nonbank subsidiary of a bank holding company may to a limited extent underwrite and deal in securities for which underwriting and dealing by a member bank is prohibited. Pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934, these so-called section 20 subsidiaries are required to register with the SEC as broker-dealers and are subject to all the financial reporting, anti-fraud and financial responsibility rules applicable to broker-dealers. In addition, transactions between insured depository institutions and their section 20 affiliates are restricted by sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c and 371c–1). The Board expects a section 20 subsidiary, like any other subsidiary of a bank holding company, to be operated prudently. Doing so would include observing corporate formalities (such as the maintenance of separate accounting and corporate records), and instituting appropriate risk management, including independent trading and exposure limits consistent with parent company guidelines.

(b) *Conditions.* As a condition of each order approving establishment of a section 20 subsidiary, a bank holding company shall comply with the following conditions.

(1) *Capital.* (i) A bank holding company shall maintain adequate capital on a fully consolidated basis. If operating a section 20 authorized to underwrite and deal in all types of debt and equity securities, a bank holding company shall maintain strong capital on a fully consolidated basis.

(ii) In the event that a bank or thrift affiliate of a section 20 subsidiary shall become less than well capitalized (as defined in section 38 of the Federal Deposit Insurance Act, 12 U.S.C. 1831o), and the bank holding company shall fail to restore it promptly to the well capitalized level, the Board may, in its discretion, reimpose the funding, credit extension and credit enhancement firewalls contained in its 1989 order allowing underwriting and dealing in bank-ineligible securities,[1] or order the bank holding company to divest the section 20 subsidiary.

(iii) A foreign bank that operates a branch or agency in the United States shall maintain strong capital on a fully consolidated basis at levels above the minimum levels required by the Basle Capital Accord. In the event that the Board determines that the foreign bank's capital has fallen below these levels and the foreign bank fails to restore its capital position promptly, the Board may, in its discretion, reimpose the funding, credit extension and credit enhancement firewalls contained in its 1990 order allowing foreign banks to underwrite and deal in bank-ineligible securities,[2] or order the foreign bank to divest the section 20 subsidiary.

(2) *Internal controls.* (i) Each bank holding company or foreign bank shall cause its subsidiary banks, thrifts, branches or agencies[3] to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in transactions underwritten or arranged by a section 20 affiliate.

(ii) Each bank holding company or foreign bank shall ensure that an independent and thorough credit evaluation has been undertaken in connection with participation by a bank, thrift, or branch or agency in such transactions, and that adequate documentation of that evaluation is maintained for review by examiners of the appropriate federal banking agency and the Federal Reserve.

(3) *Interlocks restriction.* (i) Directors, officers or employees of a bank or thrift subsidiary of a bank holding company, or a bank or thrift subsidiary or branch or agency of a foreign bank, shall not serve as a majority of the

[1] Firewalls 5–8, 19, 21 and 22 of *J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp.*, 75 Federal Reserve Bulletin 192, 214–16 (1989).

[2] Firewalls 5–8, 19, 21 and 22 of *Canadian Imperial Bank of Commerce, The Royal Bank of Canada, Barclays PLC and Barclays Bank PLC*, 76 Federal Reserve Bulletin 158, (1990).

[3] The terms ''branch'' and ''agency'' refer to a U.S. branch and agency of a foreign bank.

board of directors or the chief executive officer of an affiliated section 20 subsidiary.

(ii) Directors, officers or employees of a section 20 subsidiary shall not serve as a majority of the board of directors or the chief executive officer of an affiliated bank or thrift subsidiary or branch or agency, except that the manager of a branch or agency may act as a director of the underwriting subsidiary.

(iii) For purposes of this standard, the manager of a branch or agency of a foreign bank generally will be considered to be the chief executive officer of the branch or agency.

(4) *Customer disclosure*—(i) *Disclosure to section 20 customers.* A section 20 subsidiary shall provide, in writing, to each of its retail customers,[4] at the time an investment account is opened, the same minimum disclosures, and obtain the same customer acknowledgment, described in the Interagency Statement on Retail Sales of Nondeposit Investment Products (Statement) as applicable in such situations. These disclosures must be provided regardless of whether the section 20 subsidiary is itself engaged in activities through arrangements with a bank that is covered by the Statement.

(ii) *Disclosures accompanying investment advice.* A director, officer, or employee of a bank, thrift, branch or agency may not express an opinion on the value or the advisability of the purchase or the sale of a bank-ineligible security that he or she knows is being underwritten or dealt in by a section 20 affiliate unless he or she notifies the customer of the affiliate's role.

(5) *Intra-day credit.* Any intra-day extension of credit to a section 20 subsidiary by an affiliated bank, thrift, branch or agency shall be on market terms consistent with section 23B of the Federal Reserve Act.

(6) *Restriction on funding purchases of securities during underwriting period.* No bank, thrift, branch or agency shall knowingly extend credit to a customer secured by, or for the purpose of purchasing, any bank-ineligible security that a section 20 affiliate is underwriting or has underwritten within the past 30 days, unless:

(i) The extension of credit is made pursuant to, and consistent with any conditions imposed in a preexisting line of credit that was not established in contemplation of the underwriting; or

(ii) The extension of credit is made in connection with clearing transactions for the section 20 affiliate.

(7) *Reporting requirement.* (i) Each bank holding company or foreign bank shall submit quarterly to the appropriate Federal Reserve Bank any FOCUS report filed with the NASD or other self-regulatory organizations, and any information required by the Board to monitor compliance with these operating standards and section 20 of the Glass-Steagall Act, on forms provided by the Board.

(ii) In the event that a section 20 subsidiary is required to furnish notice concerning its capitalization to the Securities and Exchange Commission pursuant to 17 CFR 240.17a–11, a copy of the notice shall be filed concurrently with the appropriate Federal Reserve Bank.

(8) *Foreign banks.* A foreign bank shall ensure that any extension of credit by its branch or agency to a section 20 affiliate, and any purchase by such branch or agency, as principal or fiduciary, of securities for which a section 20 affiliate is a principal underwriter, conforms to sections 23A and 23B of the Federal Reserve Act, and that its branches and agencies not advertise or suggest that they are responsible for the obligations of a section 20 affiliate, consistent with section 23B(c) of the Federal Reserve Act.

[62 FR 45306, Aug. 27, 1997, as amended by Reg. Y, 63 FR 14804, Mar. 27, 1998]

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

I. OVERVIEW

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

[4] For purposes of this operating standard, a retail customer is any customer that is not an "accredited investor" as defined in 17 CFR 230.501(a).

the capital adequacy of bank holding companies (*banking organizations*).[1] 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.[4]

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 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; and management's ability to monitor and control financial and operating risks.

[1] Supervisory ratios that relate capital to total assets for bank holding companies are outlined in appendices B and D of this part.

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

[3] Banking 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.

[4] [Reserved]

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.

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

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 to the United States Department of the Treasury (Treasury) under the Troubled Asset Relief Program (TARP), established by the Emergency Economic Stabilization Act of 2008 (EESA), Division A of Public Law 110–343 (which for purposes of this appendix shall be considered qualifying noncumulative perpetual preferred stock), including related surplus;

iii. Minority interest related to qualifying common or noncumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary (Class A minority interest); and

iv. Restricted core capital elements. The aggregate of these items is limited within tier 1 capital as set forth in section II.A.1.b. of this appendix. These elements are defined to include:

(1) Qualifying cumulative perpetual preferred stock (including related surplus);

(2) Minority interest related to qualifying cumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary (Class B minority interest);

(3) Minority interest related to qualifying common stockholders' equity or perpetual preferred stock issued by a consolidated subsidiary that is neither a U.S. depository institution nor a foreign bank (Class C minority interest);

(4) Qualifying trust preferred securities; and

(5) Subordinated debentures issued prior to October 4, 2010, to the Treasury under the TARP (TARP Subordinated Securities) established by the EESA by a bank holding company that has made a valid election to be taxed under Subchapter S of Chapter 1 of the U.S. Internal Revenue Code (S-Corp BHC) or by a bank holding company organized in mutual form (Mutual BHC).

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[5]) that may be included in the tier 1 capital of an internationally active banking organization[6] 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 excess 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 limitation 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

[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.

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 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 net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized holding gains (losses) on available-for-sale debt securities are not included in 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 for cash or cash equivalents will render the instrument ineligible as a component 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 direction 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 issuer 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.[7] Similarly, perpetual preferred stock that has a dividend rate step-up or a market value conversion 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 noncumulative generally may not permit the accumulation or payment of unpaid dividends in any form, including in the form of common stock. Perpetual preferred stock that provides for the accumulation or future payment of unpaid dividends is deemed to be cumulative, regardless of whether or not it is called noncumulative.

iii. *Qualifying minority interest.* Minority interest in the common and preferred stockholders' equity accounts of a consolidated subsidiary (minority interest) represents stockholders' equity associated with common or preferred equity instruments issued by a banking organization's consolidated subsidiary that are held by investors other than the banking organization. Minority interest 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 interest 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 reason, this appendix distinguishes among three types of qualifying minority interest. Class A minority interest is minority interest related to qualifying common and noncumulative perpetual preferred equity instruments issued directly (that is, not through a subsidiary) by a consolidated U.S. depository institution[9] or foreign bank[10] subsidiary of a banking organization. Class A minority interest is not subject to a formal limitation within tier 1 capital. Class B minority interest is minority interest related to qualifying cumulative perpetual preferred equity instruments 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 minority interest is minority interest related to qualifying common or perpetual preferred stock issued by a banking organization's consolidated subsidiary that is neither a U.S. depository institution nor a foreign bank. Class C minority interest is eligible for inclusion in tier 1 capital as a restricted core capital element and is subject to the limitations set forth in sections II.A.1.b.i. and II.A.2.d.iv. of this appendix. Minority interest in small business investment companies, investment funds that hold nonfinancial equity investments (as defined in section II.B.5.b. of this appendix), and subsidiaries engaged in nonfinancial activities are not included 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.

iv. *Qualifying trust preferred securities.*

(1) A banking organization that wishes to issue trust preferred securities and include them in tier 1 capital must first consult with

[7] Traditional floating-rate or adjustable-rate perpetual preferred stock (that is, perpetual preferred stock in which the dividend rate is not affected by the issuer's credit standing or financial condition but is adjusted periodically in relation to an independent index based solely on general market interest rates), however, generally qualifies for inclusion in tier 1 capital provided all other requirements are met.

[8] Notwithstanding this provision, senior perpetual preferred stock issued to the Treasury under the TARP, established by the EESA, may be included in tier 1 capital. In addition, traditional convertible perpetual preferred stock, which the holder must or can convert into a fixed number of common shares at a preset price, generally qualifies for inclusion in tier 1 capital provided all other requirements are met.

[9] U.S. depository institutions are defined to include branches (foreign and domestic) of federally insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, and international banking facilities of domestic banks.

[10] For this purpose, a foreign bank is defined as an institution that engages in the business of banking; is recognized as a bank by the bank supervisory or monetary authorities of the country of its organization or principal banking operations; receives deposits to a substantial extent in the regular course of business; and has the power to accept demand deposits.

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[12] 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 qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill, other

[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 amount of the trust preferred securities includable in regulatory capital must, consistent with section II.(i) of this appendix, be reduced by the notional amount of the banking organization's investment in the security issued by the pooling entity.

[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 non-complying 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.

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

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

a. *Allowance for loan and lease losses*. Allowances for loan and lease losses are reserves that have been established through a charge against earnings to absorb future losses on loans or lease financing receivables. Allowances for loan and lease losses exclude ''allocated transfer risk reserves,''[13] and reserves created against identified losses.

During the transition period, the risk-based capital guidelines provide for reducing the amount of this allowance that may be included in an institution's total capital. Initially, it is unlimited. However, by year-end 1990, the amount of the allowance for loan and lease losses that will qualify as capital will be limited to 1.5 percent of an institution's weighted risk assets. By the end of the transition period, the amount of the allowance qualifying for inclusion in Tier 2 capital may not exceed 1.25 percent of weighted risk assets.[14]

b. *Perpetual preferred stock*. Perpetual preferred stock (and related surplus) that meets the requirements set forth in section II.A.1.c.ii.(1) of this appendix is eligible for inclusion in tier 2 capital without limit.[15]

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.

d. *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 banking organization.

ii. *Other restrictions on subordinated debt*. Subordinated debt included in tier 2 capital

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

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

[15] Long-term preferred stock with an original maturity of 20 years or more (including related surplus) will also qualify in this category as an element of tier 2 capital. If the holder of such an instrument has the right to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined for risk-based capital purposes as the earliest possible date on which the holder can put the instrument back to the issuing banking organization. In the last five years before the maturity of the stock, it must be treated as limited-life preferred stock, subject to the amortization provisions and quantitative restrictions set forth in sections II.A.2.d.iii. and iv. of this appendix.

must comply with the Federal Reserve's subordinated debt policy statement set forth in 12 CFR 250.166.[16] 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 the 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.* i. Such reserves reflect the formal balance sheet restatement or revaluation for capital purposes of asset carrying values to reflect current market values. The Federal 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

[16] The subordinated debt policy statement set forth in 12 CFR 250.166 notes that certain terms found in subordinated debt may provide protection to investors without adversely affecting the overall benefits of the instrument to the issuing banking organization and, thus, would be acceptable for subordinated debt included in capital. For example, a provision that prohibits a bank holding company from merging, consolidating, or selling substantially all of its assets unless the new entity redeems or assumes the subordinated debt or that designates the failure to pay principal and interest on a timely basis as an event of default would be acceptable, so long as the occurrence of such events does not allow the debt holders to accelerate the payment of principal or interest on the debt.

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.[17] These assets include:

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

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

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

(ii) Investments in banking and finance subsidiaries that are not consolidated for accounting or supervisory purposes, and investments in other designated subsidiaries or associated companies at the discretion of the Federal Reserve—deducted from total capital components (as described in greater detail below).

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

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

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

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

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

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

c. *Credit-enhancing interest-only strips receivables (I/Os)* i. Credit-enhancing I/Os are on-balance sheet assets that, in form or in substance, represent a contractual right to receive some or all of the interest due on transferred assets and expose the bank holding company to credit risk directly or indirectly associated with 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. Such I/Os, whether purchased or retained, including other similar ''spread'' assets, may be included in, that is, not deducted from, a bank holding company's capital subject to the limitations described below in sections II.B.1.d. and e. of this appendix.

ii. Both purchased and retained credit-enhancing I/Os, on a non-tax adjusted basis, are included in the total amount that is used for purposes of determining whether a bank holding company exceeds the tier 1 limitation described below in this section. In determining whether an I/O or other types of spread assets serve as a credit enhancement, the Federal Reserve will look to the economic substance of the transaction.

d. *Fair value limitation*. The amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that a bank 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,

[17] Any assets deducted from capital in computing the numerator of the ratio are not included in weighted risk assets in computing the denominator of the ratio.

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 when determining the amount of deferred tax assets that are dependent upon future taxable income.

f. *Valuation.* Bank holding companies must review the book value of 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 are deemed to be capital in the particular subsidiary.

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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.

[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.

Advances (that is, loans, extensions of credit, guarantees, commitments, or any other forms of credit exposure) to the subsidiary that are not deemed to be capital will generally not be deducted from 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]

In general, when investments in a consolidated subsidiary are deducted from a consolidated parent banking organization's capital, the subsidiary's assets will also be excluded from the consolidated assets of the parent banking organization in order to assess the latter's capital adequacy.[23]

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.

The Federal Reserve will not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies.[24] 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, instruments 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.

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.[25]

4. *Deferred-tax assets.* a. The amount of deferred-tax assets that is dependent upon future taxable income, net of the valuation allowance for deferred-tax assets, that may be included in, that is, not deducted from, a bank 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,[26] or

ii. 10 percent of tier 1 capital.

[24] 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.

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

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

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 equity 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 BHC Act in a nonfinancial company or in a company that makes investments in nonfinancial companies; in a nonfinancial company through a small business investment company (SBIC) under section 302(b) of the Small Business Investment Act of 1958;[27] 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)).[28] 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

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) [1]	Deduction from Core Capital Elements (as a percentage of the adjusted carrying value of the investment)
Less than 15 percent	8 percent.
15 percent to 24.99 percent	12 percent.
25 percent and above	25 percent.

[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

[27] An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in an SBIC that is not consolidated with the parent banking organization is treated as a nonfinancial equity investment.

[28] *See* 12 U.S.C. 1843(c)(6), (c)(7) and (k)(4)(H); 15 U.S.C. 682(b); 12 CFR 211.5(b)(1)(iii); and 12 U.S.C. 1831a. In a case in which the Board of Directors of the FDIC, 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]

iv. As noted in section I, this appendix establishes *minimum* risk-based capital ratios and banking organizations are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a banking organization from nonfinancial equity investments increases with its concentration in such investments and strong capital levels above the minimum requirements are particularly important when a banking organization has a high degree of concentration in nonfinancial equity investments (*e.g.*, in excess of 50 percent of Tier 1 capital). The Federal Reserve intends to monitor banking organizations and apply heightened supervision to equity investment activities as appropriate, including where the banking organization has a high degree of concentration in nonfinancial equity investments, to ensure that each organization maintains capital levels that are appropriate in light of its equity investment activities. The Federal Reserve also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the banking organization, or other information, indicate that a higher minimum capital requirement is appropriate.

d. *SBIC investments.* i. No deduction is required for nonfinancial equity investments that are held by a bank 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 of the bank holding company's pro rata interests in the Tier 1 capital of its subsidiary banks. Any nonfinancial equity investment that is held through or in an SBIC and not required to be deducted from Tier 1 capital under this section II.B.5.d. will be assigned a 100 percent risk-weight and included in the 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 1) 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 1, 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

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

[30] 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 percentage of 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'' 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 any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.5.e. must be included in determining the total amount of nonfinancial equity investments held by the bank holding company in relation to its Tier 1 capital for purposes of Table 1. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.5.e. will be assigned a 100-percent risk weight and included in the bank holding company's consolidated risk-weighted assets.

f. *Adjusted carrying value.* i. For purposes of this section II.*B*.5., the ''adjusted carrying value'' of investments is the aggregate value at which the investments are carried on the balance sheet of the consolidated bank holding company reduced by any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank holding company's Tier 1 capital and associated deferred tax liabilities. For example, for investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank holding company) *less* any unrealized gains on those investments that are included in other comprehensive income and not reflected in Tier 1 capital, and associated deferred tax liabilities.[33]

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

g. *Equity investments.* For purposes of this section II.*B*.5, an equity investment means any equity instrument (including common stock, preferred stock, partnership interests, interests in limited liability companies,

[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. In addition, if the bank holding company sold and repurchased shares of the company after March 13, 2000, the adjusted carrying value of the re-acquired shares 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*.5.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]

Components	Minimum requirements
CORE CAPITAL (Tier 1)	Must equal or exceed 4% of weighted-risk assets.
Common stockholders' equity	No limit.
Qualifying noncumulative perpetual preferred stock	No limit; bank holding companies should avoid undue reliance on preferred stock in tier 1.
Qualifying cumulative perpetual preferred stock	Limited to 25% of the sum of common stock, qualifying perpetual stock, and minority interests.
Minority interest in equity accounts of consolidated subsidiaries.	Organizations should avoid using minority interests to introduce elements not otherwise qualifying for tier 1 capital.
Less: Goodwill, other intangible assets, credit-enhancing interest-only strips and nonfinancial equity investments required to be deducted from capital [1]	
SUPPLEMENTARY CAPITAL (Tier 2)	Total of tier 2 is limited to 100% of tier 1. [2]
Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets. [2]
Perpetual preferred stock	No limit within tier 2.
Hybrid capital instruments and equity contract notes	No limit within tier 2.
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more).	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1 [2]; amortized for capital purposes as they approach maturity.
Revaluation reserves (equity and building)	Not included; organizations encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making an overall assessment of capital.
DEDUCTIONS (from sum of tier 1 and tier 2)	
Investments in unconsolidated subsidiaries	As a general rule, one-half of the aggregate investments will be deducted from tier 1 capital and one-half from tier 2 capital. [3]
Reciprocal holdings of banking organizations' capital securities	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority.	On a case-by-case basis or as a matter of policy after a formal rulemaking.
TOTAL CAPITAL (tier 1 + tier 2 − deductions)	Must equal or exceed 8% of weighted-risk assets.

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

* 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.

III. PROCEDURES FOR COMPUTING WEIGHTED RISK ASSETS AND OFF-BALANCE SHEET ITEMS

A. Procedures

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

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

In general, if a particular item qualifies for placement in more than one risk category, it is assigned to the category that has the lowest risk weight. A holding of a U.S. municipal revenue bond that is fully guaranteed by a U.S. bank, for example, would be assigned the 20 percent risk weight appropriate to claims guaranteed by U.S. banks, rather than the 50 percent risk weight appropriate to U.S. municipal revenue bonds.[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 bank holding company that are incommensurate with the risk weight otherwise specified below for the asset or off-balance sheet item. In addition, the Federal Reserve will, on a case-by-case basis, determine the appropriate credit conversion factor for any off-balance sheet item that does not fit wholly within the terms of one of the credit conversion factors set forth below or that imposes risks on a banking organization that are incommensurate with the credit conversion factors otherwise specified below for the off-balance sheet item. In making such a determination, the Federal Reserve will consider the similarity of the asset or off-balance sheet item to assets or off-balance sheet items explicitly treated in the guidelines, as well as other relevant factors.

B. Collateral, Guarantees, and Other Considerations

1. *Collateral.* The only forms of collateral that are formally recognized by the risk-based capital framework are: Cash on deposit in a subsidiary lending institution; securities issued or guaranteed by the central governments of the OECD-based group of countries,[35] 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

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

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

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

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

The existence of other forms of collateral or guarantees that the risk-based capital framework does not formally recognize may be taken into consideration in evaluating the risks inherent in 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* means 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 or nonperformance of another party or from an insufficiency in the value of the collateral. Credit-enhancing representations and warranties do not include:

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

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

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

iii. *Direct credit substitute* means an arrangement in which a bank 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 (third-party asset) and the risk assumed by the bank holding company exceeds the pro rata share of the bank holding company's interest in the third-party asset. If the bank holding company has no claim on 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 loan is shorter than the maturity of the commitment under which the loan is drawn;

6. Credit derivatives issued that absorb more than the bank 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 I/Os, spread accounts, cash collateral accounts, retained subordinated interests, other forms of over-collateralization, and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the bank 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 I/Os are residual interests for purposes of this appendix.

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

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

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

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

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

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

ii. *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.

c. *Externally-rated positions: credit-equivalent amounts and risk weights of recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities (including asset-backed commercial paper)*—i. *Traded positions.* With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing I/Ostrip) 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.

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

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

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

1. It has been externally rated by more than one NRSRO;

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

3. The ratings are publicly available; and

4. The ratings are based on the same criteria used to rate traded positions.

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

d. *Senior positions not externally rated.* For a recourse obligation, direct credit substitute, residual interest, or asset-or mortgage-backed security that is not externally rated but is senior or preferred in all features to a traded position (including collateralization and maturity), a bank 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. 1.* If a residual interest does not meet the requirements of sections III.B.3.c. or d. of this appendix, a bank holding 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.

2. 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.*1.* of this appendix or the full risk-based capital requirement for the assets transferred.

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

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

i. *Internal risk rating used for asset-backed programs.* A direct credit substitute (other than a purchased credit-enhancing I/O) is assumed in connection with an asset-backed commercial paper program sponsored by the bank holding company and the bank holding company is able to demonstrate to the satisfaction of the Federal Reserve, prior to relying upon its use, that the bank holding company's internal credit risk rating system is adequate. Adequate internal credit risk rating systems usually contain the following criteria:

1. The internal credit risk system is an integral part of the bank 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.

ii. *Program Ratings.* A direct credit substitute or recourse obligation (other than a residual interest) is assumed or retained in connection with a structured finance program and a NRSRO has reviewed the terms of the program and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal credit enhancements and other relevant factors, and the NRSRO specifies ranges of rating categories to them, the bank holding company may apply the rating category that corresponds to the bank holding company's position. In order to rely on a program rating, the bank holding company must demonstrate to the Federal Reserve's satisfaction that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The bank holding company must also demonstrate to the Federal Reserve's satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular position. If a bank 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.

iii. *Computer Program.* 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 loans, 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 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 *remaining* maturity. In the case of commitments, short-term is defined as one year or less *original* maturity and long-term is defined as over one year *original* maturity.

5. *Small Business Loans and Leases on Personal Property Transferred with Recourse*. a. Notwithstanding other provisions of this appendix A, a qualifying 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. 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 not required to hold duplicative risk-based capital under this appendix against the overlapping position. Instead, the bank holding company should apply to the overlapping position the applicable risk-based capital treatment that results in the highest capital charge.

C. Risk Weights

Attachment III contains a listing of the risk categories, a summary of the types of assets assigned to each category and the 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[37] of the OECD countries and U.S. Government agencies,[38] as well as all direct local currency claims on, and the portions of local currency claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that 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 guaranteed by,[39] U.S. depository institutions[40] and foreign banks[41]; and long-term

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

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

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

[39] 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.

[40] *See* footnote 9 of this appendix for the definition of a U.S. depository institution. 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.

[41] *See* footnote 10 of this appendix for the definition of a foreign bank. Foreign banks

Continued

claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions and OECD banks.[42]

b. This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. Government agencies, as well as the portions of local currency claims that are conditionally guaranteed by non-OECD central governments, to the extent that 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[43] agencies and claims on, and the portions of claims guaranteed by, the International Bank for Reconstruction and Development (World Bank), the International Finance Corporation, the Interamerican Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. General obligation claims on, or portions of claims guaranteed by the full faith and credit of, states or other political subdivisions of the U.S. or other countries of the OECD—based group are also assigned to this category.[44]

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

d. This category also includes claims[45] on, or guaranteed by, a qualifying securities firm[46] incorporated in the United States or 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

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are distinguished as either OECD banks or non-OECD banks. OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries (other than the United States) that belong to the OECD-based group of countries. Non-OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries that do not belong to the OECD-based group of countries.

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

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

[44] Claims on, or guaranteed by, states or other political subdivisions of countries that do not belong to the OECD-based group of countries are placed in the 100 percent risk category.

[45] 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.

[46] 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. Such regulation must include risk-based capital requirements comparable to those applied to banks under the Accord on International Convergence of Capital Measurement and Capital Standards (1988, as amended in 1998) (Basel Accord).

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/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. [47]

3. *Category 3: 50 percent.* This category includes loans fully secured by first liens [48] on 1- to 4-family residential properties, either owner-occupied or rented, or on multifamily residential properties,[49] that meet certain criteria.[50] Loans included in this category must have been made in accordance with prudent underwriting standards; [51] be performing in accordance with their original terms; and not be 90 days or more past due or carried in nonaccrual status. For purposes of this 50 percent risk weight category, a loan modified on a permanent or trial basis solely pursuant to the U.S. Department of Treasury's Home Affordable Mortgage Program will be considered to be performing in accordance with its original terms. The following additional criteria must also be applied to a loan secured by a multifamily residential property that is included in this category: all principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or in the case where the existing property owner is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; amortization of the principal and interest must occur over a period of not more than 30 years and the minimum original maturity for repayment of principal must not be less than 7 years; and the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is

[47] For 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 555 or 559 of the Bankruptcy Code, respectively (11 U.S.C. 555 or 559), a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407), or the Board's Regulation EE (12 CFR Part 231).

[48] If 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.

[49] Loans that qualify as loans secured by 1- to 4-family residential properties or multifamily residential properties are listed in the instructions to the FR Y–9C Report. In addition, for risk-based capital purposes, loans secured by 1- to 4-family residential properties include loans to builders with substantial project equity for the construction of 1- to 4-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest money deposits. Such loans to builders will be considered prudently underwritten only if the bank holding company has obtained sufficient documentation that the buyer of the home intends to purchase the home (*i.e.*, has a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (*i.e.*, has a firm written commitment for permanent financing of the home upon completion).

[50] Residential property loans that do not meet all the specified criteria or that are made for the purpose of speculative property development are placed in the 100 percent risk category.

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

based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in this category are privately-issued mortgage-backed securities provided that:

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

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

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

(4) If the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due. Privately-issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

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

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

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

b. This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[52] This category includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the organization on acceptances outstanding involving standard risk claims;[53] investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; all stripped mortgage-backed securities and similar instruments; and commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight). This category also includes claims representing capital of a qualifying securities firm.

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

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

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

[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.

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 participation[56] 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]

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

[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 category is appropriate to the obligor, guarantor, or collateral.

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

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

ii. 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.

[59] For example, if a banking organization has a 10 percent share of a $10 syndicated direct credit substitute that provides credit support to a $100 loan, then the banking organization's $1 *pro rata* share in the enhancement means that a $10 *pro rata* share of the loan is included in risk weighted assets.

[60] In the case of consumer home equity or mortgage lines of credit secured by liens on 1–4 family residential properties, the bank is deemed able to unconditionally cancel the commitment for the purpose of this criterion if, at its option, it can prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by relevant Federal law.

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, or which are unconditionally cancelable at any time, provided a separate credit decision is made before each drawing under the facility. Unused portions of lines of credit on retail credit cards and related plans are deemed to be short-term commitments if the 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 positive, then the current exposure is equal to that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract and should reflect changes in underlying rates, prices, and indices, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit conversion factor. 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:

CONVERSION FACTORS

[In percent]

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

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

e. For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest rate, 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.[61]

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

[61] A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

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.[62]

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

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

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

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

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

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

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

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

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

4. *Risk Weights*. Once the credit equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral.[63] However,

[62] 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.

[63] For derivative contracts, sufficiency of collateral or guarantees is generally determined by the market value of the collateral or the amount of the guarantee in relation to the credit equivalent amount. Collateral

Continued

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[64] 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 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

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and guarantees are subject to the same provisions noted under section III.*B.* of this appendix A.

[64] As 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.

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.

OBS item	Face value		Conversion factor		Credit equivalent amount
SLCS backing municipal GOs	$10,000	×	1.00	=	$10,000
Long-term commitments to private corporations	$20,000	×	0.50	=	$10,000

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

0% Category:					
Cash	5,000				
U.S. Treasuries	20,000				
	25,000	×	0	=	0
20% Category:					
Balances at domestic banks	5,000				
Credit equivalent amounts of SLCs backing GOs of U.S. municipalities	10,000				
	15,000	×	.20	=	$3,000
50% Category:					
Loans secured by first liens on 1–4 family residential properties	5,000	×	.50	=	$2,500
100% Category:					
Loans to private corporations	65,000				
Credit equivalent amounts of long-term commitments to private corporations	10,000				
	$75,000	×	1.00	=	75,000
Total Risk-weighted Assets					80,500

This bank holding company's ratio of total capital to weighted risk assets (risk-based capital ratio) would be: ($6,000/$80,500)=7.45%

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

This section IV.C. provides optional transition provisions for a banking organization that is required for financial and regulatory reporting purposes, as a result of its implementation of Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167), to consolidate certain variable interest entities

(VIEs) as defined under United States generally accepted accounting principles (GAAP). These transition provisions apply through the end of the fourth quarter following the date of a banking organization's implementation of FAS 167 (implementation date).

1. Exclusion Period

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

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

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

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

(*3*) The banking organization must consolidate the VIE on its balance sheet beginning as of the implementation date as a result of its implementation of FAS 167, and

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

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

(*1*) The banking organization is the sponsor of the ABCP program,

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

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

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

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

2. Phase-In Period

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

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

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

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

[Reg. Y, 54 FR 4209, Jan. 27, 1989]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting appendix A to part 225, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

Appendix B to Part 225—Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks: Leverage Measure

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 this part and in appendix A to part 208, a banking organization may choose to fulfill the requirements of the guidelines relating capital to total assets contained in this appendix in one of 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 this part and appendix A to part 208. Those 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:

Total Capital Ratio

[In percent]

Zone 1	Above 7.0.
Zone 2	6.0 to 7.0.
Zone 3	Below 6.0.

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.[1] Some banking organizations are engaged in significant nonbanking activities that typically require capital ratios higher than those of commercial banks alone. The Board believes that, as a matter of both safety and soundness and competitive equity, the degree of leverage common in banking should not automatically extend to nonbanking activities. Consequently, in evaluating the consolidated capital positions

[1] The guidelines will apply to bank holding companies with less than $150 million in consolidated assets on a bank-only basis unless:

(1) The holding company or any nonbank subsidiary is engaged directly or indirectly in any nonbank activity involving significant leverage or

(2) The holding company or any nonbank subsidiary has outstanding significant debt held by the general public. Debt held by the general public is defined to mean debt held by parties other than financial institutions, officers, directors, and controlling shareholders of the banking organization or their related interests.

of banking organizations, the Board is placing greater weight on the building-block approach for assessing capital requirements. This approach generally provides that nonbank subsidiaries of a banking organization should maintain levels of capital consistent with the levels that have been established by industry norms or standards, by Federal or State regulatory agencies for similar firms that are not affiliated with banking organizations, or that may be established by the Board after taking into account risk factors of a particular industry. The assessment of an organization's consolidated capital adequacy must take into account the amount and nature of all nonbank activities, and an institution's consolidated capital position should at least equal the sum of the capital requirements of the organization's bank and nonbank subsidiaries as well as those of the parent company.

SUPERVISORY ACTION

The nature and intensity of supervisory action will be determined by an organization's compliance with the required minimum primary capital ratio as well as by the zone in which the company's total capital ratio falls. Banks and bank holding companies with primary capital ratios below the 5.5 percent minimum will be considered undercapitalized unless they can demonstrate clear extenuating circumstances. Such banking organizations will be required to submit an acceptable plan for achieving compliance with the capital guidelines and will be subject to denial of applications and appropriate supervisory enforcement actions.

The zone in which an organization's total capital ratio falls will normally trigger the following supervisory responses, subject to qualitative analysis:

For institutions operating in Zone 1, the Federal Reserve will:

—Consider that capital is generally adequate if the primary capital ratio is acceptable to the Federal Reserve and is above the 5.5 percent minimum.

For institutions operating in Zone 2, the Federal Reserve will:

—Pay particular attention to financial factors, such as asset quality, liquidity, off-balance sheet risk, and interest rate risk, as they relate to the adequacy of capital. If these areas are deficient and the Federal Reserve concludes capital is not fully adequate, the Federal Reserve will intensify its monitoring and take appropriate supervisory action.

For institutions operating in Zone 3, the Federal Reserve will:

—Consider that the institution is undercapitalized, absent clear extenuating circumstances;

—Require the institution to submit a comprehensive capital plan, acceptable to the Federal Reserve, that includes a program for achieving compliance with the required minimum ratios within a reasonable time period; and

—Institute appropriate supervisory and/or administrative enforcement action, which may include the issuance of a capital directive or denial of applications, unless a capital plan acceptable to the Federal Reserve has been adopted by the institution.

TREATMENT OF INTANGIBLE ASSETS FOR THE PURPOSE OF ASSESSING THE CAPITAL ADEQUACY OF BANK HOLDING COMPANIES AND STATE MEMBER BANKS

In considering the treatment of intangible assets for the purpose of assessing capital adequacy, the Federal Reserve recognizes that the determination of the future benefits and useful lives of certain intangible assets may involve a degree of uncertainty that is not normally associated with other banking assets. Supervisory concern over intangible assets derives from this uncertainty and from the possibility that, in the event an organization experiences financial difficulties, such assets may not provide the degree of support generally associated with other assets. For this reason, the Federal Reserve will carefully review the level and specific character of intangible assets in evaluating the capital adequacy of state member banks and bank holding companies.

The Federal Reserve recognizes that intangible assets may differ with respect to predictability of any income stream directly associated with a particular asset, the existence of a market for the asset, the ability to sell the asset, or the reliability of any estimate of the asset's useful life. Certain intangible assets have predictable income streams and objectively verifiable values and may contribute to an organization's profitability and overall financial strength. The value of other intangibles, such as goodwill, may involve a number of assumptions and may be more subject to changes in general economic circumstances or to changes in an individual institution's future prospects. Consequently, the value of such intangible assets may be difficult to ascertain. Consistent with prudent banking practices and the principle of the diversification of risks, banking organizations should avoid excessive balance sheet concentration in any category or related categories of intangible assets.

Bank Holding Companies

While the Federal Reserve will consider the amount and nature of all intangible assets, those holding companies with aggregate intangible assets in excess of 25 percent of tangible primary capital (i.e., stated primary capital less all intangible assets) or those institutions with lesser, although still significant, amounts of goodwill will be subject to close scrutiny. For the purpose of assessing capital adequacy, the Federal Reserve may, on a case-by-case basis, make adjustments to an organization's capital ratios based upon the amount of intangible assets in excess of the 25 percent threshold level or upon the specific character of the organization's intangible assets in relation to its overall financial condition. Such adjustments may require some organizations to raise additional capital.

The Board expects banking organizations (including state member banks) contemplating expansion proposals to ensure that pro forma capital ratios exceed the minimum capital levels without significant reliance on intangibles, particularly goodwill. Consequently, in reviewing acquisition proposals, the Board will take into consideration both the stated primary capital ratio (that is, the ratio without any adjustment for intangible assets) and the primary capital ratio after deducting intangibles. In acting on applications, the Board will take into account the nature and amount of intangible assets and will, as appropriate, adjust capital ratios to include certain intangible assets on a case-by-case basis.

State Member Banks

State member banks with intangible assets in excess of 25 percent of intangible primary capital will be subject to close scrutiny. In addition, for the purpose of calculating capital ratios of state member banks, the Federal Reserve will deduct goodwill from primary capital and total capital. The Federal Reserve may, on a case-by-case basis, make further adjustments to a bank's capital ratios based on the amount of intangible assets (aside from goodwill) in excess of the 25 percent threshold level or on the specific character of the bank's intangible assets in relation to its overall financial condition. Such adjustments may require some banks to raise additional capital.

In addition, state member banks and bank holding companies are expected to review periodically the value at which intangible assets are carried on their balance sheets to determine whether there has been any impairment of value or whether changing circumstances warrant a shortening of amortization periods. Institutions should make appropriate reductions in carrying values and amortization periods in light of this review, and examiners will evaluate the treatment of intangible assets during on-site examinations.

DEFINITION OF CAPITAL TO BE USED IN DETERMINING CAPITAL ADEQUACY OF BANK HOLDING COMPANIES AND STATE MEMBER BANKS

Primary Capital Components

The components of primary capital are:

—Common stock,
—Perpetual preferred stock (preferred stock that does not have a stated maturity date and that may not be redeemed at the option of the holder),
—Surplus (excluding surplus relating to limited-life preferred stock),
—Undivided profits,
—Contingency and other capital reserves,
—Mandatory convertible instruments,[2]
—Allowance for possible loan and lease losses (exclusive of allocated transfer risk reserves),
—Minority interest in equity accounts of consolidated subsidiaries,
—Perpetual debt instruments (for bank holding companies but not for state member banks).

Limits on Certain Forms of Primary Capital

Bank Holding Companies. The maximum composite amount of mandatory convertible securities, perpetual debt, and perpetual preferred stock that may be counted as primary capital for bank holding companies is limited to 33.3 percent of all primary capital, including these instruments. Perpetual preferred stock issued prior to November 20, 1985 (or determined by the Federal Reserve to be in the process of being issued prior to that date), shall continue to be included as primary capital.

The maximum composite amount of mandatory convertible securities and perpetual debt that may be counted as primary capital for bank holding companies is limited to 20 percent of all primary capital, including these instruments. The maximum amount of equity commitment notes (a form of mandatory convertible securities) that may be counted as primary capital for a bank holding company is limited to 10 percent of all primary capital, including mandatory convertible securities. Amounts outstanding in excess of these limitations may be counted as secondary capital provided they meet the requirements of secondary capital instruments.

State Member Banks. The composite limitations on the amount of mandatory convertible securities and perpetual preferred stock (perpetual debt is not primary capital for state member banks) that may serve as primary capital for bank holding companies

[2] See the definitional section below that lists the criteria for mandatory convertible instruments to qualify as primary capital.

shall not be applied formally to state member banks, although the Board shall determine appropriate limits for these forms of primary capital on a case-by-case basis.

The maximum amount of mandatory convertible securities that may be counted as primary capital for state member banks is limited to 16⅔ percent of all primary capital, including mandatory convertible securities. Equity commitment notes, one form of mandatory convertible securities, shall not be included as primary capital for state member banks, except that notes issued by state member banks prior to May 15, 1985, will continue to be included in primary capital. Amounts of mandatory convertible securities in excess of these limitations may be counted as secondary capital if they meet the requirements of secondary capital instruments.

Secondary Capital Components

The components of secondary capital are:

—Limited-life preferred stock (including related surplus) and

—Bank subordinated notes and debentures and unsecured long-term debt of the parent company and its nonbank subsidiaries.

Restrictions Relating to Capital Components

To qualify as primary or secondary capital, a capital instrument should not contain or be covered by any convenants, terms, or restrictions that are inconsistent with safe and sound banking practices. Examples of such terms are those regarded as unduly interfering with the ability of the bank or holding company to conduct normal banking operations or those resulting in significantly higher dividends or interest payments in the event of a deterioration in the financial condition of the issuer.

The secondary components must meet the following conditions to qualify as capital:

—The instrument must have an original weighted-average maturity of at least seven years.

—The instrument must be unsecured.

—The instrument must clearly state on its face that it is not a deposit and is not insured by a Federal agency.

—Bank debt instruments must be subordinated to claims of depositors.

—For banks only, the aggregate amount of limited-life preferred stock and subordinate debt qualifying as capital may not exceed 50 percent of the amount of the bank's primary capital.

As secondary capital components approach maturity, the banking organization must plan to redeem or replace the instruments while maintaining an adequate overall capital position. Thus, the remaining maturity of secondary capital components will be an important consideration in assessing the adequacy of total capital.

Capital Ratios

The primary and total capital ratios for bank holding companies are computed as follows:

Primary capital ratio:

Primary capital components/Total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)

Total capital ratio:

Primary capital components + Secondary capital components/Total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)

The primary and total capital ratios for state member banks are computed as follows:

Primary capital ratio:

Primary capital components—Goodwill/Average total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)—Goodwill

Total capital ratio:

Primary capital components + Secondary capital components—Goodwill/Average total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)—Goodwill

Generally, period-end amounts will be used to calculate bank holding company ratios. However, the Federal Reserve will discourage temporary balance sheet adjustments or any other ''window dressing'' practices designed to achieve transitory compliance with the guidelines. Banking organizations are expected to maintain adequate capital positions at all times. Thus, the Federal Reserve will, on a case-by-case basis, use average total assets in the calculation of bank holding company capital ratios whenever this approach provides a more meaningful indication of an individual holding company's capital position.

For the calculation of bank capital ratios, ''average total assets'' will generally be defined as the quarterly average total assets figure reported on the bank's Report of Condition. If warranted, however, the Federal Reserve may calculate bank capital ratios based upon total assets as of period-end. All other components of the bank's capital ratios will be based upon period-end balances.

CRITERIA FOR DETERMINING THE PRIMARY CAPITAL STATUS OF MANDATORY CONVERTIBLE SECURITIES OF BANK HOLDING COMPANIES AND STATE MEMBER BANKS

Mandatory convertible securities are subordinated debt instruments that are eventually transformed into common or perpetual preferred stock within a specified period of time, not to exceed 12 years. To be counted as primary capital, mandatory convertible securities must meet the criteria set forth below. These criteria cover the two basic types of mandatory convertible securities:

''equity contract notes''—securities that obligate the holder to take common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal, and ''equity commitment notes''—securities that are redeemable only with the proceeds from the sale of common or perpetual preferred stock. Both equity commitment notes and equity contract notes qualify as primary capital for bank holding companies, but only equity contract notes qualify as primary capital for banks.

Criteria Applicable to Both Types of Mandatory Convertible Securities

a. The securities must mature in 12 years or less.

b. The issuer may redeem securities prior to maturity only with the proceeds from the sale of common or perpetual preferred stock of the bank or bank holding company. Any exception to this rule must be approved by the Federal Reserve. The securities may not be redeemed with the proceeds of another issue of mandatory convertible securities. Nor may the issuer repurchase or acquire its own mandatory convertible securities for resale or reissuance.

c. Holders of the securities may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.

d. The securities must be subordinate in right of payment to all senior indebtedness of the issuer. In the event that the proceeds of the securities are reloaned to an affiliate, the loan must be subordinated to the same degree as the original issue.

e. An issuer that intends to dedicate the proceeds of an issue of common or perpetual preferred stock to satisfy the funding requirements of an issue of mandatory convertible securities (i.e. the requirement to retire or redeem the notes with the proceeds from the issuance of common or perpetual preferred stock) generally must make such a dedication during the quarter in which the new common or preferred stock is issued.[3] As a general rule, if the dedication is not made within the prescribed period, then the securities issued may not at a later date be dedicated to the retirement or redemption of the mandatory convertible securities.[4]

Additional Criteria Applicable to Equity Contract Notes

a. The note must contain a contractual provision (or must be issued with a mandatory stock purchase contract) that requires the holder of the instrument to take the common or perpetual stock of the issuer in lieu of cash in satisfaction of the claim for principal repayment. The obligation of the holder to take the common or perpetual preferred stock of the issuer may be waived if, and to the extent that, prior to the maturity date of the obligation, the issuer sells new common or perpetual preferred stock and dedicates the proceeds to the retirement or redemption of the notes. The dedication generally must be made during the quarter in which the new common or preferred stock is issued.

b. A stock purchase contract may be separated from a security only if: (1) The holder of the contract provides sufficient collateral[5] to the issuer, or to an independent trustee for the benefit of the issuer, to assure performance under the contract and (2) the stock purchase contract requires the purchase of common or perpetual preferred stock.

[3] Common or perpetual preferred stock issued under dividend reinvestment plans or issued to finance acquisitions, including acquisitions of business entities, may be dedicated to the retirement or redemption of the mandatory convertible securities. Documentation certified by an authorized agent of the issuer showing the amount of common stock or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.

[4] The dedication procedure is necessary to ensure that the primary capital of the issuer is not overstated. For each dollar of common or perpetual preferred proceeds dedicated to the retirement or redemption of the notes, there is a corresponding reduction in the amount of outstanding mandatory securities that may qualify as primary capital. *De minimis* amounts (in relation to primary capital) of common or perpetual preferred stock issued under arrangements in which the amount of stock issued is not predictable, such as dividend reinvestment plans and employee stock option plans (but excluding public stock offerings and stock issued in connection with acquisitions), should be dedicated by no later than the company's fiscal year end.

[5] Collateral is defined as: (1) Cash or certificates of deposit; (2) U.S. government securities that will mature prior to or simultaneous with the maturity of the equity contract and that have a par or maturity value at least equal to the amount of the holder's obligation under the stock purchase contract; (3) standby letters of credit issued by an insured U.S. bank that is not an affiliate of the issuer; or (4) other collateral as may be designated from time to time by the Federal Reserve.

Additional Criteria Applicable to Equity Commitment Notes

a. The indenture or note agreement must contain the following two provisions:

1. The proceeds of the sale of common or perpetual preferred stock will be the sole source of repayment for the notes, and the issuer must dedicate the proceeds for the purpose of repaying the notes. (Documentation certified by an authorized agent of the issued showing the amount of common or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.)

2. By the time that one-third of the life of the securities has run, the issuer must have raised and dedicated an amount equal to one-third of the original principal of the securities. By the time that two-thirds of the life of the securities has run, the issuer must have raised and dedicated an amount equal to two-thirds of the original principal of the securities. At least 60 days prior to the maturity of the securities, the issuer must have raised and dedicated an amount equal to the entire original principal of the securities. Proceeds dedicated to redemption or retirement of the notes must come only from the sale of common or perpetual preferred stock. [6]

b. If the issuer fails to meet any of these periodic funding requirements, the Federal Reserve immediately will cease to treat the unfunded securities as primary capital and will take appropriate supervisory action. In addition, failure to meet the funding requirements will be viewed as a breach of a regulatory commitment and will be taken into consideration by the Board in acting on statutory applications.

c. If a security is issued by a subsidiary of a bank or bank holding company, any guarantee of the principal by that subsidiary's parent bank or bank holding company must be subordinate to the same degree as the security issued by the subsidiary and limited to repayment of the principal amount of the security at its final maturity.

CRITERIA FOR DETERMINING THE PRIMARY CAPITAL STATUS OF PERPETUAL DEBT INSTRUMENTS OF BANK HOLDING COMPANIES

1. The instrument must be unsecured and, if issued by a bank, must be subordinated to the claims of depositors.

2. The instrument may not provide the noteholder with the right to demand repayment of principal except in the event of bankruptcy, insolvency, or reorganization. The instrument must provide that nonpayment of interest shall not trigger repayment of the principal of the perpetual debt note or any other obligation of the issuer, nor shall it constitute prima facie evidence of insolvency or bankruptcy.

3. The issuer shall not voluntarily redeem the debt issue without prior approval of the Federal Reserve, except when the debt is converted to, exchanged for, or simultaneously replaced in like amount by an issue of common or perpetual preferred stock of the issuer or the issuer's parent company.

4. If issued by a bank holding company, a bank subsidiary, or a subsidiary with substantial operations, the instrument must contain a provision that allows the issuer to defer interest payments on the perpetual debt in the event of, and at the same time as the elimination of dividends on all outstanding common or preferred stock of the issuer (or in the case of a guarantee by a parent company at the same time as the elimination of the dividends of the parent company's common and preferred stock). In the case of a nonoperating subsidiary (a funding subsidiary or one formed to issue securities), the deferral of interest payments must be triggered by elimination of dividends by the parent company.

5. If issued by a bank holding company or a subsidiary with substantial operations, the instrument must convert automatically to common or perpetual preferred stock of the issuer when the issuer's retained earnings and surplus accounts become negative. If an operating subsidiary's perpetual debt is guaranteed by its parent, the debt may convert to the shares of the issuer or guarantor and such conversion may be triggered when the issuer's or parent's retained earnings and surplus accounts become negative. If issued by a nonoperating subsidiary of a bank holding company or bank, the instrument must convert automatically to common or preferred stock of the issuer's parent when the retained earnings and surplus accounts of the issuer's parent become negative.

[Reg. Y, 50 FR 16066, Apr. 24, 1985, as amended at 51 FR 40969, Nov. 12, 1986. Redesignated and amended at 54 FR 4209, Jan. 27, 1989; 55 FR 32832, Aug. 10, 1990; 58 FR 474, Jan. 6, 1993]

APPENDIX C TO PART 225—SMALL BANK HOLDING COMPANY POLICY STATEMENT

Policy Statement on Assessment of Financial and Managerial Factors

In acting on applications filed under the Bank Holding Company Act, the Board has adopted, and continues to follow, the principle that bank holding companies should serve as a source of strength for their subsidiary banks. When bank holding companies incur debt and rely upon the earnings of their subsidiary banks as the means of repaying such debt, a question arises as to the

[6] The funded portions of the securities will be deducted from primary capital to avoid double counting.

probable effect upon the financial condition of the holding company and its subsidiary bank or banks.

The Board believes that a high level of debt at the parent holding company impairs the ability of a bank holding company to provide financial assistance to its subsidiary bank(s) and, in some cases, the servicing requirements on such debt may be a significant drain on the resources of the bank(s). For these reasons, the Board has not favored the use of acquisition debt in the formation of bank holding companies or in the acquisition of additional banks. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board, therefore, has permitted the formation and expansion of small bank holding companies with debt levels higher than would be permitted for larger holding companies. Approval of these applications has been given on the condition that small bank holding companies demonstrate the ability to service acquisition debt without straining the capital of their subsidiary banks and, further, that such companies restore their ability to serve as a source of strength for their subsidiary banks within a relatively short period of time.

In the interest of continuing its policy of facilitating the transfer of ownership in banks without compromising bank safety and soundness, the Board has, as described below, adopted the following procedures and standards for the formation and expansion of small bank holding companies subject to this policy statement.

1. APPLICABILITY OF POLICY STATEMENT

This policy statement applies only to bank holding companies with *pro forma* consolidated assets of less than $500 million that (i) are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) do not conduct significant off-balance sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; and (iii) do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission. The Board may in its discretion exclude any bank holding company, regardless of asset size, from the policy statement if such action is warranted for supervisory purposes.[1]

While this policy statement primarily applies to the formation of small bank holding companies, it also applies to existing small bank holding companies that wish to acquire an additional bank or company and to transactions involving changes in control, stock redemptions, or other shareholder transactions.[2]

2. ONGOING REQUIREMENTS

The following guidelines must be followed on an ongoing basis for all organizations operating under this policy statement.

A. Reduction in parent company leverage: Small bank holding companies are to reduce their parent company debt consistent with the requirement that all debt be retired within 25 years of being incurred. The Board also expects that these bank holding companies reach a debt to equity ratio of .30:1 or less within 12 years of the incurrence of the debt.[3] The bank holding company must also

[1] [Reserved]

[2] The appropriate Reserve Bank should be contacted to determine the manner in which a specific situation may qualify for treatment under this policy statement.

[3] The term *debt*, as used in the ratio of debt to equity, means any borrowed funds (exclusive of short-term borrowings that arise out of current transactions, the proceeds of which are used for current transactions), and any securities issued by, or obligations of, the holding company that are the functional equivalent of borrowed funds.

Subordinated debt associated with trust preferred securities generally would be treated as debt for purposes of paragraphs 2.C., 3.A., 4.A.i., and 4.B.i. of this policy statement. A bank holding company, however, may exclude from debt an amount of subordinated debt associated with trust preferred securities up to 25 percent of the holding company's equity (as defined below) less goodwill on the parent company's balance sheet in determining compliance with the requirements of such paragraphs of the policy statement. In addition, a bank holding company subject to this policy statement that has not issued subordinated debt associated with a new issuance of trust preferred securities after December 31, 2005, may exclude from debt any subordinated debt associated with trust preferred securities until December 31, 2010. Bank holding companies subject to this policy statement also may exclude from debt until December 31, 2010, any subordinated debt associated with refinanced issuances of trust preferred securities originally issued on or prior to December 31, 2005, provided that the refinancing does not increase the bank holding company's outstanding amount of subordinated debt. Subordinated debt associated with trust preferred securities will not be included as debt in determining compliance with any other requirements of this policy statement.

In addition, notwithstanding any other provision of this policy statement and for purposes of compliance with paragraphs 2.C., 3.A., 4.A.i, and 4.B.i. of this policy statement,

Continued

comply with debt servicing and other requirements imposed by its creditors.

B. Capital adequacy: Each insured depository subsidiary of a small bank holding company is expected to be well-capitalized. Any institution that is not well-capitalized is expected to become well-capitalized within a brief period of time.

C. Dividend restrictions: A small bank holding company whose debt to equity ratio is greater than 1.0:1 is not expected to pay corporate dividends until such time as it reduces its debt to equity ratio to 1.0:1 or less and otherwise meets the criteria set forth in §§225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y.[4]

Small bank holding companies formed before the effective date of this policy statement may switch to a plan that adheres to the intent of this statement provided they comply with the requirements set forth above.

3. CORE REQUIREMENTS FOR ALL APPLICANTS

In assessing applications or notices by organizations subject to this policy statement, the Board will continue to take into account a full range of financial and other information about the applicant, and its current and proposed subsidiaries, including the recent trend and stability of earnings, past and prospective growth, asset quality, the ability to meet debt servicing requirements without placing an undue strain on the resources of the bank(s), and the record and competency of management. In addition, the Board will require applicants to meet the following requirements:

A. Minimum down payment: The amount of acquisition debt should not exceed 75 percent of the purchase price of the bank(s) or company to be acquired. When the owner(s) of the holding company incurs debt to finance the purchase of the bank(s) or company, such debt will be considered acquisition debt even though it does not represent an obligation of the bank holding company, unless the owner(s) can demonstrate that such debt can be serviced without reliance on the resources of the bank(s) or bank holding company.

B. Ability to reduce parent company leverage: The bank holding company must clearly be able to reduce its debt to equity ratio and comply with its loan agreement(s) as set forth in paragraph 2A above.

Failure to meet the criteria in this section would normally result in denial of an application.

4. ADDITIONAL APPLICATION REQUIREMENTS FOR EXPEDITED/WAIVED PROCESSING

A. Expedited notices under §§225.14 and 225.23 of Regulation Y: A small bank holding company proposal will be eligible for the expedited processing procedures set forth in §§225.14 and 225.23 of Regulation Y if the bank holding company is in compliance with the ongoing requirements of this policy statement, the bank holding company meets the core requirements for all applicants noted above, and the following requirements are met:

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both a bank holding company that is organized in mutual form and a bank holding company that has made a valid election to be taxed under Subchapter S of Chapter 1 of the U.S. Internal Revenue Code may exclude from debt subordinated debentures issued to the United States Department of the Treasury under (i) the Troubled Asset Relief Program established by the Emergency Economic Stabilization Act of 2008, Division A of Public Law 110–343, 122 Stat. 3765 (2008), and (ii) the Small Business Lending Fund established by the Small Business Jobs Act of 2010, Title IV of Public Law 111–240, 124 Stat. 2504 (2010).

The term *equity*, as used in the ratio of debt to equity, means the total stockholders' equity of the bank holding company as defined in accordance with generally accepted accounting principles. In determining the total amount of stockholders' equity, the bank holding company should account for its investments in the common stock of subsidiaries by the equity method of accounting.

Ordinarily the Board does not view redeemable preferred stock as a substitute for common stock in a small bank holding company. Nevertheless, to a limited degree and under certain circumstances, the Board will consider redeemable preferred stock as equity in the capital accounts of the holding company if the following conditions are met: (1) The preferred stock is redeemable only at the option of the issuer; and (2) the debt to equity ratio of the holding company would be at or remain below .30:1 following the redemption or retirement of any preferred stock. Preferred stock that is convertible into common stock of the holding company may be treated as equity.

[4] Dividends may be paid by small bank holding companies with debt to equity at or below 1.0:1 and otherwise meeting the requirements of §§225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) if the dividends are reasonable in amount, do not adversely affect the ability of the bank holding company to service its debt in an orderly manner, and do not adversely affect the ability of the subsidiary banks to be well-capitalized. It is expected that dividends will be eliminated if the holding company is (1) not reducing its debt consistent with the requirement that the debt to equity ratio be reduced to .30:1 within 12 years of consummation of the proposal or (2) not meeting the requirements of its loan agreement(s).

i. The parent bank holding company has a *pro forma* debt to equity ratio of 1.0:1 or less.

ii. The bank holding company meets all of the criteria for expedited action set forth in §§225.14 or 225.23 of Regulation Y.

B. Waiver of stock redemption filing: A small bank holding company will be eligible for the stock redemption filing exception for well-capitalized bank holding companies contained in §225.4(b)(6) if the following requirements are met:

i. The parent bank holding company has a *pro forma d*ebt to equity ratio of 1.0:1 or less.

ii. The bank holding company is in compliance with the ongoing requirements of this policy statement and meets the requirements of §§225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y.

[Reg. Y, 62 FR 9343, Feb. 28, 1997, as amended at 71 FR 9902, Feb. 28, 2006; 74 FR 26081, June 1, 2009]

APPENDIX D TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: TIER 1 LEVERAGE MEASURE

I. OVERVIEW

a. The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of bank holding companies (banking organizations).[1] The principal objectives of this measure is to place a constraint on the maximum degree to which a banking organization can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

b. The tier 1 leverage guidelines apply on a consolidated basis to any bank holding company with consolidated assets of $500 million or more. The tier 1 leverage 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. The Federal Reserve may apply the tier 1 leverage guidelines at its discretion to any bank holding company, regardless of asset size, if such action is warranted for supervisory purposes.[2]

c. The tier 1 leverage 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. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

II. THE TIER 1 LEVERAGE RATIO

a. The Board has established a minimum ratio of Tier 1 capital to total assets of 3.0 percent for strong bank holding companies (rated composite ''1'' under the BOPEC rating system of bank holding companies), and for bank holding companies that have implemented the Board's risk-based capital measure for market risk as set forth in appendices A and E of this part. For all other bank holding companies, the minimum ratio of Tier 1 capital to total assets is 4.0 percent. Banking organizations with supervisory, financial, operational, or managerial weaknesses, as well as organizations that are anticipating or experiencing significant growth, are expected to maintain capital ratios well above the minimum levels. Moreover, higher capital ratios may be required for any bank holding company if warranted by its particular circumstances or risk profile. In all cases, bank holding companies should hold capital commensurate with the level and nature of the risks, including the volume and severity of problem loans, to which they are exposed.

b. A banking organization's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital as set forth in the risk-based capital guidelines contained in appendix A of this part will be used. As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the organization's Consolidated Financial Statements (FR Y–9C Report), less goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, are in excess of 25 percent of Tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of

[1] Supervisory ratios that related capital to total assets for state member banks are outlined in appendix B of this part.

[2] [Reserved]

Tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of appendix A of this part; and the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from Tier 1 capital.[3]

c. Whenever appropriate, including when an organization is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual organization's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Federal Reserve policy and practice with regard to leverage guidelines. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong capital position substantially above minimum supervisory levels, without significant reliance on intangible assets.

d. Notwithstanding anything in this appendix to the contrary, a bank holding company may deduct from its average total consolidated assets the amount of any asset-backed commercial paper (i) purchased by the 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.

[Reg. Y, 59 FR 65926, Dec. 22, 1994, as amended by 60 FR 39231, Aug. 1, 1995; 63 FR 30370, June 4, 1998; 63 FR 42676, Aug. 10, 1998; 66 FR 59651, Nov. 29, 2001; 67 FR 3803, Jan. 25, 2002; 70 FR 11838, Mar. 10, 2005; 71 FR 9902, Feb. 28, 2006; 73 FR 55708, Sept. 26, 2008; 74 FR 6224, Feb. 6, 2009]

APPENDIX E TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: MARKET RISK

Section 1. Purpose, Applicability, and Reservation of Authority

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

(b) *Applicability.* (1) This appendix applies to any bank holding company with aggregate trading assets and trading liabilities (as reported in the bank holding company's most recent quarterly Consolidated Financial Statements for Bank Holding Companies (FR Y–9C)), equal to:

(i) 10 percent or more of quarter-end total assets as reported on the most recent quarterly FR Y–9C; or

(ii) $1 billion or more.

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

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

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

[3] Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A of this part.

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

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

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

Section 2. Definitions

For purposes of this appendix, the following definitions apply:

Affiliate with respect to a company means any company that controls, is controlled by, or is under common control with, the company.

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

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

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

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

Control A person or company controls a company if it:

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

(2) Consolidates the company for financial reporting purposes.

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

Correlation trading position means:

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

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

(3) A correlation trading position does not include:

(i) A resecuritization position;

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

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

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

Covered position means the following positions:

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

(i) The position is a trading position or hedges another covered position;[44] and

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

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

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

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

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

[43] Securities subject to repurchase and lending agreements are included as if they are still owned by the lender.

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

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

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

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

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

(vii) Any direct real estate holding.

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

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

Default by a sovereign entity means noncompliance by the sovereign entity with its external debt service obligations or the inability or unwillingness of a sovereign entity to service an existing obligation according to its original contractual terms, as evidenced by failure to pay principal and interest timely and fully, arrearages, or restructuring.

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

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

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

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

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

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

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

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

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

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

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

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

Investment grade means that the entity to which the bank holding company is exposed through a loan or security, or the reference entity with respect to a credit derivative, has adequate capacity to meet financial commitments for the projected life of the asset or exposure. Such an entity or reference entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected.

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

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

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

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

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

Publicly traded means traded on:

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

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

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

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

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

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

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

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

(4)(i) The transaction is a securities contract for the purposes of section 555 of the Bankruptcy Code (11 U.S.C. 555), a qualified financial contract for the purposes of section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions for the purposes of sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407) or the Board's Regulation EE (12 CFR part 231); or

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

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

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

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

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

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

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

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

Resecuritization position means a covered position that is:

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

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

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

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

Securitization means a transaction in which:

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

(2) The credit risk associated with the underlying exposures has been separated into at least two tranches that reflect different levels of seniority;

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

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

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

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

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

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

(9) The Board may deem an exposure to a transaction that meets the definition of a securitization, notwithstanding paragraph (5), (6), or (7) of this definition, to be a

securitization based on the transaction's leverage, risk profile, or economic substance.

Securitization position means a covered position that is:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Tier 1 capital is defined in Appendix A to this part or Appendix G to this part, as applicable.

Tier 2 capital is defined in Appendix A to this part or Appendix G to this part, as applicable.

Trading position means a position that is held by the bank holding company for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits.

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

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

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

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

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

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

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

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

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

(i) The trading strategy must articulate the expected holding period of, and the market risk associated with, each portfolio of trading positions.

(ii) The hedging strategy must articulate for each portfolio of trading positions the level of market risk the bank holding company is willing to accept and must detail the instruments, techniques, and strategies the bank holding company will use to hedge the risk of the portfolio.

(b) *Management of covered positions.* (1) *Active management.* A bank holding company must have clearly defined policies and procedures for actively managing all covered positions. At a minimum, these policies and procedures must require:

(i) Marking positions to market or to model on a daily basis;

(ii) Daily assessment of the bank holding company's ability to hedge position and portfolio risks, and of the extent of market liquidity;

(iii) Establishment and daily monitoring of limits on positions by a risk control unit independent of the trading business unit;

(iv) Daily monitoring by senior management of information described in paragraphs (b)(1)(i) through (b)(1)(iii) of this section;

(v) At least annual reassessment of established limits on positions by senior management; and

(vi) At least annual assessments by qualified personnel of the quality of market inputs to the valuation process, the soundness of key assumptions, the reliability of parameter estimation in pricing models, and the stability and accuracy of model calibration under alternative market scenarios.

(2) *Valuation of covered positions.* The bank holding company must have a process for prudent valuation of its covered positions that includes policies and procedures on the valuation of positions, marking positions to market or to model, independent price verification, and valuation adjustments or reserves. The valuation process must consider, as appropriate, unearned credit spreads, close-out costs, early termination costs, investing and funding costs, liquidity, and model risk.

(c) *Requirements for internal models.* (1) A bank holding company must obtain the prior written approval of the Board or the appropriate Reserve Bank, with concurrence of the Board, before using any internal model to calculate its risk-based capital requirement under this appendix.

(2) A bank holding company must meet all of the requirements of this section on an ongoing basis. The bank holding company must promptly notify the Board and the appropriate Reserve Bank when:

(i) The bank holding company plans to extend the use of a model that the Board or the appropriate Reserve Bank, with concurrence of the Board has approved under this appendix to an additional business line or product type;

(ii) The bank holding company makes any change to an internal model approved by the Board or the appropriate Reserve Bank, with concurrence of the Board, under this appendix that would result in a material change in the bank holding company's risk-weighted asset amount for a portfolio of covered positions; or

(iii) The bank holding company makes any material change to its modeling assumptions.

(3) The Board or the appropriate Reserve Bank, with concurrence of the Board, may rescind its approval of the use of any internal model (in whole or in part) or of the determination of the approach under section 9(a)(2)(ii) of this appendix for a bank holding company's modeled correlation trading positions and determine an appropriate capital requirement for the covered positions to which the model would apply, if the Board or the appropriate Reserve Bank, with concurrence of the Board, determines that the model no longer complies with this appendix or fails to reflect accurately the risks of the bank holding company's covered positions.

(d) *Control, oversight, and validation mechanisms.* (1) The bank holding company must have a risk control unit that reports directly to senior management and is independent from the business trading units.

(2) The bank holding company must validate its internal models initially and on an ongoing basis. The bank holding company's validation process must be independent of the internal models' development, implementation, and operation, or the validation process must be subjected to an independent review of its adequacy and effectiveness. Validation must include:

(i) An evaluation of the conceptual soundness of (including developmental evidence supporting) the internal models;

(ii) An ongoing monitoring process that includes verification of processes and the comparison of the bank holding company's model outputs with relevant internal and external data sources or estimation techniques; and

(iii) An outcomes analysis process that includes backtesting. For internal models used to calculate the VaR-based measure, this process must include a comparison of the changes in the bank holding company's portfolio value that would have occurred were end-of-day positions to remain unchanged (therefore, excluding fees, commissions, reserves, net interest income, and intraday trading) with VaR-based measures during a sample period not used in model development.

(3) The bank holding company must stress test the market risk of its covered positions at a frequency appropriate to each portfolio, and in no case less frequently than quarterly. The stress tests must take into account concentration risk (including but not limited to concentrations in single issuers, industries, sectors, or markets), illiquidity under stressed market conditions, and risks arising from the bank holding company's trading activities that may not be adequately captured in its internal models.

(4) The bank holding company must have an internal audit function independent of business-line management that at least annually assesses the effectiveness of the controls supporting the bank holding company's market risk measurement systems, including the activities of the business trading units and independent risk control unit, compliance with policies and procedures, and calculation of the bank holding company's measures for market risk under this appendix. At least annually, the internal audit function must report its findings to the bank holding company's board of directors (or a committee thereof).

(e) *Internal assessment of capital adequacy*. The bank holding company must have a rigorous process for assessing its overall capital adequacy in relation to its market risk. The assessment must take into account risks that may not be captured fully in the VaR-based measure, including concentration and liquidity risk under stressed market conditions.

(f) *Documentation*. The bank holding company must adequately document all material aspects of its internal models, management and valuation of covered positions, control, oversight, validation and review processes and results, and internal assessment of capital adequacy.

Section 4. Adjustments to the Risk-Based Capital Ratio Calculations

(a) *Risk-based capital ratio denominators*. A bank holding company must calculate its general risk-based capital ratio denominator by following the steps described in paragraphs (a)(1) through (a)(4) of this section. A bank holding company subject to Appendix G to this part must use its general risk-based capital ratio denominator for purposes of determining its total risk-based capital ratio and its tier 1 risk-based capital ratio under section 3(a)(2)(ii) and section 3(a)(3)(ii), respectively, of Appendix G to this part, provided that the bank holding company may not use the supervisory formula approach (SFA) in section 10(b)(2)(vii)(B) of this appendix for purposes of this calculation. A bank holding company subject to Appendix G to this part also must calculate an advanced risk-based capital ratio denominator by following the steps in paragraphs (a)(1) through (a)(4) of this section for purposes of determining its total risk-based capital ratio and its tier 1 risk-based capital ratio under sections 3(a)(2)(i) and section 3(a)(3)(i), respectively, of Appendix G to this part.

(1) *Adjusted risk-weighted assets*. (i) The bank holding company must calculate:

(A) General adjusted risk-weighted assets, which equals risk-weighted assets as determined in accordance with Appendix A to this part with the adjustments in paragraphs (a)(1)(ii) and, if applicable, (a)(1)(iii) of this section; and

(B) For a bank holding company subject to Appendix G to this part, advanced adjusted risk-weighted assets, which equal risk-weighted assets as determined in accordance with Appendix G to this part with the adjustments in paragraph (a)(1)(ii) of this section.

(ii) For purposes of calculating its general and advanced adjusted risk-weighted assets under paragraphs (a)(1)(i)(A) and (a)(1)(i)(B) of this section, respectively, the bank holding company must exclude the risk-weighted asset amounts of all covered positions (except foreign exchange positions that are not trading positions and over-the-counter derivative positions).

(iii) For purposes of calculating its general adjusted risk-weighted assets under paragraph (a)(1)(i)(A) of this section, a bank holding company may exclude receivables that arise from the posting of cash collateral and are associated with qualifying securities borrowing transactions to the extent the receivable is collateralized by the market value of the borrowed securities.

(2) *Measure for market risk*. The bank holding company must calculate the general measure for market risk (except, as provided in paragraph (a) of this section, that the bank holding company may not use the SFA in section 10(b)(2)(vii)(B) of this appendix for purposes of this calculation), which equals the sum of the VaR-based capital requirement, stressed VaR-based capital requirement, specific risk add-ons, incremental risk capital requirement, comprehensive risk capital requirement, and capital requirement for *de minimis* exposures all as defined under this paragraph (a)(2). A bank holding company subject to Appendix G to this part also must calculate the advanced measure for market risk, which equals the sum of the VaR-based capital requirement, stressed VaR-based capital requirement, specific risk add-ons, incremental risk capital requirement, comprehensive risk capital requirement, and capital requirement for *de minimis* exposures as defined under this paragraph (a)(2).

(i) *VaR-based capital requirement.* A bank holding company's VaR-based capital requirement equals the greater of:

(A) The previous day's VaR-based measure as calculated under section 5 of this appendix; or

(B) The average of the daily VaR-based measures as calculated under section 5 of this appendix for each of the preceding 60 business days multiplied by three, except as provided in paragraph (b) of this section.

(ii) *Stressed VaR-based capital requirement.* A bank holding company's stressed VaR-based capital requirement equals the greater of:

(A) The most recent stressed VaR-based measure as calculated under section 6 of this appendix; or

(B) The average of the stressed VaR-based measures as calculated under section 6 of this appendix for each of the preceding 12 weeks multiplied by three, except as provided in paragraph (b) of this section.

(iii) *Specific risk add-ons.* A bank holding company's specific risk add-ons equal any specific risk add-ons that are required under section 7 of this appendix and are calculated in accordance with section 10 of this appendix.

(iv) *Incremental risk capital requirement.* A bank holding company's incremental risk capital requirement equals any incremental risk capital requirement as calculated under section 8 of this appendix.

(v) *Comprehensive risk capital requirement.* A bank holding company's comprehensive risk capital requirement equals any comprehensive risk capital requirement as calculated under section 9 of this appendix.

(vi) *Capital requirement for de minimis exposures.* A bank holding company's capital requirement for *de minimis* exposures equals:

(A) The absolute value of the market value of those *de minimis* exposures that are not captured in the bank holding company's VaR-based measure or under paragraph (a)(2)(vi)(B) of this section; and

(B) With the prior written approval of the Board or the appropriate Reserve Bank, with concurrence of the Board, the capital requirement for any *de minimis* exposures using alternative techniques that appropriately measure the market risk associated with those exposures.

(3) *Market risk equivalent assets.* The bank holding company must calculate general market risk equivalent assets as the general measure for market risk (as calculated in paragraph (a)(2) of this section) multiplied by 12.5. A bank holding company subject to Appendix G to this part also must calculate advanced market risk equivalent assets as the advanced measure for market risk (as calculated in paragraph (a)(2) of this section) multiplied by 12.5.

(4) *Denominator calculation.* (i) The bank holding company must add general market risk equivalent assets (as calculated in paragraph (a)(3) of this section) to general adjusted risk-weighted assets (as calculated in paragraph (a)(1)(i) of this section). The resulting sum is the bank holding company's general risk-based capital ratio denominator.

(ii) A bank holding company subject to Appendix G to this part must add advanced market risk equivalent assets (as calculated in paragraph (a)(3) of this section) to advanced adjusted risk-weighted assets (as calculated in paragraph (a)(1)(i) of this section). The resulting sum is the bank holding company's advanced risk-based capital ratio denominator.

(b) *Backtesting.* A bank holding company must compare each of its most recent 250 business days' trading losses (excluding fees, commissions, reserves, net interest income, and intraday trading) with the corresponding daily VaR-based measures calibrated to a one-day holding period and at a one-tail, 99.0 percent confidence level. A bank holding company must begin backtesting as required by this paragraph no later than one year after the later of January 1, 2013 and the date on which the bank holding company becomes subject to this appendix. In the interim, consistent with safety and soundness principles, a bank holding company subject to this appendix as of its effective date should continue to follow backtesting procedures in accordance with the supervisory expectations of the Board or the appropriate Reserve Bank.

(1) Once each quarter, the bank holding company must identify the number of exceptions (that is, the number of business days for which the actual daily net trading loss, if any, exceeds the corresponding daily VaR-based measure) that have occurred over the preceding 250 business days.

(2) A bank holding company must use the multiplication factor in table 1 of this appendix that corresponds to the number of exceptions identified in paragraph (b)(1) of this section to determine its VaR-based capital requirement for market risk under paragraph (a)(2)(i) of this section and to determine its stressed VaR-based capital requirement for market risk under paragraph (a)(2)(ii) of this section until it obtains the next quarter's backtesting results, unless the Board or the appropriate Reserve Bank, with the concurrence of the Board notifies the bank holding company in writing that a different adjustment or other action is appropriate.

TABLE 1—MULTIPLICATION FACTORS BASED ON RESULTS OF BACKTESTING

Number of exceptions	Multiplication factor
4 or fewer	3.00
5	3.40
6	3.50

TABLE 1—MULTIPLICATION FACTORS BASED ON RESULTS OF BACKTESTING—Continued

Number of exceptions	Multiplication factor
7	3.65
8	3.75
9	3.85
10 or more	4.00

Section 5. VaR-Based Measure

(a) *General requirement.* A bank holding company must use one or more internal models to calculate daily a VaR-based measure of the general market risk of all covered positions. The daily VaR-based measure also may reflect the bank holding company's specific risk for one or more portfolios of debt and equity positions, if the internal models meet the requirements of paragraph (b)(1) of section 7 of this appendix. The daily VaR-based measure must also reflect the bank holding company's specific risk for any portfolio of correlation trading positions that is modeled under section 9 of this appendix. A bank holding company may elect to include term repo-style transactions in its VaR-based measure, provided that the bank holding company includes all such term repo-style transactions consistently over time.

(1) The bank holding company's internal models for calculating its VaR-based measure must use risk factors sufficient to measure the market risk inherent in all covered positions. The market risk categories must include, as appropriate, interest rate risk, credit spread risk, equity price risk, foreign exchange risk, and commodity price risk. For material positions in the major currencies and markets, modeling techniques must incorporate enough segments of the yield curve—in no case less than six—to capture differences in volatility and less than perfect correlation of rates along the yield curve.

(2) The VaR-based measure may incorporate empirical correlations within and across risk categories, provided the bank holding company validates and demonstrates the reasonableness of its process for measuring correlations. If the VaR-based measure does not incorporate empirical correlations across risk categories, the bank holding company must add the separate measures from its internal models used to calculate the VaR-based measure for the appropriate market risk categories (interest rate risk, credit spread risk, equity price risk, foreign exchange rate risk, and/or commodity price risk) to determine its aggregate VaR-based measure.

(3) The VaR-based measure must include the risks arising from the nonlinear price characteristics of options positions or positions with embedded optionality and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates, prices, or other material risk factors. A bank holding company with a large or complex options portfolio must measure the volatility of options positions or positions with embedded optionality by different maturities and/or strike prices, where material.

(4) The bank holding company must be able to justify to the satisfaction of the Board or the appropriate Reserve Bank, with the concurrence of the Board the omission of any risk factors from the calculation of its VaR-based measure that the bank holding company uses in its pricing models.

(5) The bank holding company must demonstrate to the satisfaction of the Board or the appropriate Reserve Bank, with the concurrence of the Board the appropriateness of any proxies used to capture the risks of the bank holding company's actual positions for which such proxies are used.

(b) *Quantitative requirements for VaR-based measure.* (1) The VaR-based measure must be calculated on a daily basis using a one-tail, 99.0 percent confidence level, and a holding period equivalent to a 10-business-day movement in underlying risk factors, such as rates, spreads, and prices. To calculate VaR-based measures using a 10-business-day holding period, the bank holding company may calculate 10-business-day measures directly or may convert VaR-based measures using holding periods other than 10 business days to the equivalent of a 10-business-day holding period. A bank holding company that converts its VaR-based measure in such a manner must be able to justify the reasonableness of its approach to the satisfaction of the Board or the appropriate Reserve Bank, with the concurrence of the Board.

(2) The VaR-based measure must be based on a historical observation period of at least one year. Data used to determine the VaR-based measure must be relevant to the bank holding company's actual exposures and of sufficient quality to support the calculation of risk-based capital requirements. The bank holding company must update data sets at least monthly or more frequently as changes in market conditions or portfolio composition warrant. For a bank holding company that uses a weighting scheme or other method for the historical observation period, the bank holding company must either:

(i) Use an effective observation period of at least one year in which the average time lag of the observations is at least six months; or

(ii) Demonstrate to the Board or the appropriate Reserve Bank, with the concurrence of the Board that its weighting scheme is more effective than a weighting scheme with an average time lag of at least six months representing the volatility of the bank holding company's trading portfolio over a full business cycle. A bank holding company using this option must update its data more frequently than monthly and in a manner appropriate for the type of weighting scheme.

(c) A bank holding company must divide its portfolio into a number of significant subportfolios approved by the Board or the appropriate Reserve Bank, with concurrence of the Board, for subportfolio backtesting purposes. These subportfolios must be sufficient to allow the bank holding company and the Board or the appropriate Reserve Bank, with concurrence of the Board, to assess the adequacy of the VaR model at the risk factor level; the Board or the appropriate Reserve Bank, with concurrence of the Board, will evaluate the appropriateness of these subportfolios relative to the value and composition of the bank holding company's covered positions. The bank holding company must retain and make available to the Board and the appropriate Reserve Bank the following information for each subportfolio for each business day over the previous two years (500 business days), with no more than a 60-day lag:

(1) A daily VaR-based measure for the subportfolio calibrated to a one-tail, 99.0 percent confidence level;

(2) The daily profit or loss for the subportfolio (that is, the net change in price of the positions held in the portfolio at the end of the previous business day); and

(3) The p-value of the profit or loss on each day (that is, the probability of observing a profit that is less than, or a loss that is greater than, the amount reported for purposes of paragraph (c)(2) of this section based on the model used to calculate the VaR-based measure described in paragraph (c)(1) of this section).

Section 6. Stressed VaR-Based Measure

(a) *General requirement.* At least weekly, a bank holding company must use the same internal model(s) used to calculate its VaR-based measure to calculate a stressed VaR-based measure.

(b) *Quantitative requirements for stressed VaR-based measure.* (1) A bank holding company must calculate a stressed VaR-based measure for its covered positions using the same model(s) used to calculate the VaR-based measure, subject to the same confidence level and holding period applicable to the VaR-based measure under section 5 of this appendix, but with model inputs calibrated to historical data from a continuous 12-month period that reflects a period of significant financial stress appropriate to the bank holding company's current portfolio.

(2) The stressed VaR-based measure must be calculated at least weekly and be no less than the bank holding company's VaR-based measure.

(3) A bank holding company must have policies and procedures that describe how it determines the period of significant financial stress used to calculate the bank holding company's stressed VaR-based measure under this section and must be able to provide empirical support for the period used. The bank holding company must obtain the prior approval of the Board or the appropriate Reserve Bank, with concurrence of the Board, for, and notify the Board and the appropriate Reserve Bank if the bank holding company makes any material changes to, these policies and procedures. The policies and procedures must address:

(i) How the bank holding company links the period of significant financial stress used to calculate the stressed VaR-based measure to the composition and directional bias of its current portfolio; and

(ii) The bank holding company's process for selecting, reviewing, and updating the period of significant financial stress used to calculate the stressed VaR-based measure and for monitoring the appropriateness of the period to the bank holding company's current portfolio.

(4) Nothing in this section prevents the Board or the appropriate Reserve Bank, with concurrence of the Board from requiring a bank holding company to use a different period of significant financial stress in the calculation of the stressed VaR-based measure.

Section 7. Specific Risk

(a) *General requirement.* A bank holding company must use one of the methods in this section to measure the specific risk for each of its debt, equity, and securitization positions with specific risk.

(b) *Modeled specific risk.* A bank holding company may use models to measure the specific risk of covered positions as provided in paragraph (a) of section 5 of this appendix (therefore, excluding securitization positions that are not modeled under section 9 of this appendix). A bank holding company must use models to measure the specific risk of correlation trading positions that are modeled under section 9 of this appendix.

(1) *Requirements for specific risk modeling.* (i) If a bank holding company uses internal models to measure the specific risk of a portfolio, the internal models must:

(A) Explain the historical price variation in the portfolio;

(B) Be responsive to changes in market conditions;

(C) Be robust to an adverse environment, including signaling rising risk in an adverse environment; and

(D) Capture all material components of specific risk for the debt and equity positions in the portfolio. Specifically, the internal models must:

(*1*) Capture event risk and idiosyncratic risk;

(*2*) Capture and demonstrate sensitivity to material differences between positions that are similar but not identical and to changes in portfolio composition and concentrations.

(ii) If a bank holding company calculates an incremental risk measure for a portfolio of debt or equity positions under section 8 of this appendix, the bank holding company is not required to capture default and credit migration risks in its internal models used to measure the specific risk of those portfolios.

(2) *Specific risk fully modeled for one or more portfolios.* If the bank holding company's VaR-based measure captures all material aspects of specific risk for one or more of its portfolios of debt, equity, or correlation trading positions, the bank holding company has no specific risk add-on for those portfolios for purposes of paragraph (a)(2)(iii) of section 4 of this appendix.

(c) *Specific risk not modeled.*

(1) If the bank holding company's VaR-based measure does not capture all material aspects of specific risk for a portfolio of debt, equity, or correlation trading positions, the bank holding company must calculate a specific-risk add-on for the portfolio under the standardized measurement method as described in section 10 of this appendix.

(2) A bank holding company must calculate a specific risk add-on under the standardized measurement method as described in section 10 of this appendix for all of its securitization positions that are not modeled under section 9 of this appendix.

Section 8. Incremental Risk

(a) *General requirement.* A bank holding company that measures the specific risk of a portfolio of debt positions under section 7(b) of this appendix using internal models must calculate at least weekly an incremental risk measure for that portfolio according to the requirements in this section. The incremental risk measure is the bank holding company's measure of potential losses due to incremental risk over a one-year time horizon at a one-tail, 99.9 percent confidence level, either under the assumption of a constant level of risk, or under the assumption of constant positions. With the prior approval of the Board or the appropriate Reserve Bank, with concurrence of the Board, a bank holding company may choose to include portfolios of equity positions in its incremental risk model, provided that it consistently includes such equity positions in a manner that is consistent with how the bank holding company internally measures and manages the incremental risk of such positions at the portfolio level. If equity positions are included in the model, for modeling purposes default is considered to have occurred upon the default of any debt of the issuer of the equity position. A bank holding company may not include correlation trading positions or securitization positions in its incremental risk measure.

(b) *Requirements for incremental risk modeling.* For purposes of calculating the incremental risk measure, the incremental risk model must:

(1) Measure incremental risk over a one-year time horizon and at a one-tail, 99.9 percent confidence level, either under the assumption of a constant level of risk, or under the assumption of constant positions.

(i) A constant level of risk assumption means that the bank holding company rebalances, or rolls over, its trading positions at the beginning of each liquidity horizon over the one-year horizon in a manner that maintains the bank holding company's initial risk level. The bank holding company must determine the frequency of rebalancing in a manner consistent with the liquidity horizons of the positions in the portfolio. The liquidity horizon of a position or set of positions is the time required for a bank holding company to reduce its exposure to, or hedge all of its material risks of, the position(s) in a stressed market. The liquidity horizon for a position or set of positions may not be less than the shorter of three months or the contractual maturity of the position.

(ii) A constant position assumption means that the bank holding company maintains the same set of positions throughout the one-year horizon. If a bank holding company uses this assumption, it must do so consistently across all portfolios.

(iii) A bank holding company's selection of a constant position or a constant risk assumption must be consistent between the bank holding company's incremental risk model and its comprehensive risk model described in section 9 of this appendix, if applicable.

(iv) A bank holding company's treatment of liquidity horizons must be consistent between the bank holding company's incremental risk model and its comprehensive risk model described in section 9 of this appendix, if applicable.

(2) Recognize the impact of correlations between default and migration events among obligors.

(3) Reflect the effect of issuer and market concentrations, as well as concentrations that can arise within and across product classes during stressed conditions.

(4) Reflect netting only of long and short positions that reference the same financial instrument.

(5) Reflect any material mismatch between a position and its hedge.

(6) Recognize the effect that liquidity horizons have on dynamic hedging strategies. In such cases, a bank holding company must:

(i) Choose to model the rebalancing of the hedge consistently over the relevant set of trading positions;

(ii) Demonstrate that the inclusion of rebalancing results in a more appropriate risk measurement;

(iii) Demonstrate that the market for the hedge is sufficiently liquid to permit rebalancing during periods of stress; and

(iv) Capture in the incremental risk model any residual risks arising from such hedging strategies.

(7) Reflect the nonlinear impact of options and other positions with material nonlinear behavior with respect to default and migration changes.

(8) Maintain consistency with the bank holding company's internal risk management methodologies for identifying, measuring, and managing risk.

(c) *Calculation of incremental risk capital requirement.* The incremental risk capital requirement is the greater of:

(1) The average of the incremental risk measures over the previous 12 weeks; or

(2) The most recent incremental risk measure.

Section 9. Comprehensive Risk

(a) *General requirement.* (1) Subject to the prior approval of the Board or the appropriate Reserve Bank, with concurrence of the Board, a bank holding company may use the method in this section to measure comprehensive risk, that is, all price risk, for one or more portfolios of correlation trading positions.

(2) A bank holding company that measures the price risk of a portfolio of correlation trading positions using internal models must calculate at least weekly a comprehensive risk measure that captures all price risk according to the requirements of this section. The comprehensive risk measure is either:

(i) The sum of:

(A) The bank holding company's modeled measure of all price risk determined according to the requirements in paragraph (b) of this section; and

(B) A surcharge for the bank holding company's modeled correlation trading positions equal to the total specific risk add-on for such positions as calculated under section 10 of this appendix multiplied by 8.0 percent; or

(ii) With approval of the Board or the appropriate Reserve Bank, with concurrence of the Board and provided the bank holding company has met the requirements of this section for a period of at least one year and can demonstrate the effectiveness of the model through the results of ongoing model validation efforts including robust benchmarking, the greater of:

(A) The bank holding company's modeled measure of all price risk determined according to the requirements in paragraph (b) of this section; or

(B) The total specific risk add-on that would apply to the bank's modeled correlation trading positions as calculated under section 10 of this appendix multiplied by 8.0 percent.

(b) *Requirements for modeling all price risk.* If a bank holding company uses an internal model to measure the price risk of a portfolio of correlation trading positions:

(1) The internal model must measure comprehensive risk over a one-year time horizon at a one-tail, 99.9 percent confidence level, either under the assumption of a constant level of risk, or under the assumption of constant positions.

(2) The model must capture all material price risk, including but not limited to the following:

(i) The risks associated with the contractual structure of cash flows of the position, its issuer, and its underlying exposures;

(ii) Credit spread risk, including nonlinear price risks;

(iii) The volatility of implied correlations, including nonlinear price risks such as the cross-effect between spreads and correlations;

(iv) Basis risk;

(v) Recovery rate volatility as it relates to the propensity for recovery rates to affect tranche prices; and

(vi) To the extent the comprehensive risk measure incorporates the benefits of dynamic hedging, the static nature of the hedge over the liquidity horizon must be recognized. In such cases, a bank holding company must:

(A) Choose to model the rebalancing of the hedge consistently over the relevant set of trading positions;

(B) Demonstrate that the inclusion of rebalancing results in a more appropriate risk measurement;

(C) Demonstrate that the market for the hedge is sufficiently liquid to permit rebalancing during periods of stress; and

(D) Capture in the comprehensive risk model any residual risks arising from such hedging strategies;

(3) The bank holding company must use market data that are relevant in representing the risk profile of the bank holding company's correlation trading positions in order to ensure that the bank holding company fully captures the material risks of the correlation trading positions in its comprehensive risk measure in accordance with this section; and

(4) The bank holding company must be able to demonstrate that its model is an appropriate representation of comprehensive risk in light of the historical price variation of its correlation trading positions.

(c) *Requirements for stress testing.*

(1) A bank holding company must at least weekly apply specific, supervisory stress scenarios to its portfolio of correlation trading positions that capture changes in:

(i) Default rates;

(ii) Recovery rates;

(iii) Credit spreads;

(iv) Correlations of underlying exposures; and

(v) Correlations of a correlation trading position and its hedge.

(2) Other requirements. (i) A bank holding company must retain and make available to the Board or the appropriate Reserve Bank, with concurrence of the Board the results of the supervisory stress testing, including comparisons with the capital requirements generated by the bank holding company's comprehensive risk model.

(ii) A bank holding company must report to the Board or the appropriate Reserve Bank, with concurrence of the Board promptly any instances where the stress tests indicate any material deficiencies in the comprehensive risk model.

(d) *Calculation of comprehensive risk capital requirement.* The comprehensive risk capital requirement is the greater of:

(1) The average of the comprehensive risk measures over the previous 12 weeks; or

(2) The most recent comprehensive risk measure.

Section 10. Standardized Measurement Method for Specific Risk

(a) *General requirement.* A bank holding company must calculate a total specific risk add-on for each portfolio of debt and equity positions for which the bank holding company's VaR-based measure does not capture all material aspects of specific risk and for all securitization positions that are not modeled under section 9 of this appendix. A bank holding company must calculate each specific risk add-on in accordance with the requirements of this section. Notwithstanding any other definition or requirement in this appendix, a position that would have qualified as a debt position or an equity position but for the fact that it qualifies as a correlation trading position under paragraph (2) of the definition of correlation trading position, shall be considered a debt position or an equity position, respectively, for purposes of this section 10.

(1) The specific risk add-on for an individual debt or securitization position that represents sold credit protection is capped at the notional amount of the credit derivative contract. The specific risk add-on for an individual debt or securitization position that represents purchased credit protection is capped at the current market value of the transaction plus the absolute value of the present value of all remaining payments to the protection seller under the transaction. This sum is equal to the value of the protection leg of the transaction.

(2) For debt, equity, or securitization positions that are derivatives with linear payoffs, a bank holding company must assign a specific risk-weighting factor to the market value of the effective notional amount of the underlying instrument or index portfolio, except for a securitization position for which the bank holding company directly calculates a specific risk add-on using the SFA in paragraph (b)(2)(vii)(B) of this section. A swap must be included as an effective notional position in the underlying instrument or portfolio, with the receiving side treated as a long position and the paying side treated as a short position. For debt, equity, or securitization positions that are derivatives with nonlinear payoffs, a bank holding company must risk weight the market value of the effective notional amount of the underlying instrument or portfolio multiplied by the derivative's delta.

(3) For debt, equity, or securitization positions, a bank holding company may net long and short positions (including derivatives) in identical issues or identical indices. A bank holding company may also net positions in depositary receipts against an opposite position in an identical equity in different markets, provided that the bank holding company includes the costs of conversion.

(4) A set of transactions consisting of either a debt position and its credit derivative hedge or a securitization position and its credit derivative hedge has a specific risk add-on of zero if:

(i) The debt or securitization position is fully hedged by a total return swap (or similar instrument where there is a matching of swap payments and changes in market value of the debt or securitization position);

(ii) There is an exact match between the reference obligation of the swap and the debt or securitization position;

(iii) There is an exact match between the currency of the swap and the debt or securitization position; and

(iv) There is either an exact match between the maturity date of the swap and the maturity date of the debt or securitization position; or, in cases where a total return swap references a portfolio of positions with different maturity dates, the total return swap maturity date must match the maturity date of the underlying asset in that portfolio that has the latest maturity date.

(5) The specific risk add-on for a set of transactions consisting of either a debt position and its credit derivative hedge or a securitization position and its credit derivative hedge that does not meet the criteria of paragraph (a)(4) of this section is equal to 20.0 percent of the capital requirement for the side of the transaction with the higher specific risk add-on when:

(i) The credit risk of the position is fully hedged by a credit default swap or similar instrument;

(ii) There is an exact match between the reference obligation of the credit derivative hedge and the debt or securitization position;

(iii) There is an exact match between the currency of the credit derivative hedge and the debt or securitization position; and

(iv) There is either an exact match between the maturity date of the credit derivative hedge and the maturity date of the debt or securitization position; or, in the case where the credit derivative hedge has a standard maturity date:

(A) The maturity date of the credit derivative hedge is within 30 business days of the maturity date of the debt or securitization position; or

(B) For purchased credit protection, the maturity date of the credit derivative hedge is later than the maturity date of the debt or securitization position, but is no later than the standard maturity date for that instrument that immediately follows the maturity date of the debt or securitization position. The maturity date of the credit derivative hedge may not exceed the maturity date of the debt or securitization position by more than 90 calendar days.

(6) The specific risk add-on for a set of transactions consisting of either a debt position and its credit derivative hedge or a securitization position and its credit derivative hedge that does not meet the criteria of either paragraph (a)(4) or (a)(5) of this section, but in which all or substantially all of the price risk has been hedged, is equal to the specific risk add-on for the side of the transaction with the higher specific risk add-on.

(b) *Debt and securitization positions.* (1) The total specific risk add-on for a portfolio of debt or securitization positions is the sum of the specific risk add-ons for individual debt or securitization positions, as computed under this section. To determine the specific risk add-on for individual debt or securitization positions, a bank holding company must multiply the absolute value of the current market value of each net long or net short debt or securitization position in the portfolio by the appropriate specific risk-weighting factor as set forth in paragraphs (b)(2)(i) through (b)(2)(vii) of this section.

(2) For the purpose of this section, the appropriate specific risk-weighting factors include:

(i) *Sovereign debt positions.* (A) *In general.* A bank holding company must assign a specific risk-weighting factor to a sovereign debt position based on the CRC applicable to the sovereign entity and, as applicable, the remaining contractual maturity of the position, in accordance with table 2. Sovereign debt positions that are backed by the full faith and credit of the United States are treated as having a CRC of 0.

TABLE 2—SPECIFIC RISK-WEIGHTING FACTORS FOR SOVEREIGN DEBT POSITIONS

		Specific risk-weighting factor	Percent
CRC of Sovereign	0–1		0.0
	2–3	Remaining contractual maturity of 6 months or less.	0.25
		Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
		Remaining contractual maturity exceeds 24 months.	1.6
	4–6		8.0
	7		12.0
No CRC			8.0
Default by the Sovereign Entity			12.0

(B) Notwithstanding paragraph (b)(2)(i)(A) of this section, a bank holding company may assign to a sovereign debt position a specific risk-weighting factor that is lower than the applicable specific risk-weighting factor in table 2 if:

(*1*) The position is denominated in the sovereign entity's currency;

(*2*) The bank holding company has at least an equivalent amount of liabilities in that currency; and

(*3*) The sovereign entity allows banks under its jurisdiction to assign the lower specific risk-weighting factor to the same exposures to the sovereign entity.

(C) A bank holding company must assign a 12.0 percent specific risk-weighting factor to a sovereign debt position immediately upon determination that a default has occurred; or if a default has occurred within the previous five years.

(D) A bank holding company must assign an 8.0 percent specific risk-weighting factor to a sovereign debt position if the sovereign entity does not have a CRC assigned to it, unless the sovereign debt position must be assigned a higher specific risk-weighting factor under paragraph (b)(2)(i)(C) of this section.

(ii) *Certain supranational entity and multilateral development bank debt positions.* A bank holding company may assign a 0.0 percent specific risk-weighting factor to a debt position that is an exposure to the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, or an MDB.

(iii) *GSE debt positions.* A bank holding company must assign a 1.6 percent specific risk-weighting factor to a debt position that is an exposure to a GSE. Notwithstanding the foregoing, a bank holding company must assign an 8.0 percent specific risk-weighting factor to preferred stock issued by a GSE.

(iv) *Depository institution, foreign bank, and credit union debt positions.* (A) Except as provided in paragraph (b)(2)(iv)(B) of this section, a bank holding company must assign a specific risk-weighting factor to a debt position that is an exposure to a depository institution, a foreign bank, or a credit union using the specific risk-weighting factor that corresponds to that entity's sovereign of incorporation and, as applicable, the remaining contractual maturity of the position, in accordance with table 3.

TABLE 3—SPECIFIC RISK-WEIGHTING FACTORS FOR DEPOSITORY INSTITUTION, FOREIGN BANK, AND CREDIT UNION DEBT POSITIONS

		Specific risk-weighting factor	Percent
CRC of Sovereign	0–2	Remaining contractual maturity of 6 months or less.	0.25
		Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
		Remaining contractual maturity exceeds 24 months.	1.6
	3		8.0
	4–7		12.0
No CRC			8.0
Default by the Sovereign Entity			12.0

(B) A bank holding company must assign a specific risk-weighting factor of 8.0 percent to a debt position that is an exposure to a depository institution or a foreign bank that is includable in the depository institution's or foreign bank's regulatory capital and that is not subject to deduction as a reciprocal holding under the [general risk-based capital rules].

(C) A bank holding company must assign a 12.0 percent specific risk-weighting factor to a debt position that is an exposure to a foreign bank immediately upon determination that a default by the foreign bank's sovereign of incorporation has occurred or if a default by the foreign bank's sovereign of incorporation has occurred within the previous five years.

(v) *PSE debt positions.* (A) Except as provided in paragraph (b)(2)(v)(B) of this section, a bank holding company must assign a specific risk-weighting factor to a debt position that is an exposure to a PSE based on the specific risk-weighting factor that corresponds to the PSE's sovereign of incorporation and to the position's categorization as a general obligation or revenue obligation and, as applicable, the remaining contractual maturity of the position, as set forth in tables 4 and 5.

(B) A bank holding company may assign a lower specific risk-weighting factor than would otherwise apply under tables 4 and 5 to a debt position that is an exposure to a foreign PSE if:

(*1*) The PSE's sovereign of incorporation allows banks under its jurisdiction to assign a lower specific risk-weighting factor to such position; and

(*2*) The specific risk-weighting factor is not lower than the risk weight that corresponds to the PSE's sovereign of incorporation in accordance with tables 4 and 5.

(C) A bank holding company must assign a 12.0 percent specific risk-weighting factor to a PSE debt position immediately upon determination that a default by the PSE's sovereign of incorporation has occurred or if a default by the PSE's sovereign of incorporation has occurred within the previous five years.

TABLE 4—SPECIFIC RISK-WEIGHTING FACTORS FOR PSE GENERAL OBLIGATION DEBT POSITIONS

		General obligation specific risk-weighting factor (in percent)	Percent
CRC of Sovereign	0–2	Remaining contractual maturity of 6 months or less.	0.25
		Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
		Remaining contractual maturity exceeds 24 months.	1.6
	3		8.0
	4–7		12.0
No CRC			8.0
Default by the Sovereign Entity			12.0

TABLE 5—SPECIFIC RISK-WEIGHTING FACTORS FOR PSE REVENUE OBLIGATION DEBT POSITIONS

		Revenue obligation specific risk-weighting factor	Percent
CRC of Sovereign	0–1	Remaining contractual maturity of 6 months or less.	0.25
		Remaining contractual maturity of greater than 6 and up to and including 24 months.	1.0
		Remaining contractual maturity exceeds 24 months.	1.6
	2–3		8.0
	4–7		12.0
No CRC			8.0
Default by the Sovereign Entity			12.0

(vi) *Corporate debt positions.* Except as otherwise provided in paragraph (b)(2)(vi)(B), a bank holding company must assign a specific risk-weighting factor to a corporate debt position in accordance with the investment grade methodology in paragraph (b)(2)(vi)(A) of this section.

(A) *Investment grade methodology.* (*1*) For corporate debt positions that are exposures to entities that have issued and outstanding publicly traded instruments, a bank holding company must assign a specific risk-weighting factor based on the category and remaining contractual maturity of the position, in accordance with table 6. For purposes of this paragraph (A), the bank holding company must determine whether the position is in the investment grade or not investment grade category.

TABLE 6—SPECIFIC RISK-WEIGHTING FACTORS FOR CORPORATE DEBT POSITIONS UNDER THE INVESTMENT GRADE METHODOLOGY

Category	Remaining contractual maturity	Specific risk-weighting factor (in percent)
Investment Grade	6 months or less	0.50
	Greater than 6 and up to and including 24 months	2.00
	Greater than 24 months	4.00
Not-investment Grade		12.00

(*2*) A bank holding company must assign an 8.0 percent specific risk-weighting factor for corporate debt positions that are exposures to entities that do not have publicly traded instruments outstanding.

(B) *Limitations.* (*1*) A bank holding company must assign a specific risk-weighting factor of at least 8.0 percent to an interest-only mortgage-backed security that is not a securitization position.

(*2*) A bank holding company shall not assign a corporate debt position a specific risk-weighting factor that is lower than the specific risk-weighting factor that corresponds to the CRC of the issuer's sovereign of incorporation in table 1.

(vii) *Securitization positions.* (A) *General requirements.* (*1*) A bank holding company that does not use the [advanced capital adequacy framework] must assign a specific risk-weighting factor to a securitization position using either the simplified supervisory formula approach (SSFA) in accordance with section 11 of this appendix or assign a specific risk-weighting factor of 100 percent to the position.

(*2*) A bank holding company that uses the [advanced capital adequacy framework] must calculate a specific risk add-on for a securitization position using the SFA in section 45 of Appendix G to this part and in accordance with paragraph (b)(2)(vii)(B) of this section if the bank holding company and the securitization position each qualifies to use the SFA under the [advanced capital adequacy framework]. A bank holding company that uses the [advanced capital adequacy framework] and that has a securitization position that does not qualify for the SFA may assign a specific risk-weighting factor to the securitization position using the SSFA in accordance with section 11 of this appendix or assign a specific risk-weighting factor of 100 percent to the position.

(*3*) A bank holding company must treat a short securitization position as if it is a long securitization position solely for calculation purposes when using the SFA in paragraph (b)(2)(vii)(B) or the SSFA in section 11 of this appendix.

(B) *SFA.* To calculate the specific risk add-on for a securitization position using the SFA, a bank holding company that is subject to Appendix G to this part must set the specific risk add-on for the position equal to the risk-based capital requirement, calculated under section 45 of Appendix G to this part.

(C) *SSFA.* To use the SSFA to determine the specific risk-weighting factor for a securitization position, a bank holding company must calculate the specific risk-weighting factor in accordance with section 11 of this appendix.

(D) *Nth-to-default credit derivatives.* A bank holding company must determine a specific risk add-on using the SFA in paragraph (b)(2)(vii)(B), or assign a specific risk-weighting factor using the SSFA in section 11 of this appendix to an nth-to-default credit derivative in accordance with this paragraph (D), irrespective of whether the bank holding company is a net protection buyer or net protection seller. A bank holding company must determine its position in the nth-to-default credit derivative as the largest notional dollar amount of all the underlying exposures.

(*1*) For purposes of determining the specific risk add-on using the SFA in paragraph (b)(2)(vii)(B) or the specific risk-weighting factor for an nth-to-default credit derivative using the SSFA in section 11 of this appendix, the bank holding company must calculate the attachment point and detachment point of its position as follows:

(*i*) The attachment point (parameter A) is the ratio of the sum of the notional amounts of all underlying exposures that are subordinated to the bank holding company's position to the total notional amount of all underlying exposures. For purposes of using the SFA to calculate the specific add-on for its position in an nth-to-default credit derivative, parameter A must be set equal to *the credit enhancement level* (L) input to the SFA formula. In the case of a first-to-default credit derivative, there are no underlying exposures that are subordinated to the bank holding company's position. In the case of a second-or-subsequent-to-default credit derivative, the smallest (n-1) notional amounts of the underlying exposure(s) are subordinated to the bank holding company's position.

(*ii*) The detachment point (parameter D) equals the sum of parameter A plus the ratio of the notional amount of the bank holding company's position in the nth-to-default credit derivative to the total notional amount of all underlying exposures. For purposes of using the SFA to calculate the specific risk add-on for its position in an nth-to-default credit derivative, parameter D must be set to equal L plus the *thickness of tranche* (T) input to the SFA formula.

(*2*) A bank holding company that does not use the SFA to determine a specific risk-add on, or the SSFA to determine a specific risk-weighting factor for its position in an nth-to-default credit derivative must assign a specific risk-weighting factor of 100 percent to the position.

(c) *Modeled correlation trading positions*. For purposes of calculating the comprehensive risk measure for modeled correlation trading positions under either paragraph (a)(2)(i) or (a)(2)(ii) of section 9 of this appendix, the total specific risk add-on is the greater of:

(1) The sum of the bank holding company's specific risk add-ons for each net long correlation trading position calculated under this section; or

(2) The sum of the bank holding company's specific risk add-ons for each net short correlation trading position calculated under this section.

(d) *Non-modeled securitization positions*. For securitization positions that are not correlation trading positions and for securitizations that are correlation trading positions not modeled under section 9 of this appendix, the total specific risk add-on is the greater of:

(1) The sum of the bank holding company's specific risk add-ons for each net long securitization position calculated under this section; or

(2) The sum of the bank holding company's specific risk add-ons for each net short securitization position calculated under this section.

(e) *Equity positions*. The total specific risk add-on for a portfolio of equity positions is the sum of the specific risk add-ons of the individual equity positions, as computed under this section. To determine the specific risk add-on of individual equity positions, a bank holding company must multiply the absolute value of the current market value of each net long or net short equity position by the appropriate specific risk-weighting factor as determined under this paragraph:

(1) The bank holding company must multiply the absolute value of the current market value of each net long or net short equity position by a specific risk-weighting factor of 8.0 percent. For equity positions that are index contracts comprising a well-diversified portfolio of equity instruments, the absolute value of the current market value of each net long or net short position is multiplied by a specific risk-weighting factor of 2.0 percent.[46]

(2) For equity positions arising from the following futures-related arbitrage strategies, a bank holding company may apply a 2.0 percent specific risk-weighting factor to one side (long or short) of each position with the opposite side exempt from an additional capital requirement:

(i) Long and short positions in exactly the same index at different dates or in different market centers; or

(ii) Long and short positions in index contracts at the same date in different, but similar indices.

(3) For futures contracts on main indices that are matched by offsetting positions in a basket of stocks comprising the index, a bank holding company may apply a 2.0 percent specific risk-weighting factor to the futures and stock basket positions (long and short), provided that such trades are deliberately entered into and separately controlled, and that the basket of stocks is comprised of stocks representing at least 90.0 percent of the capitalization of the index. A main index refers to the Standard & Poor's 500 Index, the FTSE All-World Index, and any other index for which the bank holding company can demonstrate to the satisfaction of the Board or the appropriate Reserve Bank, with concurrence of the Board that the equities represented in the index have liquidity, depth of market, and size of bid-ask spreads comparable to equities in the Standard & Poor's 500 Index and FTSE All-World Index.

[46] A portfolio is well-diversified if it contains a large number of individual equity positions, with no single position representing a substantial portion of the portfolio's total market value.

(f) *Due diligence requirements.* (1) A bank holding company must demonstrate to the satisfaction of the Board or the appropriate Reserve Bank, with concurrence of the Board a comprehensive understanding of the features of a securitization position that would materially affect the performance of the position by conducting and documenting the analysis set forth in paragraph (f)(2) of this section. The bank holding company's analysis must be commensurate with the complexity of the securitization position and the materiality of the position in relation to capital.

(2) To support the demonstration of its comprehensive understanding, for each securitization position a bank holding company must:

(i) Conduct an analysis of the risk characteristics of a securitization position prior to acquiring the position and document such analysis within three business days after acquiring the position, considering:

(A) Structural features of the securitization that would materially impact the performance of the position, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

(B) Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification data on the underlying exposure(s);

(C) Relevant market data of the securitization, for example, bid-ask spreads, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the securitization; and

(D) For resecuritization positions, performance information on the underlying securitization exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the securitization exposures; and

(ii) On an on-going basis (no less frequently than quarterly), evaluate, review, and update as appropriate the analysis required under paragraph (f)(1) of this section for each securitization position.

Section 11. Simplified Supervisory Formula Approach

(a) *General requirements.* To use the SSFA to determine the specific risk-weighting factor for a securitization position, a bank holding company must have data that enables it to assign accurately the parameters described in paragraph (b) of this section. Data used to assign the parameters described in paragraph (b) of this section must be the most currently available data and no more than 91 calendar days old. A bank holding company that does not have the appropriate data to assign the parameters described and defined, for purposes of this section, in paragraph (b) of this section must assign a specific risk-weighting factor of 100 percent to the position.

(b) *SSFA parameters.* To calculate the specific risk-weighting factor for a securitization position using the SSFA, a bank holding company must have accurate information on the five inputs to the SSFA calculation described in paragraphs (b)(1) through (b)(5) of this section:

(1) K_G is the weighted-average (with unpaid principal used as the weight for each exposure) total capital requirement of the underlying exposures calculated using the [general risk-based capital rules]. K_G is expressed as a decimal value between zero and 1 (that is, an average risk weight of 100 percent represents a value of K_G equal to .08).

(2) Parameter W is expressed as a decimal value between zero and one. Parameter W is the ratio of the sum of the dollar amounts of any underlying exposures within the securitized pool that meet any of the criteria as set forth in paragraphs (i) through (vi) of this paragraph (b)(2) to the ending balance, measured in dollars, of underlying exposures:

(i) Ninety days or more past due;

(ii) Subject to a bankruptcy or insolvency proceeding;

(iii) In the process of foreclosure;

(iv) Held as real estate owned;

(v) Has contractually deferred interest payments for 90 days or more; or

(vi) Is in default.

(3) Parameter A is the attachment point for the position, which represents the threshold at which credit losses will first be allocated to the position. Parameter A equals the ratio of the current dollar amount of underlying exposures that are subordinated to the position of the bank holding company to the current dollar amount of underlying exposures. Any reserve account funded by the accumulated cash flows from the underlying exposures that is subordinated to the position that contains the bank holding company's securitization exposure may be included in the calculation of parameter A to the extent that cash is present in the account. Parameter A is expressed as a decimal value between zero and one.

(4) Parameter D is the detachment point for the position, which represents the threshold at which credit losses of principal allocated to the position would result in a total loss of principal. Parameter D equals parameter A plus the ratio of the current dollar amount of the securitization positions that

are *pari passu* with the position (that is, have equal seniority with respect to credit risk) to the current dollar amount of the underlying exposures. Parameter D is expressed as a decimal value between zero and one.

(5) A supervisory calibration parameter, p, is equal to 0.5 for securitization positions that are not resecuritization positions and equal to 1.5 for resecuritization positions.

(c) *Mechanics of the SSFA.* K_G and W are used to calculate K_A, the augmented value of K_G, which reflects the observed credit quality of the underlying pool of exposures. K_A is defined in paragraph (d) of this section. The values of parameters A and D, relative to K_A determine the specific risk-weighting factor assigned to a position as described in this paragraph and paragraph (d) of this section. The specific risk-weighting factor assigned to a securitization position, or portion of a position, as appropriate, is the larger of the specific risk-weighting factor determined in accordance with this paragraph and paragraph (d) of this section and a specific risk-weighting factor of 1.6 percent.

(1) When the detachment point, parameter D, for a securitization position is less than or equal to K_A, the position must be assigned a specific risk-weighting factor of 100 percent.

(2) When the attachment point, parameter A, for a securitization position is greater than or equal to K_A, the bank holding company must calculate the specific risk-weighting factor in accordance with paragraph (d) of this section.

(3) When A is less than K_A and D is greater than K_A, the specific risk-weighting factor is a weighted-average of 1.00 and K_{SSFA} calculated in accordance with paragraph (d) of this section, but with the parameter A revised to be set equal to K_A. For the purpose of this weighted-average calculation:

(i) The weight assigned to 1.00 equals $\frac{K_A - A}{D - A}$.

(ii) The weight assigned to K_{SSFA} equals $\frac{D - K_A}{D - A}$. The specific risk-weighting factor will be set equal to:

$$SRWF = 100 \times \left[\left(\frac{K_A - A}{D - A}\right) \times 1.00\right] + \left[\left(\frac{D \quad K_A}{D - A}\right) \times K_{SSFA}\right]$$

(d) <u>SSFA equation</u>. (1) The [bank] must define the following parameters:

$$K_A = (1 - W) \cdot K_G + (0.5 \cdot W)$$

$$a = -\frac{1}{p \cdot K_A}$$

$$u = D - K_A$$

$$l = A - K_A$$

$e = 2.71828$, the base of the natural logarithms.

(2) Then the [bank] must calculate K_{SSFA} according to the following equation:

$$K_{SSFA} = \frac{e^{a \cdot u} - e^{a \cdot l}}{a(u - l)}$$

(3) The specific risk-weighting factor for the position (expressed as a percent) is equal to $K_{SSFA} \times 100$.

Section 12. Market Risk Disclosures

(a) *Scope.* A bank holding company must comply with this section unless it is a consolidated subsidiary of a bank holding company or a depository institution that is subject to these requirements or of a non-U.S. banking organization that is subject to comparable public disclosure requirements in its home jurisdiction. A bank holding company must make quantitative disclosures publicly each calendar quarter. If a significant change occurs, such that the most recent reporting amounts are no longer reflective of the bank holding company's capital adequacy and risk profile, then a brief discussion of this change and its likely impact must be provided as soon as practicable thereafter. Qualitative disclosures that typically do not change each quarter may be disclosed annually, provided any significant changes are disclosed in the interim. If a bank holding company believes that disclosure of specific commercial or financial information would prejudice seriously its position by making public certain information that is either proprietary or confidential in nature, the bank holding company is not required to disclose these specific items, but must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed.

(b) *Disclosure policy.* The bank holding company must have a formal disclosure policy approved by the board of directors that addresses the bank holding company's approach for determining its market risk disclosures. The policy must address the associated internal controls and disclosure controls and procedures. The board of directors and senior management must ensure that appropriate verification of the disclosures takes place and that effective internal controls and disclosure controls and procedures are maintained. One or more senior officers of the bank holding company must attest that the disclosures meet the requirements of this appendix, and the board of directors and senior management are responsible for establishing and maintaining an effective internal control structure over financial reporting, including the disclosures required by this section.

(c) *Quantitative disclosures.*

(1) For each material portfolio of covered positions, the bank holding company must disclose publicly the following information at least quarterly:

(i) The high, low, and mean VaR-based measures over the reporting period and the VaR-based measure at period-end;

(ii) The high, low, and mean stressed VaR-based measures over the reporting period and the stressed VaR-based measure at period-end;

(iii) The high, low, and mean incremental risk capital requirements over the reporting period and the incremental risk capital requirement at period-end;

(iv) The high, low, and mean comprehensive risk capital requirements over the reporting period and the comprehensive risk capital requirement at period-end, with the period-end requirement broken down into appropriate risk classifications (for example, default risk, migration risk, correlation risk);

(v) Separate measures for interest rate risk, credit spread risk, equity price risk, foreign exchange risk, and commodity price risk used to calculate the VaR-based measure; and

(vi) A comparison of VaR-based estimates with actual gains or losses experienced by the bank holding company, with an analysis of important outliers.

(2) In addition, the bank holding company must disclose publicly the following information at least quarterly:

(i) The aggregate amount of on-balance sheet and off-balance sheet securitization positions by exposure type; and

(ii) The aggregate amount of correlation trading positions.

(d) *Qualitative disclosures.* For each material portfolio of covered positions, the bank holding company must disclose publicly the following information at least annually, or more frequently in the event of material changes for each portfolio:

(1) The composition of material portfolios of covered positions;

(2) The bank holding company's valuation policies, procedures, and methodologies for covered positions including, for securitization positions, the methods and key assumptions used for valuing such positions, any significant changes since the last reporting period, and the impact of such change;

(3) The characteristics of the internal models used for purposes of this appendix. For the incremental risk capital requirement and the comprehensive risk capital requirement, this must include:

(i) The approach used by the bank holding company to determine liquidity horizons;

(ii) The methodologies used to achieve a capital assessment that is consistent with the required soundness standard; and

(iii) The specific approaches used in the validation of these models;

(4) A description of the approaches used for validating and evaluating the accuracy of internal models and modeling processes for purposes of this appendix;

(5) For each market risk category (that is, interest rate risk, credit spread risk, equity price risk, foreign exchange risk, and commodity price risk), a description of the stress tests applied to the positions subject to the factor;

(6) The results of the comparison of the bank holding company's internal estimates for purposes of this appendix with actual outcomes during a sample period not used in model development;

(7) The soundness standard on which the bank holding company's internal capital adequacy assessment under this appendix is based, including a description of the methodologies used to achieve a capital adequacy assessment that is consistent with the soundness standard;

(8) A description of the bank holding company's processes for monitoring changes in the credit and market risk of securitization positions, including how those processes differ for resecuritization positions; and

(8) A description of the bank holding company's policy governing the use of credit risk mitigation to mitigate the risks of securitization and resecuritization positions.

[77 FR 53113, Aug. 30, 2012]

APPENDIX F TO PART 225—INTERAGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

TABLE OF CONTENTS

I. INTRODUCTION

These Interagency Guidelines Establishing Information Security Standards (Guidelines) set forth standards pursuant to sections 501 and 505 of the Gramm-Leach-Bliley Act (15 U.S.C. 6801 and 6805). These Guidelines address standards for developing and implementing administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of customer information.

A. *Scope.* The Guidelines apply to customer information maintained by or on behalf of bank holding companies and their nonbank subsidiaries or affiliates (except brokers, dealers, persons providing insurance, investment companies, and investment advisors), for which the Board has supervisory authority.

B. *Preservation of Existing Authority.* These Guidelines do not in any way limit the authority of the Board to address unsafe or unsound practices, violations of law, unsafe or unsound conditions, or other practices. The Board may take action under these Guidelines independently of, in conjunction with, or in addition to, any other enforcement action available to the Board.

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

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

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

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

c. *Customer information* means any record containing nonpublic personal information, as defined in §216.3(n) of this chapter, about a customer, whether in paper, electronic, or other form, that is maintained by or on behalf of the bank holding company.

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

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

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

II. STANDARDS FOR SAFEGUARDING CUSTOMER INFORMATION

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

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

1. Ensure the security and confidentiality of customer information;

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

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

III. DEVELOPMENT AND IMPLEMENTATION OF INFORMATION SECURITY PROGRAM

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

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

2. Oversee the development, implementation, and maintenance of the bank holding company's information security program, including assigning specific responsibility for its implementation and reviewing reports from management.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

G. *Implement the Standards.*

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

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

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

SUPPLEMENT A TO APPENDIX F TO PART 225—INTERAGENCY GUIDANCE ON RESPONSE PROGRAMS FOR UNAUTHORIZED ACCESS TO CUSTOMER INFORMATION AND CUSTOMER NOTICE

I. BACKGROUND

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

A. Interagency Security Guidelines

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

1. Ensure the security and confidentiality of customer information;

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

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

B. Risk Assessment and Controls

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

a. Reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems;

b. The likelihood and potential damage of threats, taking into consideration the sensitivity of customer information; and

c. The sufficiency of policies, procedures, customer information systems, and other arrangements in place to control risks.[3]

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

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

b. Background checks for employees with responsibilities for access to customer information; and

c. Response programs that specify actions to be taken when the financial institution suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies.[5]

C. Service Providers

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

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

[2] 12 CFR part 30, app. B (OCC); 12 CFR part 208, app. D–2 and part 225, app. F (Board); 12 CFR part 364, app. B (FDIC); and 12 CFR part 570, app. B (OTS). The ''Interagency Guidelines Establishing Information Security Standards'' were formerly known as ''The Interagency Guidelines Establishing Information Security Standards.''

[3] *See* Security Guidelines, III.B.

[4] *See* Security Guidelines, III.C.

[5] *See* Security Guidelines, III.C.

[6] *See* Security Guidelines, II.B. and III.D. Further, the Agencies note that, in addition

II. RESPONSE PROGRAM

Millions of Americans, throughout the country, have been victims of identity theft.[7] Identity thieves misuse personal information they obtain from a number of sources, including financial institutions, to perpetrate identity theft. Therefore, financial institutions should take preventative measures to safeguard customer information against attempts to gain unauthorized access to the information. For example, financial institutions should place access controls on customer information systems and conduct background checks for employees who are authorized to access customer information.[8] However, every financial institution should also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems[9] that occur nonetheless. A response program should be a key part of an institution's information security program.[10] The program should be appropriate to the size and complexity of the institution and the nature and scope of its activities.

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

A. Components of a Response Program

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

a. Assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused;

b. Notifying its primary Federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of *sensitive* customer information, as defined below;

c. Consistent with the Agencies' Suspicious Activity Report (''SAR'') regulations,[12] notifying appropriate law enforcement authorities, in addition to filing a timely SAR in

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to contractual obligations to a financial institution, a service provider may be required to implement its own comprehensive information security program in accordance with the Safeguards Rule promulgated by the Federal Trade Commission (''FTC''), 16 CFR part 314.

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

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

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

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

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

[12] An institution's obligation to file a SAR is set out in the Agencies' SAR regulations and Agency guidance. *See* 12 CFR 21.11 (national banks, Federal branches and agencies); 12 CFR 208.62 (State member banks); 12 CFR 211.5(k) (Edge and agreement corporations); 12 CFR 211.24(f) (uninsured State branches and agencies of foreign banks); 12 CFR 225.4(f) (bank holding companies and their nonbank subsidiaries); 12 CFR part 353 (State non-member banks); and 12 CFR 563.180 (savings associations). National banks must file SARs in connection with computer intrusions and other computer crimes. *See* OCC Bulletin 2000–14, ''Infrastructure Threats—Intrusion Risks'' (May 15, 2000); Advisory Letter 97–9, ''Reporting Computer Related Crimes'' (November 19, 1997) (general

Continued

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

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

e. Notifying customers when warranted.

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

III. CUSTOMER NOTICE

Financial institutions have an affirmative duty to protect their customers' information against unauthorized access or use. Notifying customers of a security incident involving the unauthorized access or use of the customer's information in accordance with the standard set forth below is a key part of that duty. Timely notification of customers is important to manage an institution's reputation risk. Effective notice also may reduce an institution's legal risk, assist in maintaining good customer relations, and enable the institution's customers to take steps to protect themselves against the consequences of identity theft. When customer notification is warranted, an institution may not forgo notifying its customers of an incident because the institution believes that it may be potentially embarrassed or inconvenienced by doing so.

A. Standard for Providing Notice

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

1. Sensitive Customer Information

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

2. Affected Customers

If a financial institution, based upon its investigation, can determine from its logs or other data precisely which customers' information has been improperly accessed, it may limit notification to those customers with regard to whom the institution determines that misuse of their information has occurred or is reasonably possible. However, there may be situations where the institution determines that a group of files has been accessed improperly, but is unable to identify which specific customers' information has been accessed. If the circumstances of the unauthorized access lead the institution to determine that misuse of the information is reasonably possible, it should notify all customers in the group.

guidance still applicable though instructions for new SAR form published in 65 FR 1229, 1230 (January 7, 2000)). *See also* Federal Reserve SR 01–11, Identity Theft and Pretext Calling, Apr. 26, 2001; SR 97–28, Guidance Concerning Reporting of Computer Related Crimes by Financial Institutions, Nov. 6, 1997; FDIC FIL 48–2000, Suspicious Activity Reports, July 14, 2000; FIL 47–97, Preparation of Suspicious Activity Reports, May 6, 1997; OTS CEO Memorandum 139, Identity Theft and Pretext Calling, May 4, 2001; CEO Memorandum 126, New Suspicious Activity Report Form, July 5, 2000; *http://www.ots.treas.gov/BSA* (for the latest SAR form and filing instructions required by OTS as of July 1, 2003).

[13] *See* FFIEC Information Technology Examination Handbook, Information Security Booklet, Dec. 2002, pp. 68–74.

B. Content of Customer Notice

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

a. A recommendation that the customer review account statements and immediately report any suspicious activity to the institution;

b. A description of fraud alerts and an explanation of how the customer may place a fraud alert in the customer's consumer reports to put the customer's creditors on notice that the customer may be a victim of fraud;

c. A recommendation that the customer periodically obtain credit reports from each nationwide credit reporting agency and have information relating to fraudulent transactions deleted;

d. An explanation of how the customer may obtain a credit report free of charge; and

e. Information about the availability of the FTC's online guidance regarding steps a consumer can take to protect against identity theft. The notice should encourage the customer to report any incidents of identity theft to the FTC, and should provide the FTC's Web site address and toll-free telephone number that customers may use to obtain the identity theft guidance and report suspected incidents of identity theft.[15]

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

C. Delivery of Customer Notice

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

[66 FR 8636, Feb. 1, 2001, as amended at 70 FR 15751, 15753, Mar. 29, 2005; 71 FR 5780, Feb. 3, 2006]

APPENDIX G TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: INTERNAL-RATINGS-BASED AND ADVANCED MEASUREMENT APPROACHES

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

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

PART I. GENERAL PROVISIONS

Section 1. Purpose, Applicability, Reservation of Authority, and Principle of Conservatism

(a) *Purpose*. This appendix establishes:

(1) Minimum qualifying criteria for bank holding company using bank holding company-specific internal risk measurement and management processes for calculating risk-based capital requirements;

(2) Methodologies for such bank holding company to calculate their risk-based capital requirements; and

(3) Public disclosure requirements for such bank holding company.

(b) *Applicability*. (1) This appendix applies to a bank holding company that:

(i) Has consolidated total assets, as reported on the most recent year-end Consolidated Report of Condition and Income (Call Report) or Thrift Financial Report (TFR), equal to $250 billion or more;

(ii) Has consolidated total on-balance sheet foreign exposure at the most recent year-end equal to $10 billion or more (where total on-balance sheet foreign exposure equals total cross-border claims less claims with head office or guarantor located in another country plus redistributed guaranteed amounts to the country of head office or guarantor plus local country claims on local residents plus revaluation gains on foreign exchange and derivative products, calculated in accordance with the Federal Financial Institutions Examination Council (FFIEC) 009 Country Exposure Report);

(iii) Is a subsidiary of a depository institution that uses 12 CFR part 3, appendix C, 12 CFR part 208, appendix F, 12 CFR part 325, appendix D, or 12 CFR part 567, appendix C, to calculate its risk-based capital requirements; or

(iv) Is a subsidiary of a bank holding company that uses 12 CFR part 225, appendix G, to calculate its risk-based capital requirements.

(2) Any bank holding company may elect to use this appendix to calculate its risk-based capital requirements.

(3) A bank holding company that is subject to this appendix must use this appendix unless the Federal Reserve determines in writing that application of this appendix is not appropriate in light of the bank holding company's asset size, level of complexity, risk profile, or scope of operations. In making a determination under this paragraph, the Federal Reserve will apply notice and response procedures in the same manner and to the same extent as the notice and response procedures in 12 CFR 263.202.

(c) *Reservation of authority*—(1) *Additional capital in the aggregate*. The Federal Reserve may require a bank holding company to hold an amount of capital greater than otherwise required under this appendix if the Federal Reserve determines that the bank holding company's risk-based capital requirement under this appendix is not commensurate with the bank holding company's credit, market, operational, or other risks. In making a determination under this paragraph, the Federal Reserve will apply notice and response procedures in the same manner and to the same extent as the notice and response procedures in 12 CFR 263.202.

(2) *Specific risk-weighted asset amounts*. (i) If the Federal Reserve determines that the risk-weighted asset amount calculated under this appendix by the bank holding company for one or more exposures is not commensurate with the risks associated with those exposures, the Federal Reserve may require the bank holding company to assign a different risk-weighted asset amount to the exposures, to assign different risk parameters to the exposures (if the exposures are wholesale or retail exposures), or to use different model assumptions for the exposures (if relevant), all as specified by the Federal Reserve.

(ii) If the Federal Reserve determines that the risk-weighted asset amount for operational risk produced by the bank holding company under this appendix is not commensurate with the operational risks of the bank holding company, the Federal Reserve may require the bank holding company to assign a different risk-weighted asset amount for operational risk, to change elements of its operational risk analytical framework, including distributional and dependence assumptions, or to make other changes to the bank holding company's operational risk management processes, data and assessment systems, or quantification systems, all as specified by the Federal Reserve.

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

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

(d) *Principle of conservatism.* Notwithstanding the requirements of this appendix, a bank holding company may choose not to apply a provision of this appendix to one or more exposures, provided that:

(1) The bank holding company can demonstrate on an ongoing basis to the satisfaction of the Federal Reserve that not applying the provision would, in all circumstances, unambiguously generate a risk-based capital requirement for each such exposure greater than that which would otherwise be required under this appendix;

(2) The bank holding company appropriately manages the risk of each such exposure;

(3) The bank holding company notifies the Federal Reserve in writing prior to applying this principle to each such exposure; and

(4) The exposures to which the bank holding company applies this principle are not, in the aggregate, material to the bank holding company.

Section 2. Definitions

Advanced internal ratings-based (IRB) systems means a bank holding company's internal risk rating and segmentation system; risk parameter quantification system; data management and maintenance system; and control, oversight, and validation system for credit risk of wholesale and retail exposures.

Advanced systems means a bank holding company's advanced IRB systems, operational risk management processes, operational risk data and assessment systems, operational risk quantification systems, and, to the extent the bank holding company uses the following systems, the internal models methodology, double default excessive correlation detection process, IMA for equity exposures, and IAA for securitization exposures to ABCP programs.

Affiliate with respect to a company means any company that controls, is controlled by, or is under common control with, the company.

Applicable external rating means:

(1) With respect to an exposure that has multiple external ratings assigned by NRSROs, the lowest solicited external rating assigned to the exposure by any NRSRO; and

(2) With respect to an exposure that has a single external rating assigned by an NRSRO, the external rating assigned to the exposure by the NRSRO.

Applicable inferred rating means:

(1) With respect to an exposure that has multiple inferred ratings, the lowest inferred rating based on a solicited external rating; and

(2) With respect to an exposure that has a single inferred rating, the inferred rating.

Asset-backed commercial paper (ABCP) program means a program that primarily issues commercial paper that:

(1) Has an external rating; and

(2) Is backed by underlying exposures held in a bankruptcy-remote SPE.

Asset-backed commercial paper (ABCP) program sponsor means a bank holding company that:

(1) Establishes an ABCP program;

(2) Approves the sellers permitted to participate in an ABCP program;

(3) Approves the exposures to be purchased by an ABCP program; or

(4) Administers the ABCP program by monitoring the underlying exposures, underwriting or otherwise arranging for the placement of debt or other obligations issued by the program, compiling monthly reports, or ensuring compliance with the program documents and with the program's credit and investment policy.

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

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

Benchmarking means the comparison of a bank holding company's internal estimates with relevant internal and external data or with estimates based on other estimation techniques.

Business environment and internal control factors means the indicators of a bank holding company's operational risk profile that reflect a current and forward-looking assessment of the bank holding company's underlying business risk factors and internal control environment.

Carrying value means, with respect to an asset, the value of the asset on the balance sheet of the bank holding company, determined in accordance with GAAP.

Clean-up call means a contractual provision that permits an originating bank holding company or servicer to call securitization exposures before their stated maturity or call date. See also *eligible clean-up call*.

Commodity derivative contract means a commodity-linked swap, purchased commodity-linked option, forward commodity-linked contract, or any other instrument linked to commodities that gives rise to similar counterparty credit risks.

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

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

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

(2) Consolidates the company for financial reporting purposes.

Controlled early amortization provision means an early amortization provision that meets all the following conditions:

(1) The originating bank holding company has appropriate policies and procedures to ensure that it has sufficient capital and liquidity available in the event of an early amortization;

(2) Throughout the duration of the securitization (including the early amortization period), there is the same pro rata sharing of interest, principal, expenses, losses, fees, recoveries, and other cash flows from the underlying exposures based on the originating bank holding company's and the investors' relative shares of the underlying exposures outstanding measured on a consistent monthly basis;

(3) The amortization period is sufficient for at least 90 percent of the total underlying exposures outstanding at the beginning of the early amortization period to be repaid or recognized as in default; and

(4) The schedule for repayment of investor principal is not more rapid than would be allowed by straight-line amortization over an 18-month period.

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

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

(1) Represents a contractual right to receive some or all of the interest and no more than a minimal amount of principal due on the underlying exposures of a securitization; and

(2) Exposes the holder to credit risk directly or indirectly associated with the underlying exposures that exceeds a pro rata share of the holder's claim on the underlying exposures, whether through subordination provisions or other credit-enhancement techniques.

Credit-enhancing representations and warranties means representations and warranties that are made or assumed in connection with a transfer of underlying exposures (including loan servicing assets) and that obligate a bank holding company to protect another party from losses arising from the credit risk of the underlying exposures. Credit-enhancing representations and warranties include provisions to protect a party from losses resulting from the default or nonperformance of the obligors of the underlying exposures or from an insufficiency in the value of the collateral backing the underlying exposures. Credit-enhancing representations and warranties do not include:

(1) Early default clauses and similar warranties that permit the return of, or premium refund clauses that cover, first-lien residential mortgage exposures for a period not to exceed 120 days from the date of transfer, provided that the date of transfer is within one year of origination of the residential mortgage exposure;

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

(3) Warranties that permit the return of underlying exposures in instances of misrepresentation, fraud, or incomplete documentation.

Credit risk mitigant means collateral, a credit derivative, or a guarantee.

Credit-risk-weighted assets means 1.06 multiplied by the sum of:

(1) Total wholesale and retail risk-weighted assets;

(2) Risk-weighted assets for securitization exposures; and

(3) Risk-weighted assets for equity exposures.

Current exposure means, with respect to a netting set, the larger of zero or the market value of a transaction or portfolio of transactions within the netting set that would be lost upon default of the counterparty, assuming no recovery on the value of the transactions. Current exposure is also called replacement cost.

Default—(1) *Retail*. (i) A retail exposure of a bank holding company is in default if:

(A) The exposure is 180 days past due, in the case of a residential mortgage exposure or revolving exposure;

(B) The exposure is 120 days past due, in the case of all other retail exposures; or

(C) The bank holding company has taken a full or partial charge-off, write-down of principal, or material negative fair value adjustment of principal on the exposure for credit-related reasons.

(ii) Notwithstanding paragraph (1)(i) of this definition, for a retail exposure held by a non-U.S. subsidiary of the bank holding company that is subject to an internal ratings-based approach to capital adequacy consistent with the Basel Committee on Banking Supervision's "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" in a non-U.S. jurisdiction, the bank holding company may elect to use the definition of default that is used in that jurisdiction, provided that the bank holding company has obtained prior approval from the Federal Reserve to use the definition of default in that jurisdiction.

(iii) A retail exposure in default remains in default until the bank holding company has reasonable assurance of repayment and performance for all contractual principal and interest payments on the exposure.

(2) *Wholesale*. (i) A bank holding company's wholesale obligor is in default if:

(A) The bank holding company determines that the obligor is unlikely to pay its credit obligations to the bank holding company in full, without recourse by the bank holding company to actions such as realizing collateral (if held); or

(B) The obligor is past due more than 90 days on any material credit obligation(s) to the bank holding company.[1]

(ii) An obligor in default remains in default until the bank holding company has reasonable assurance of repayment and performance for all contractual principal and interest payments on all exposures of the bank holding company to the obligor (other than exposures that have been fully written-down or charged-off).

Dependence means a measure of the association among operational losses across and within units of measure.

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

Derivative contract means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivatives, and any other instrument that poses similar counterparty credit risks. Derivative contracts also include unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument or five business days.

Early amortization provision means a provision in the documentation governing a securitization that, when triggered, causes investors in the securitization exposures to be repaid before the original stated maturity of the securitization exposures, unless the provision:

(1) Is triggered solely by events not directly related to the performance of the underlying exposures or the originating bank holding company (such as material changes in tax laws or regulations); or

(2) Leaves investors fully exposed to future draws by obligors on the underlying exposures even after the provision is triggered.

Economic downturn conditions means, with respect to an exposure held by the bank holding company, those conditions in which the aggregate default rates for that exposure's wholesale or retail exposure subcategory (or subdivision of such subcategory selected by the bank holding company) in the exposure's national jurisdiction (or subdivision of such jurisdiction selected by the bank holding company) are significantly higher than average.

Effective maturity (M) of a wholesale exposure means:

(1) For wholesale exposures other than repo-style transactions, eligible margin loans, and OTC derivative contracts described in paragraph (2) or (3) of this definition:

(i) The weighted-average remaining maturity (measured in years, whole or fractional) of the expected contractual cash flows from the exposure, using the undiscounted amounts of the cash flows as weights; or

(ii) The nominal remaining maturity (measured in years, whole or fractional) of the exposure.

(2) For repo-style transactions, eligible margin loans, and OTC derivative contracts subject to a qualifying master netting agreement for which the bank holding company does not apply the internal models approach in paragraph (d) of section 32 of this appendix, the weighted-average remaining maturity (measured in years, whole or fractional) of the individual transactions subject to the qualifying master netting agreement, with the weight of each individual transaction set equal to the notional amount of the transaction.

(3) For repo-style transactions, eligible margin loans, and OTC derivative contracts for which the bank holding company applies the internal models approach in paragraph (d) of section 32 of this appendix, the value

[1] Overdrafts are past due once the obligor has breached an advised limit or been advised of a limit smaller than the current outstanding balance.

determined in paragraph (d)(4) of section 32 of this appendix.

Effective notional amount means, for an eligible guarantee or eligible credit derivative, the lesser of the contractual notional amount of the credit risk mitigant and the EAD of the hedged exposure, multiplied by the percentage coverage of the credit risk mitigant. For example, the effective notional amount of an eligible guarantee that covers, on a pro rata basis, 40 percent of any losses on a $100 bond would be $40.

Eligible clean-up call means a clean-up call that:

(1) Is exercisable solely at the discretion of the originating bank holding company or servicer;

(2) Is not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization; and

(3) (i) For a traditional securitization, is only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding; or

(ii) For a synthetic securitization, is only exercisable when 10 percent or less of the principal amount of the reference portfolio of underlying exposures (determined as of the inception of the securitization) is outstanding.

Eligible credit derivative means a credit derivative in the form of a credit default swap, n^{th}-to-default swap, total return swap, or any other form of credit derivative approved by the Federal Reserve, provided that:

(1) The contract meets the requirements of an eligible guarantee and has been confirmed by the protection purchaser and the protection provider;

(2) Any assignment of the contract has been confirmed by all relevant parties;

(3) If the credit derivative is a credit default swap or n^{th}-to-default swap, the contract includes the following credit events:

(i) Failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and

(ii) Bankruptcy, insolvency, or inability of the obligor on the reference exposure to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and similar events;

(4) The terms and conditions dictating the manner in which the contract is to be settled are incorporated into the contract;

(5) If the contract allows for cash settlement, the contract incorporates a robust valuation process to estimate loss reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;

(6) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provides that any required consent to transfer may not be unreasonably withheld;

(7) If the credit derivative is a credit default swap or n^{th}-to-default swap, the contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event; and

(8) If the credit derivative is a total return swap and the bank holding company records net payments received on the swap as net income, the bank holding company records offsetting deterioration in the value of the hedged exposure (either through reductions in fair value or by an addition to reserves).

Eligible credit reserves means all general allowances that have been established through a charge against earnings to absorb credit losses associated with on- or off-balance sheet wholesale and retail exposures, including the allowance for loan and lease losses (ALLL) associated with such exposures but excluding allocated transfer risk reserves established pursuant to 12 U.S.C. 3904 and other specific reserves created against recognized losses.

Eligible double default guarantor, with respect to a guarantee or credit derivative obtained by a bank holding company, means:

(1) *U.S.-based entities.* A depository institution, a bank holding company, a savings and loan holding company (as defined in 12 U.S.C. 1467a) provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), a securities broker or dealer registered with the SEC under the Securities Exchange Act of 1934 (15 U.S.C. 78o *et seq.*), or an insurance company in the business of providing credit protection (such as a monoline bond insurer or re-insurer) that is subject to supervision by a State insurance regulator, if:

(i) At the time the guarantor issued the guarantee or credit derivative or at any time thereafter, the bank holding company assigned a PD to the guarantor's rating grade that was equal to or lower than the PD associated with a long-term external rating in the third-highest investment-grade rating category; and

(ii) The bank holding company currently assigns a PD to the guarantor's rating grade that is equal to or lower than the PD associated with a long-term external rating in the lowest investment-grade rating category; or

(2) *Non-U.S.-based entities.* A foreign bank (as defined in §211.2 of the Federal Reserve Board's Regulation K (12 CFR 211.2)), a non-U.S.-based securities firm, or a non-U.S.-based insurance company in the business of providing credit protection, if:

(i) The bank holding company demonstrates that the guarantor is subject to consolidated supervision and regulation comparable to that imposed on U.S. depository institutions, securities broker-dealers, or insurance companies (as the case may be), or has issued and outstanding an unsecured long-term debt security without credit enhancement that has a long-term applicable external rating of at least investment grade;

(ii) At the time the guarantor issued the guarantee or credit derivative or at any time thereafter, the bank holding company assigned a PD to the guarantor's rating grade that was equal to or lower than the PD associated with a long-term external rating in the third-highest investment-grade rating category; and

(iii) The bank holding company currently assigns a PD to the guarantor's rating grade that is equal to or lower than the PD associated with a long-term external rating in the lowest investment-grade rating category.

Eligible guarantee means a guarantee that:

(1) Is written and unconditional;

(2) Covers all or a pro rata portion of all contractual payments of the obligor on the reference exposure;

(3) Gives the beneficiary a direct claim against the protection provider;

(4) Is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;

(5) Is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced;

(6) Requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligor on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment;

(7) Does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure; and

(8) Is not provided by an affiliate of the bank holding company, unless the affiliate is an insured depository institution, bank, securities broker or dealer, or insurance company that:

(i) Does not control the bank holding company; and

(ii) Is subject to consolidated supervision and regulation comparable to that imposed on U.S. depository institutions, securities broker-dealers, or insurance companies (as the case may be).

Eligible margin loan means an extension of credit where:

(1) The extension of credit is collateralized exclusively by liquid and readily marketable debt or equity securities, gold, or conforming residential mortgages;

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

(3) The extension of credit is conducted under an agreement that provides the bank holding company the right to accelerate and terminate the extension of credit and to liquidate or set off collateral promptly upon an event of default (including upon an event of bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;[2] and

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

Eligible operational risk offsets means amounts, not to exceed expected operational loss, that:

(1) Are generated by internal business practices to absorb highly predictable and reasonably stable operational losses, including reserves calculated consistent with GAAP; and

(2) Are available to cover expected operational losses with a high degree of certainty over a one-year horizon.

Eligible purchased wholesale exposure means a purchased wholesale exposure that:

(1) The bank holding company or securitization SPE purchased from an unaffiliated seller and did not directly or indirectly originate;

(2) Was generated on an arm's-length basis between the seller and the obligor (intercompany accounts receivable and receivables

[2] This requirement is met where all transactions under the agreement are (i) executed under U.S. law and (ii) constitute ''securities contracts'' under section 555 of the Bankruptcy Code (11 U.S.C. 555), qualified financial contracts under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or netting contracts between or among financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407) or the Federal Reserve Board's Regulation EE (12 CFR part 231).

subject to contra-accounts between firms that buy and sell to each other do not satisfy this criterion);

(3) Provides the bank holding company or securitization SPE with a claim on all proceeds from the exposure or a pro rata interest in the proceeds from the exposure;

(4) Has an M of less than one year; and

(5) When consolidated by obligor, does not represent a concentrated exposure relative to the portfolio of purchased wholesale exposures.

Eligible securitization guarantor means:

(1) A sovereign entity, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, Federal Agricultural Mortgage Corporation (Farmer Mac), a multilateral development bank, a depository institution, a bank holding company, a savings and loan holding company (as defined in 12 U.S.C. 1467a) provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), a foreign bank (as defined in §211.2 of the Federal Reserve Board's Regulation K (12 CFR 211.2)), or a securities firm;

(2) Any other entity (other than a securitization SPE) that has issued and outstanding an unsecured long-term debt security without credit enhancement that has a long-term applicable external rating in one of the three highest investment-grade rating categories; or

(3) Any other entity (other than a securitization SPE) that has a PD assigned by the bank holding company that is lower than or equal to the PD associated with a long-term external rating in the third highest investment-grade rating category.

Eligible servicer cash advance facility means a servicer cash advance facility in which:

(1) The servicer is entitled to full reimbursement of advances, except that a servicer may be obligated to make non-reimbursable advances for a particular underlying exposure if any such advance is contractually limited to an insignificant amount of the outstanding principal balance of that exposure;

(2) The servicer's right to reimbursement is senior in right of payment to all other claims on the cash flows from the underlying exposures of the securitization; and

(3) The servicer has no legal obligation to, and does not, make advances to the securitization if the servicer concludes the advances are unlikely to be repaid.

Equity derivative contract means an equity-linked swap, purchased equity-linked option, forward equity-linked contract, or any other instrument linked to equities that gives rise to similar counterparty credit risks.

Equity exposure means:

(1) A security or instrument (whether voting or non-voting) that represents a direct or indirect ownership interest in, and is a residual claim on, the assets and income of a company, unless:

(i) The issuing company is consolidated with the bank holding company under GAAP;

(ii) The bank holding company is required to deduct the ownership interest from tier 1 or tier 2 capital under this appendix;

(iii) The ownership interest incorporates a payment or other similar obligation on the part of the issuing company (such as an obligation to make periodic payments); or

(iv) The ownership interest is a securitization exposure;

(2) A security or instrument that is mandatorily convertible into a security or instrument described in paragraph (1) of this definition;

(3) An option or warrant that is exercisable for a security or instrument described in paragraph (1) of this definition; or

(4) Any other security or instrument (other than a securitization exposure) to the extent the return on the security or instrument is based on the performance of a security or instrument described in paragraph (1) of this definition.

Excess spread for a period means:

(1) Gross finance charge collections and other income received by a securitization SPE (including market interchange fees) over a period minus interest paid to the holders of the securitization exposures, servicing fees, charge-offs, and other senior trust or similar expenses of the SPE over the period; divided by

(2) The principal balance of the underlying exposures at the end of the period.

Exchange rate derivative contract means a cross-currency interest rate swap, forward foreign-exchange contract, currency option purchased, or any other instrument linked to exchange rates that gives rise to similar counterparty credit risks.

Excluded mortgage exposure means any one-to four-family residential pre-sold construction loan for a residence for which the purchase contract is cancelled that would receive a 100 percent risk weight under section 618(a)(2) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act and under 12 CFR part 225, appendix A, section III.C.3.

Expected credit loss (ECL) means:

(1) For a wholesale exposure to a non-defaulted obligor or segment of non-defaulted retail exposures that is carried at fair value with gains and losses flowing through earnings or that is classified as held-for-sale and is carried at the lower of cost or fair value with losses flowing through earnings, zero.

(2) For all other wholesale exposures to non-defaulted obligors or segments of non-defaulted retail exposures, the product of PD times LGD times EAD for the exposure or segment.

(3) For a wholesale exposure to a defaulted obligor or segment of defaulted retail exposures, the bank holding company's impairment estimate for allowance purposes for the exposure or segment.

(4) Total ECL is the sum of expected credit losses for all wholesale and retail exposures other than exposures for which the bank holding company has applied the double default treatment in section 34 of this appendix.

Expected exposure (EE) means the expected value of the probability distribution of non-negative credit risk exposures to a counterparty at any specified future date before the maturity date of the longest term transaction in the netting set. Any negative market values in the probability distribution of market values to a counterparty at a specified future date are set to zero to convert the probability distribution of market values to the probability distribution of credit risk exposures.

Expected operational loss (EOL) means the expected value of the distribution of potential aggregate operational losses, as generated by the bank holding company's operational risk quantification system using a one-year horizon.

Expected positive exposure (EPE) means the weighted average over time of expected (non-negative) exposures to a counterparty where the weights are the proportion of the time interval that an individual expected exposure represents. When calculating risk-based capital requirements, the average is taken over a one-year horizon.

Exposure at default (EAD). (1) For the on-balance sheet component of a wholesale exposure or segment of retail exposures (other than an OTC derivative contract, or a repo-style transaction or eligible margin loan for which the bank holding company determines EAD under section 32 of this appendix), EAD means:

(i) If the exposure or segment is a security classified as available-for-sale, the bank holding company's carrying value (including net accrued but unpaid interest and fees) for the exposure or segment less any allocated transfer risk reserve for the exposure or segment, less any unrealized gains on the exposure or segment, and plus any unrealized losses on the exposure or segment; or

(ii) If the exposure or segment is not a security classified as available-for-sale, the bank holding company's carrying value (including net accrued but unpaid interest and fees) for the exposure or segment less any allocated transfer risk reserve for the exposure or segment.

(2) For the off-balance sheet component of a wholesale exposure or segment of retail exposures (other than an OTC derivative contract, or a repo-style transaction or eligible margin loan for which the bank holding company determines EAD under section 32 of this appendix) in the form of a loan commitment, line of credit, trade-related letter of credit, or transaction-related contingency, EAD means the bank holding company's best estimate of net additions to the outstanding amount owed the bank holding company, including estimated future additional draws of principal and accrued but unpaid interest and fees, that are likely to occur over a one-year horizon assuming the wholesale exposure or the retail exposures in the segment were to go into default. This estimate of net additions must reflect what would be expected during economic downturn conditions. Trade-related letters of credit are short-term, self-liquidating instruments that are used to finance the movement of goods and are collateralized by the underlying goods. Transaction-related contingencies relate to a particular transaction and include, among other things, performance bonds and performance-based letters of credit.

(3) For the off-balance sheet component of a wholesale exposure or segment of retail exposures (other than an OTC derivative contract, or a repo-style transaction or eligible margin loan for which the bank holding company determines EAD under section 32 of this appendix) in the form of anything other than a loan commitment, line of credit, trade-related letter of credit, or transaction-related contingency, EAD means the notional amount of the exposure or segment.

(4) EAD for OTC derivative contracts is calculated as described in section 32 of this appendix. A bank holding company also may determine EAD for repo-style transactions and eligible margin loans as described in section 32 of this appendix.

(5) For wholesale or retail exposures in which only the drawn balance has been securitized, the bank holding company must reflect its share of the exposures' undrawn balances in EAD. Undrawn balances of revolving exposures for which the drawn balances have been securitized must be allocated between the seller's and investors' interests on a pro rata basis, based on the proportions of the seller's and investors' shares of the securitized drawn balances.

Exposure category means any of the wholesale, retail, securitization, or equity exposure categories.

External operational loss event data means, with respect to a bank holding company, gross operational loss amounts, dates, recoveries, and relevant causal information for operational loss events occurring at organizations other than the bank holding company.

External rating means a credit rating that is assigned by an NRSRO to an exposure, provided:

(1) The credit rating fully reflects the entire amount of credit risk with regard to all payments owed to the holder of the exposure. If a holder is owed principal and interest on

an exposure, the credit rating must fully reflect the credit risk associated with timely repayment of principal and interest. If a holder is owed only principal on an exposure, the credit rating must fully reflect only the credit risk associated with timely repayment of principal; and

(2) The credit rating is published in an accessible form and is or will be included in the transition matrices made publicly available by the NRSRO that summarize the historical performance of positions rated by the NRSRO.

Financial collateral means collateral:

(1) In the form of:

(i) Cash on deposit with the bank holding company (including cash held for the bank holding company by a third-party custodian or trustee);

(ii) Gold bullion;

(iii) Long-term debt securities that have an applicable external rating of one category below investment grade or higher;

(iv) Short-term debt instruments that have an applicable external rating of at least investment grade;

(v) Equity securities that are publicly traded;

(vi) Convertible bonds that are publicly traded;

(vii) Money market mutual fund shares and other mutual fund shares if a price for the shares is publicly quoted daily; or

(viii) Conforming residential mortgages; and

(2) In which the bank holding company has a perfected, first priority security interest or, outside of the United States, the legal equivalent thereof (with the exception of cash on deposit and notwithstanding the prior security interest of any custodial agent).

GAAP means generally accepted accounting principles as used in the United States.

Gain-on-sale means an increase in the equity capital (as reported on Schedule HC of the FR Y–9C Report) of a bank holding company that results from a securitization (other than an increase in equity capital that results from the bank holding company's receipt of cash in connection with the securitization).

Guarantee means a financial guarantee, letter of credit, insurance, or other similar financial instrument (other than a credit derivative) that allows one party (beneficiary) to transfer the credit risk of one or more specific exposures (reference exposure) to another party (protection provider). See also *eligible guarantee.*

High volatility commercial real estate (HVCRE) exposure means a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances:

(1) One- to four-family residential properties; or

(2) Commercial real estate projects in which:

(i) The loan-to-value ratio is less than or equal to the applicable maximum supervisory loan-to-value ratio in the relevant agency's real estate lending standards at 12 CFR part 34, Subpart D (OCC), 12 CFR part 208, appendix C (Federal Reserve); 12 CFR part 365, Subpart D (FDIC); and 12 CFR 560.100–560.101 (OTS).

(ii) The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised ''as completed'' value; and

(iii) The borrower contributed the amount of capital required by paragraph (2)(ii) of this definition before the bank holding company advances funds under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project. The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full. Permanent financing may be provided by the bank holding company that provided the ADC facility as long as the permanent financing is subject to the bank holding company's underwriting criteria for long-term mortgage loans.

Inferred rating. A securitization exposure has an *inferred rating* equal to the external rating referenced in paragraph (2)(i) of this definition if:

(1) The securitization exposure does not have an external rating; and

(2) Another securitization exposure issued by the same issuer and secured by the same underlying exposures:

(i) Has an external rating;

(ii) Is subordinated in all respects to the unrated securitization exposure;

(iii) Does not benefit from any credit enhancement that is not available to the unrated securitization exposure; and

(iv) Has an effective remaining maturity that is equal to or longer than that of the unrated securitization exposure.

Interest rate derivative contract means a single-currency interest rate swap, basis swap, forward rate agreement, purchased interest rate option, when-issued securities, or any other instrument linked to interest rates that gives rise to similar counterparty credit risks.

Internal operational loss event data means, with respect to a bank holding company, gross operational loss amounts, dates, recoveries, and relevant causal information for operational loss events occurring at the bank holding company.

Investing bank holding company means, with respect to a securitization, a bank holding company that assumes the credit risk of a securitization exposure (other than an originating bank holding company of the securitization). In the typical synthetic securitization, the investing bank holding company sells credit protection on a pool of underlying exposures to the originating bank holding company.

Investment fund means a company:

(1) All or substantially all of the assets of which are financial assets; and

(2) That has no material liabilities.

Investors' interest EAD means, with respect to a securitization, the EAD of the underlying exposures multiplied by the ratio of:

(1) The total amount of securitization exposures issued by the securitization SPE to investors; divided by

(2) The outstanding principal amount of underlying exposures.

Loss given default (LGD) means:

(1) For a wholesale exposure, the greatest of:

(i) Zero;

(ii) The bank holding company's empirically based best estimate of the long-run default-weighted average economic loss, per dollar of EAD, the bank holding company would expect to incur if the obligor (or a typical obligor in the loss severity grade assigned by the bank holding company to the exposure) were to default within a one-year horizon over a mix of economic conditions, including economic downturn conditions; or

(iii) The bank holding company's empirically based best estimate of the economic loss, per dollar of EAD, the bank holding company would expect to incur if the obligor (or a typical obligor in the loss severity grade assigned by the bank holding company to the exposure) were to default within a one-year horizon during economic downturn conditions.

(2) For a segment of retail exposures, the greatest of:

(i) Zero;

(ii) The bank holding company's empirically based best estimate of the long-run default-weighted average economic loss, per dollar of EAD, the bank holding company would expect to incur if the exposures in the segment were to default within a one-year horizon over a mix of economic conditions, including economic downturn conditions; or

(iii) The bank holding company's empirically based best estimate of the economic loss, per dollar of EAD, the bank holding company would expect to incur if the exposures in the segment were to default within a one-year horizon during economic downturn conditions.

(3) The economic loss on an exposure in the event of default is all material credit-related losses on the exposure (including accrued but unpaid interest or fees, losses on the sale of collateral, direct workout costs, and an appropriate allocation of indirect workout costs). Where positive or negative cash flows on a wholesale exposure to a defaulted obligor or a defaulted retail exposure (including proceeds from the sale of collateral, workout costs, additional extensions of credit to facilitate repayment of the exposure, and draw-downs of unused credit lines) occur after the date of default, the economic loss must reflect the net present value of cash flows as of the default date using a discount rate appropriate to the risk of the defaulted exposure.

Main index means the Standard & Poor's 500 Index, the FTSE All-World Index, and any other index for which the bank holding company can demonstrate to the satisfaction of the Federal Reserve that the equities represented in the index have comparable liquidity, depth of market, and size of bid-ask spreads as equities in the Standard & Poor's 500 Index and FTSE All-World Index.

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

Nationally recognized statistical rating organization (NRSRO) means an entity registered with the SEC as a nationally recognized statistical rating organization under section 15E of the Securities Exchange Act of 1934 (15 U.S.C. 78o–7).

Netting set means a group of transactions with a single counterparty that are subject to a qualifying master netting agreement or qualifying cross-product master netting agreement. For purposes of the internal models methodology in paragraph (d) of section 32 of this appendix, each transaction that is not subject to such a master netting agreement is its own netting set.

N^{th}-to-default credit derivative means a credit derivative that provides credit protection only for the n^{th}-defaulting reference exposure in a group of reference exposures.

Obligor means the legal entity or natural person contractually obligated on a wholesale exposure, except that a bank holding company may treat the following exposures as having separate obligors:

(1) Exposures to the same legal entity or natural person denominated in different currencies;

(2) (i) An income-producing real estate exposure for which all or substantially all of the repayment of the exposure is reliant on

the cash flows of the real estate serving as collateral for the exposure; the bank holding company, in economic substance, does not have recourse to the borrower beyond the real estate collateral; and no cross-default or cross-acceleration clauses are in place other than clauses obtained solely out of an abundance of caution; and

(ii) Other credit exposures to the same legal entity or natural person; and

(3) (i) A wholesale exposure authorized under section 364 of the U.S. Bankruptcy Code (11 U.S.C. 364) to a legal entity or natural person who is a debtor-in-possession for purposes of Chapter 11 of the Bankruptcy Code; and

(ii) Other credit exposures to the same legal entity or natural person.

Operational loss means a loss (excluding insurance or tax effects) resulting from an operational loss event. Operational loss includes all expenses associated with an operational loss event except for opportunity costs, forgone revenue, and costs related to risk management and control enhancements implemented to prevent future operational losses.

Operational loss event means an event that results in loss and is associated with any of the following seven operational loss event type categories:

(1) Internal fraud, which means the operational loss event type category that comprises operational losses resulting from an act involving at least one internal party of a type intended to defraud, misappropriate property, or circumvent regulations, the law, or company policy, excluding diversity- and discrimination-type events.

(2) External fraud, which means the operational loss event type category that comprises operational losses resulting from an act by a third party of a type intended to defraud, misappropriate property, or circumvent the law. Retail credit card losses arising from non-contractual, third-party initiated fraud (for example, identity theft) are external fraud operational losses. All other third-party initiated credit losses are to be treated as credit risk losses.

(3) Employment practices and workplace safety, which means the operational loss event type category that comprises operational losses resulting from an act inconsistent with employment, health, or safety laws or agreements, payment of personal injury claims, or payment arising from diversity- and discrimination-type events.

(4) Clients, products, and business practices, which means the operational loss event type category that comprises operational losses resulting from the nature or design of a product or from an unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements).

(5) Damage to physical assets, which means the operational loss event type category that comprises operational losses resulting from the loss of or damage to physical assets from natural disaster or other events.

(6) Business disruption and system failures, which means the operational loss event type category that comprises operational losses resulting from disruption of business or system failures.

(7) Execution, delivery, and process management, which means the operational loss event type category that comprises operational losses resulting from failed transaction processing or process management or losses arising from relations with trade counterparties and vendors.

Operational risk means the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events (including legal risk but excluding strategic and reputational risk).

Operational risk exposure means the 99.9^{th} percentile of the distribution of potential aggregate operational losses, as generated by the bank holding company's operational risk quantification system over a one-year horizon (and not incorporating eligible operational risk offsets or qualifying operational risk mitigants).

Originating bank holding company, with respect to a securitization, means a bank holding company that:

(1) Directly or indirectly originated or securitized the underlying exposures included in the securitization; or

(2) Serves as an ABCP program sponsor to the securitization.

Other retail exposure means an exposure (other than a securitization exposure, an equity exposure, a residential mortgage exposure, an excluded mortgage exposure, a qualifying revolving exposure, or the residual value portion of a lease exposure) that is managed as part of a segment of exposures with homogeneous risk characteristics, not on an individual-exposure basis, and is either:

(1) An exposure to an individual for non-business purposes; or

(2) An exposure to an individual or company for business purposes if the bank holding company's consolidated business credit exposure to the individual or company is $1 million or less.

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

Probability of default (PD) means:

(1) For a wholesale exposure to a non-defaulted obligor, the bank holding company's empirically based best estimate of the long-run average one-year default rate for the rating grade assigned by the bank holding company to the obligor, capturing the average

default experience for obligors in the rating grade over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the rating grade.

(2) For a segment of non-defaulted retail exposures, the bank holding company's empirically based best estimate of the long-run average one-year default rate for the exposures in the segment, capturing the average default experience for exposures in the segment over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the segment and adjusted upward as appropriate for segments for which seasoning effects are material. For purposes of this definition, a segment for which seasoning effects are material is a segment where there is a material relationship between the time since origination of exposures within the segment and the bank holding company's best estimate of the long-run average one-year default rate for the exposures in the segment.

(3) For a wholesale exposure to a defaulted obligor or segment of defaulted retail exposures, 100 percent.

Protection amount (P) means, with respect to an exposure hedged by an eligible guarantee or eligible credit derivative, the effective notional amount of the guarantee or credit derivative, reduced to reflect any currency mismatch, maturity mismatch, or lack of restructuring coverage (as provided in section 33 of this appendix).

Publicly traded means traded on:

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

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

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

(ii) Provides a liquid, two-way market for the instrument in question, meaning that there are enough independent bona fide offers to buy and sell so that a sales price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined promptly and a trade can be settled at such a price within five business days.

Qualifying central counterparty means a counterparty (for example, a clearinghouse) that:

(1) Facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts;

(2) Requires all participants in its arrangements to be fully collateralized on a daily basis; and

(3) The bank holding company demonstrates to the satisfaction of the Federal Reserve is in sound financial condition and is subject to effective oversight by a national supervisory authority.

Qualifying cross-product master netting agreement means a qualifying master netting agreement that provides for termination and close-out netting across multiple types of financial transactions or qualifying master netting agreements in the event of a counterparty's default, provided that:

(1) The underlying financial transactions are OTC derivative contracts, eligible margin loans, or repo-style transactions; and

(2) The bank holding company obtains a written legal opinion verifying the validity and enforceability of the agreement under applicable law of the relevant jurisdictions if the counterparty fails to perform upon an event of default, including upon an event of bankruptcy, insolvency, or similar proceeding.

Qualifying master netting agreement means any written, legally enforceable bilateral agreement, provided that:

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including bankruptcy, insolvency, or similar proceeding, of the counterparty;

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

(3) The bank holding company has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that:

(i) The agreement meets the requirements of paragraph (2) of this definition; and

(ii) In the event of a legal challenge (including one resulting from default or from bankruptcy, insolvency, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions;

(4) The bank holding company establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of this definition; and

(5) The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it would make otherwise under the agreement, or no payment at all, to a defaulter or the estate of a

defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement).

Qualifying revolving exposure (QRE) means an exposure (other than a securitization exposure or equity exposure) to an individual that is managed as part of a segment of exposures with homogeneous risk characteristics, not on an individual-exposure basis, and:

(1) Is revolving (that is, the amount outstanding fluctuates, determined largely by the borrower's decision to borrow and repay, up to a pre-established maximum amount);

(2) Is unsecured and unconditionally cancelable by the bank holding company to the fullest extent permitted by Federal law; and

(3) Has a maximum exposure amount (drawn plus undrawn) of up to $100,000.

Repo-style transaction means a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction, including a transaction in which the bank holding company acts as agent for a customer and indemnifies the customer against loss, provided that:

(1) The transaction is based solely on liquid and readily marketable securities, cash, gold, or conforming residential mortgages;

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

(3)(i) The transaction is a ''securities contract'' or ''repurchase agreement'' under section 555 or 559, respectively, of the Bankruptcy Code (11 U.S.C. 555 or 559), a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407) or the Federal Reserve Board's Regulation EE (12 CFR part 231); or

(ii) If the transaction does not meet the criteria set forth in paragraph (3)(i) of this definition, then either:

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

(B) The transaction is:

(*1*) Either overnight or unconditionally cancelable at any time by the bank holding company; and

(*2*) Executed under an agreement that provides the bank holding company the right to accelerate, terminate, and close-out the transaction on a net basis and to liquidate or set off collateral promptly upon an event of counterparty default; and

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

Residential mortgage exposure means an exposure (other than a securitization exposure, equity exposure, or excluded mortgage exposure) that is managed as part of a segment of exposures with homogeneous risk characteristics, not on an individual-exposure basis, and is:

(1) An exposure that is primarily secured by a first or subsequent lien on one- to four-family residential property; or

(2) An exposure with an original and outstanding amount of $1 million or less that is primarily secured by a first or subsequent lien on residential property that is not one to four family.

Retail exposure means a residential mortgage exposure, a qualifying revolving exposure, or an other retail exposure.

Retail exposure subcategory means the residential mortgage exposure, qualifying revolving exposure, or other retail exposure subcategory.

Risk parameter means a variable used in determining risk-based capital requirements for wholesale and retail exposures, specifically probability of default (PD), loss given default (LGD), exposure at default (EAD), or effective maturity (M).

Scenario analysis means a systematic process of obtaining expert opinions from business managers and risk management experts to derive reasoned assessments of the likelihood and loss impact of plausible high-severity operational losses. Scenario analysis may include the well-reasoned evaluation and use of external operational loss event data, adjusted as appropriate to ensure relevance to a bank holding company's operational risk profile and control structure.

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

Securitization means a traditional securitization or a synthetic securitization.

Securitization exposure means an on-balance sheet or off-balance sheet credit exposure that arises from a traditional or synthetic securitization (including credit-enhancing representations and warranties).

Securitization special purpose entity (securitization SPE) means a corporation, trust, or other entity organized for the specific purpose of holding underlying exposures of a securitization, the activities of which are limited to those appropriate to accomplish this purpose, and the structure of which is intended to isolate the underlying exposures held by the entity from the credit risk of the seller of the underlying exposures to the entity.

Senior securitization exposure means a securitization exposure that has a first priority claim on the cash flows from the underlying exposures. When determining whether a securitization exposure has a first priority claim on the cash flows from the underlying exposures, a bank holding company is not required to consider amounts due under interest rate or currency derivative contracts, fees due, or other similar payments. Both the most senior commercial paper issued by an ABCP program and a liquidity facility that supports the ABCP program may be senior securitization exposures if the liquidity facility provider's right to reimbursement of the drawn amounts is senior to all claims on the cash flows from the underlying exposures except amounts due under interest rate or currency derivative contracts, fees due, or other similar payments.

S*ervicer cash advance facility* means a facility under which the servicer of the underlying exposures of a securitization may advance cash to ensure an uninterrupted flow of payments to investors in the securitization, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures. See also *eligible servicer cash advance facility*.

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

Sovereign exposure means:

(1) A direct exposure to a sovereign entity; or

(2) An exposure directly and unconditionally backed by the full faith and credit of a sovereign entity.

Subsidiary means, with respect to a company, a company controlled by that company.

Synthetic securitization means a transaction in which:

(1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than a guarantee that transfers only the credit risk of an individual retail exposure);

(2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;

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

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

Tier 1 capital is defined in 12 CFR part 225, appendix A, as modified in part II of this appendix.

Tier 2 capital is defined in 12 CFR part 225, appendix A, as modified in part II of this appendix.

Total qualifying capital means the sum of tier 1 capital and tier 2 capital, after all deductions required in this appendix.

Total risk-weighted assets means:

(1) The sum of:

(i) Credit risk-weighted assets; and

(ii) Risk-weighted assets for operational risk; minus

(2) Excess eligible credit reserves not included in tier 2 capital.

Total wholesale and retail risk-weighted assets means the sum of risk-weighted assets for wholesale exposures to non-defaulted obligors and segments of non-defaulted retail exposures; risk-weighted assets for wholesale exposures to defaulted obligors and segments of defaulted retail exposures; risk-weighted assets for assets not defined by an exposure category; and risk-weighted assets for non-material portfolios of exposures (all as determined in section 31 of this appendix) and risk-weighted assets for unsettled transactions (as determined in section 35 of this appendix) minus the amounts deducted from capital pursuant to 12 CFR part 225, appendix A (excluding those deductions reversed in section 12 of this appendix).

Traditional securitization means a transaction in which:

(1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees;

(2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;

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

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

(5) The underlying exposures are not owned by an operating company;

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

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

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

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

Tranche means all securitization exposures associated with a securitization that have the same seniority level.

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

Unexpected operational loss (UOL) means the difference between the bank holding company's operational risk exposure and the bank holding company's expected operational loss.

Unit of measure means the level (for example, organizational unit or operational loss event type) at which the bank holding company's operational risk quantification system generates a separate distribution of potential operational losses.

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

Wholesale exposure means a credit exposure to a company, natural person, sovereign entity, or governmental entity (other than a securitization exposure, retail exposure, excluded mortgage exposure, or equity exposure). Examples of a wholesale exposure include:

(1) A non-tranched guarantee issued by a bank holding company on behalf of a company;

(2) A repo-style transaction entered into by a bank holding company with a company and any other transaction in which a bank holding company posts collateral to a company and faces counterparty credit risk;

(3) An exposure that a bank holding company treats as a covered position under 12 CFR part 225, appendix E for which there is a counterparty credit risk capital requirement;

(4) A sale of corporate loans by a bank holding company to a third party in which the bank holding company retains full recourse;

(5) An OTC derivative contract entered into by a bank holding company with a company;

(6) An exposure to an individual that is not managed by a bank holding company as part of a segment of exposures with homogeneous risk characteristics; and

(7) A commercial lease.

Wholesale exposure subcategory means the HVCRE or non-HVCRE wholesale exposure subcategory.

Section 3. Minimum Risk-Based Capital Requirements

(a)(1) Except as modified by paragraph (c) of this section or by section 23 of this appendix, each bank holding company must meet a minimum:

(i) Total risk-based capital ratio of 8.0 percent; and

(ii) Tier 1 risk-based capital ratio of 4.0 percent.

(2) A bank holding company's total risk-based capital ratio is the lower of:

(i) Its total qualifying capital to total risk-weighted assets, and

(ii) Its total risk-based capital ratio as calculated under 12 CFR part 208, appendix A, as adjusted to include certain debt or equity instruments issued before May 19, 2010 as described in section 171(b)(4)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

(3) A bank holding company's tier 1 risk-based capital ratio is the lower of:

(i) Its tier 1 capital to total risk-weighted assets, and

(ii) Its tier 1 risk-based capital ratio as calculated under 12 CFR part 208, appendix A, as adjusted to include certain debt or equity instruments issued before May 19, 2010 as described in section 171(b)(4)(B) of the Dodd-Frank Act.

(b) Each bank holding company must hold capital commensurate with the level and nature of all risks to which the bank holding company is exposed.

(c) When a bank holding company subject to 12 CFR part 225, appendix E calculates its risk-based capital requirements under this appendix, the bank holding company must also refer to 12 CFR part 225, appendix E for supplemental rules to calculate risk-based capital requirements adjusted for market risk.

PART II. QUALIFYING CAPITAL

Section 11. Additional Deductions

(a) *General.* A bank holding company that uses this appendix must make the same deductions from its tier 1 capital and tier 2 capital required in 12 CFR part 225, appendix A, except that:

(1) A bank holding company is not required to deduct certain equity investments and CEIOs (as provided in section 12 of this appendix); and

(2) A bank holding company also must make the deductions from capital required by paragraphs (b) and (c) of this section.

(b) *Deductions from tier 1 capital.* A bank holding company must deduct from tier 1 capital any gain-on-sale associated with a securitization exposure as provided in paragraph (a) of section 41 and paragraphs (a)(1), (c), (g)(1), and (h)(1) of section 42 of this appendix.

(c) *Deductions from tier 1 and tier 2 capital.* A bank holding company must deduct the exposures specified in paragraphs (c)(1) through (c)(7) in this section 50 percent from tier 1 capital and 50 percent from tier 2 capital. If the amount deductible from tier 2 capital exceeds the bank holding company's actual tier 2 capital, however, the bank holding company must deduct the excess from tier 1 capital.

(1) *Credit-enhancing interest-only strips (CEIOs).* In accordance with paragraphs (a)(1) and (c) of section 42 of this appendix, any CEIO that does not constitute gain-on-sale.

(2) *Non-qualifying securitization exposures.* In accordance with paragraphs (a)(4) and (c) of section 42 of this appendix, any securitization exposure that does not qualify for the Ratings-Based Approach, the Internal Assessment Approach, or the Supervisory Formula Approach under sections 43, 44, and 45 of this appendix, respectively.

(3) *Securitizations of non-IRB exposures.* In accordance with paragraphs (c) and (g)(4) of section 42 of this appendix, certain exposures to a securitization any underlying exposure of which is not a wholesale exposure, retail exposure, securitization exposure, or equity exposure.

(4) *Low-rated securitization exposures.* In accordance with section 43 and paragraph (c) of section 42 of this appendix, any securitization exposure that qualifies for and must be deducted under the Ratings-Based Approach.

(5) *High-risk securitization exposures subject to the Supervisory Formula Approach.* In accordance with paragraphs (b) and (c) of section 45 of this appendix and paragraph (c) of section 42 of this appendix, certain high-risk securitization exposures (or portions thereof) that qualify for the Supervisory Formula Approach.

(6) *Eligible credit reserves shortfall.* In accordance with paragraph (a)(1) of section 13 of this appendix, any eligible credit reserves shortfall.

(7) *Certain failed capital markets transactions.* In accordance with paragraph (e)(3) of section 35 of this appendix, the bank holding company's exposure on certain failed capital markets transactions.

(8) A bank holding company must also deduct an amount equal to the minimum regulatory capital requirement established by the regulator of any insurance underwriting subsidiary of the holding company. For U.S.-based insurance underwriting subsidiaries, this amount generally would be 200 percent of the subsidiary's Authorized Control Level as established by the appropriate state regulator of the insurance company.

Section 12. Deductions and Limitations Not Required.

(a) *Deduction of CEIOs.* A bank holding company is not required to make the deductions from capital for CEIOs in 12 CFR part 225, appendix A, section II.B.1.e.

(b) *Deduction for certain equity investments.* A bank holding company is not required to make the deductions from capital for nonfinancial equity investments in 12 CFR part 225, appendix A, section II.B.5.

Section 13. Eligible Credit Reserves

(a) *Comparison of eligible credit reserves to expected credit losses*—(1) *Shortfall of eligible credit reserves.* If a bank holding company's eligible credit reserves are less than the bank holding company's total expected credit losses, the bank holding company must deduct the shortfall amount 50 percent from tier 1 capital and 50 percent from tier 2 capital. If the amount deductible from tier 2 capital exceeds the bank holding company's actual tier 2 capital, the bank holding company must deduct the excess amount from tier 1 capital.

(2) *Excess eligible credit reserves.* If a bank holding company's eligible credit reserves exceed the bank holding company's total expected credit losses, the bank holding company may include the excess amount in tier 2 capital to the extent that the excess amount does not exceed 0.6 percent of the bank holding company's credit-risk-weighted assets.

(b) *Treatment of allowance for loan and lease losses.* Regardless of any provision in 12 CFR part 225, appendix A, the ALLL is included in tier 2 capital only to the extent provided in paragraph (a)(2) of this section and in section 24 of this appendix.

PART III. QUALIFICATION

Section 21. Qualification Process

(a) *Timing.* (1) A bank holding company that is described in paragraph (b)(1) of section 1 of this appendix must adopt a written implementation plan no later than six months after the later of April 1, 2008, or the date the bank holding company meets a criterion in that section. The implementation plan must incorporate an explicit first floor period start date no later than 36 months after the later of April 1, 2008, or the date the bank holding company meets at least one criterion under paragraph (b)(1) of section 1 of this appendix. The Federal Reserve may extend the first floor period start date.

(2) A bank holding company that elects to be subject to this appendix under paragraph (b)(2) of section 1 of this appendix must adopt a written implementation plan.

(b) *Implementation plan.* (1) The bank holding company's implementation plan must address in detail how the bank holding company complies, or plans to comply, with the qualification requirements in section 22 of this appendix. The bank holding company also must maintain a comprehensive and sound planning and governance process to oversee the implementation efforts described in the plan. At a minimum, the plan must:

(i) Comprehensively address the qualification requirements in section 22 of this appendix for the bank holding company and each consolidated subsidiary (U.S. and foreign-based) of the bank holding company with respect to all portfolios and exposures of the bank holding company and each of its consolidated subsidiaries;

(ii) Justify and support any proposed temporary or permanent exclusion of business lines, portfolios, or exposures from application of the advanced approaches in this appendix (which business lines, portfolios, and exposures must be, in the aggregate, immaterial to the bank holding company);

(iii) Include the bank holding company's self-assessment of:

(A) The bank holding company's current status in meeting the qualification requirements in section 22 of this appendix; and

(B) The consistency of the bank holding company's current practices with the Federal Reserve's supervisory guidance on the qualification requirements;

(iv) Based on the bank holding company's self-assessment, identify and describe the areas in which the bank holding company proposes to undertake additional work to comply with the qualification requirements in section 22 of this appendix or to improve the consistency of the bank holding company's current practices with the Federal Reserve's supervisory guidance on the qualification requirements (gap analysis);

(v) Describe what specific actions the bank holding company will take to address the areas identified in the gap analysis required by paragraph (b)(1)(iv) of this section;

(vi) Identify objective, measurable milestones, including delivery dates and a date when the bank holding company's implementation of the methodologies described in this appendix will be fully operational;

(vii) Describe resources that have been budgeted and are available to implement the plan; and

(viii) Receive approval of the bank holding company's board of directors.

(2) The bank holding company must submit the implementation plan, together with a copy of the minutes of the board of directors' approval, to the Federal Reserve at least 60 days before the bank holding company proposes to begin its parallel run, unless the Federal Reserve waives prior notice.

(c) *Parallel run.* Before determining its risk-based capital requirements under this appendix and following adoption of the implementation plan, the bank holding company must conduct a satisfactory parallel run. A satisfactory parallel run is a period of no less than four consecutive calendar quarters during which the bank holding company complies with the qualification requirements in section 22 of this appendix to the satisfaction of the Federal Reserve. During the parallel run, the bank holding company must report to the Federal Reserve on a calendar quarterly basis its risk-based capital ratios using 12 CFR part 225, appendix A and the risk-based capital requirements described in this appendix. During this period, the bank holding company is subject to 12 CFR part 225, appendix A.

(d) *Approval to calculate risk-based capital requirements under this appendix.* The Federal Reserve will notify the bank holding company of the date that the bank holding company may begin its first floor period if the Federal Reserve determines that:

(1) The bank holding company fully complies with all the qualification requirements in section 22 of this appendix;

(2) The bank holding company has conducted a satisfactory parallel run under paragraph (c) of this section; and

(3) The bank holding company has an adequate process to ensure ongoing compliance with the qualification requirements in section 22 of this appendix.

(e) *Transitional floor periods.* Following a satisfactory parallel run, a bank holding company is subject to three transitional floor periods.

(1) *Risk-based capital ratios during the transitional floor periods*—(i) *Tier 1 risk-based capital ratio.* During a bank holding company's transitional floor periods, the bank holding company's tier 1 risk-based capital ratio is equal to the lower of:

(A) The bank holding company's floor-adjusted tier 1 risk-based capital ratio; or

(B) The bank holding company's advanced approaches tier 1 risk-based capital ratio.

(ii) *Total risk-based capital ratio.* During a bank holding company's transitional floor periods, the bank holding company's total risk-based capital ratio is equal to the lower of:

(A) The bank holding company's floor-adjusted total risk-based capital ratio; or

(B) The bank holding company's advanced approaches total risk-based capital ratio.

(2) *Floor-adjusted risk-based capital ratios.* (i) A bank holding company's floor-adjusted tier 1 risk-based capital ratio during a transitional floor period is equal to the bank holding company's tier 1 capital as calculated under 12 CFR part 225, appendix A, divided by the product of:

(A) The bank holding company's total risk-weighted assets as calculated under 12 CFR part 225, appendix A; and

(B) The appropriate transitional floor percentage in Table 1.

(ii) A bank holding company's floor-adjusted total risk-based capital ratio during a transitional floor period is equal to the sum of the bank holding company's tier 1 and tier 2 capital as calculated under 12 CFR part 225, appendix A, divided by the product of:

(A) The bank holding company's total risk-weighted assets as calculated under 12 CFR part 225, appendix A; and

(B) The appropriate transitional floor percentage in Table 1.

(iii) A bank holding company that meets the criteria in paragraph (b)(1) or (b)(2) of section 1 of this appendix as of April 1, 2008, must use 12 CFR part 225, appendix A during the parallel run and as the basis for its transitional floors.

TABLE 1—TRANSITIONAL FLOORS

Transitional floor period	Transitional floor percentage
First floor period	95 percent.
Second floor period	90 percent.
Third floor period	85 percent.

(3) *Advanced approaches risk-based capital ratios.* (i) A bank holding company's advanced approaches tier 1 risk-based capital ratio equals the bank holding company's tier 1 risk-based capital ratio as calculated under this appendix (other than this section on transitional floor periods).

(ii) A bank holding company's advanced approaches total risk-based capital ratio equals the bank holding company's total risk-based capital ratio as calculated under this appendix (other than this section on transitional floor periods).

(4) *Reporting.* During the transitional floor periods, a bank holding company must report to the Federal Reserve on a calendar quarterly basis both floor-adjusted risk-based capital ratios and both advanced approaches risk-based capital ratios.

(5) *Exiting a transitional floor period.* A bank holding company may not exit a transitional floor period until the bank holding company has spent a minimum of four consecutive calendar quarters in the period and the Federal Reserve has determined that the bank holding company may exit the floor period. The Federal Reserve's determination will be based on an assessment of the bank holding company's ongoing compliance with the qualification requirements in section 22 of this appendix.

(6) *Interagency study.* After the end of the second transition year (2010), the Federal banking agencies will publish a study that evaluates the advanced approaches to determine if there are any material deficiencies. For any primary Federal supervisor to authorize any institution to exit the third transitional floor period, the study must determine that there are no such material deficiencies that cannot be addressed by then-existing tools, or, if such deficiencies are found, they are first remedied by changes to this appendix. Notwithstanding the preceding sentence, a primary Federal supervisor that disagrees with the finding of material deficiency may not authorize any institution under its jurisdiction to exit the third transitional floor period unless it provides a public report explaining its reasoning.

Section 22. Qualification Requirements

(a) *Process and systems requirements.* (1) A bank holding company must have a rigorous process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining an appropriate level of capital.

(2) The systems and processes used by a bank holding company for risk-based capital purposes under this appendix must be consistent with the bank holding company's internal risk management processes and management information reporting systems.

(3) Each bank holding company must have an appropriate infrastructure with risk measurement and management processes that meet the qualification requirements of this section and are appropriate given the bank holding company's size and level of complexity. Regardless of whether the systems and models that generate the risk parameters necessary for calculating a bank holding company's risk-based capital requirements are located at any affiliate of the bank holding company, the bank holding company itself must ensure that the risk parameters and reference data used to determine its risk-based capital requirements are representative of its own credit risk and operational risk exposures.

(b) *Risk rating and segmentation systems for wholesale and retail exposures.* (1) A bank holding company must have an internal risk rating and segmentation system that accurately and reliably differentiates among degrees of credit risk for the bank holding company's wholesale and retail exposures.

(2) For wholesale exposures:

(i) A bank holding company must have an internal risk rating system that accurately and reliably assigns each obligor to a single rating grade (reflecting the obligor's likelihood of default). A bank holding company may elect, however, not to assign to a rating grade an obligor to whom the bank holding company extends credit based solely on the financial strength of a guarantor, provided that all of the bank holding company's exposures to the obligor are fully covered by eligible guarantees, the bank holding company applies the PD substitution approach in paragraph (c)(1) of section 33 of this appendix to all exposures to that obligor, and the bank holding company immediately assigns the obligor to a rating grade if a guarantee can no longer be recognized under this appendix. The bank holding company's wholesale obligor rating system must have at least seven discrete rating grades for non-defaulted obligors and at least one rating grade for defaulted obligors.

(ii) Unless the bank holding company has chosen to directly assign LGD estimates to each wholesale exposure, the bank holding company must have an internal risk rating system that accurately and reliably assigns each wholesale exposure to a loss severity rating grade (reflecting the bank holding company's estimate of the LGD of the exposure). A bank holding company employing loss severity rating grades must have a sufficiently granular loss severity grading system to avoid grouping together exposures with widely ranging LGDs.

(3) For retail exposures, a bank holding company must have an internal system that groups retail exposures into the appropriate retail exposure subcategory, groups the retail exposures in each retail exposure subcategory into separate segments with homogeneous risk characteristics, and assigns accurate and reliable PD and LGD estimates for each segment on a consistent basis. The bank holding company's system must identify and group in separate segments by subcategories exposures identified in paragraphs (c)(2)(ii) and (iii) of section 31 of this appendix.

(4) The bank holding company's internal risk rating policy for wholesale exposures must describe the bank holding company's rating philosophy (that is, must describe how wholesale obligor rating assignments are affected by the bank holding company's choice of the range of economic, business, and industry conditions that are considered in the obligor rating process).

(5) The bank holding company's internal risk rating system for wholesale exposures must provide for the review and update (as appropriate) of each obligor rating and (if applicable) each loss severity rating whenever the bank holding company receives new material information, but no less frequently than annually. The bank holding company's retail exposure segmentation system must provide for the review and update (as appropriate) of assignments of retail exposures to segments whenever the bank holding company receives new material information, but generally no less frequently than quarterly.

(c) *Quantification of risk parameters for wholesale and retail exposures.* (1) The bank holding company must have a comprehensive risk parameter quantification process that produces accurate, timely, and reliable estimates of the risk parameters for the bank holding company's wholesale and retail exposures.

(2) Data used to estimate the risk parameters must be relevant to the bank holding company's actual wholesale and retail exposures, and of sufficient quality to support the determination of risk-based capital requirements for the exposures.

(3) The bank holding company's risk parameter quantification process must produce appropriately conservative risk parameter estimates where the bank holding company has limited relevant data, and any adjustments that are part of the quantification process must not result in a pattern of bias toward lower risk parameter estimates.

(4) The bank holding company's risk parameter estimation process should not rely on the possibility of U.S. government financial assistance, except for the financial assistance that the U.S. government has a legally binding commitment to provide.

(5) Where the bank holding company's quantifications of LGD directly or indirectly incorporate estimates of the effectiveness of its credit risk management practices in reducing its exposure to troubled obligors prior to default, the bank holding company must support such estimates with empirical analysis showing that the estimates are consistent with its historical experience in dealing with such exposures during economic downturn conditions.

(6) PD estimates for wholesale obligors and retail segments must be based on at least five years of default data. LGD estimates for wholesale exposures must be based on at least seven years of loss severity data, and LGD estimates for retail segments must be based on at least five years of loss severity data. EAD estimates for wholesale exposures must be based on at least seven years of exposure amount data, and EAD estimates for retail segments must be based on at least five years of exposure amount data.

(7) Default, loss severity, and exposure amount data must include periods of economic downturn conditions, or the bank holding company must adjust its estimates of risk parameters to compensate for the lack of data from periods of economic downturn conditions.

(8) The bank holding company's PD, LGD, and EAD estimates must be based on the definition of default in this appendix.

(9) The bank holding company must review and update (as appropriate) its risk parameters and its risk parameter quantification process at least annually.

(10) The bank holding company must at least annually conduct a comprehensive review and analysis of reference data to determine relevance of reference data to the bank holding company's exposures, quality of reference data to support PD, LGD, and EAD estimates, and consistency of reference data to the definition of default contained in this appendix.

(d) *Counterparty credit risk model.* A bank holding company must obtain the prior written approval of the Federal Reserve under section 32 of this appendix to use the internal models methodology for counterparty credit risk.

(e) *Double default treatment.* A bank holding company must obtain the prior written approval of the Federal Reserve under section 34 of this appendix to use the double default treatment.

(f) *Securitization exposures.* A bank holding company must obtain the prior written approval of the Federal Reserve under section 44 of this appendix to use the Internal Assessment Approach for securitization exposures to ABCP programs.

(g) *Equity exposures model.* A bank holding company must obtain the prior written approval of the Federal Reserve under section 53 of this appendix to use the Internal Models Approach for equity exposures.

(h) *Operational risk*—(1) *Operational risk management processes.* A bank holding company must:

(i) Have an operational risk management function that:

(A) Is independent of business line management; and

(B) Is responsible for designing, implementing, and overseeing the bank holding company's operational risk data and assessment systems, operational risk quantification systems, and related processes;

(ii) Have and document a process (which must capture business environment and internal control factors affecting the bank holding company's operational risk profile) to identify, measure, monitor, and control operational risk in bank holding company products, activities, processes, and systems; and

(iii) Report operational risk exposures, operational loss events, and other relevant operational risk information to business unit management, senior management, and the board of directors (or a designated committee of the board).

(2) *Operational risk data and assessment systems.* A bank holding company must have operational risk data and assessment systems that capture operational risks to which the bank holding company is exposed. The bank holding company's operational risk data and assessment systems must:

(i) Be structured in a manner consistent with the bank holding company's current business activities, risk profile, technological processes, and risk management processes; and

(ii) Include credible, transparent, systematic, and verifiable processes that incorporate the following elements on an ongoing basis:

(A) *Internal operational loss event data.* The bank holding company must have a systematic process for capturing and using internal operational loss event data in its operational risk data and assessment systems.

(*1*) The bank holding company's operational risk data and assessment systems must include a historical observation period of at least five years for internal operational loss event data (or such shorter period approved by the Federal Reserve to address transitional situations, such as integrating a new business line).

(*2*) The bank holding company must be able to map its internal operational loss event data into the seven operational loss event type categories.

(*3*) The bank holding company may refrain from collecting internal operational loss event data for individual operational losses below established dollar threshold amounts if the bank holding company can demonstrate to the satisfaction of the Federal Reserve that the thresholds are reasonable, do not exclude important internal operational loss event data, and permit the bank holding company to capture substantially all the dollar value of the bank holding company's operational losses.

(B) *External operational loss event data.* The bank holding company must have a systematic process for determining its methodologies for incorporating external operational loss event data into its operational risk data and assessment systems.

(C) *Scenario analysis.* The bank holding company must have a systematic process for determining its methodologies for incorporating scenario analysis into its operational risk data and assessment systems.

(D) *Business environment and internal control factors.* The bank holding company must incorporate business environment and internal control factors into its operational risk data and assessment systems. The bank holding company must also periodically compare the results of its prior business environment and internal control factor assessments against its actual operational losses incurred in the intervening period.

(3) *Operational risk quantification systems.* (i) The bank holding company's operational risk quantification systems:

(A) Must generate estimates of the bank holding company's operational risk exposure using its operational risk data and assessment systems;

(B) Must employ a unit of measure that is appropriate for the bank holding company's range of business activities and the variety of operational loss events to which it is exposed, and that does not combine business activities or operational loss events with demonstrably different risk profiles within the same loss distribution;

(C) Must include a credible, transparent, systematic, and verifiable approach for weighting each of the four elements, described in paragraph (h)(2)(ii) of this section, that a bank holding company is required to incorporate into its operational risk data and assessment systems;

(D) May use internal estimates of dependence among operational losses across and within units of measure if the bank holding company can demonstrate to the satisfaction of the Federal Reserve that its process for estimating dependence is sound, robust to a variety of scenarios, and implemented with integrity, and allows for the uncertainty surrounding the estimates. If the bank holding company has not made such a demonstration, it must sum operational risk exposure estimates across units of measure to calculate its total operational risk exposure; and

(E) Must be reviewed and updated (as appropriate) whenever the bank holding company becomes aware of information that may have a material effect on the bank holding company's estimate of operational risk exposure, but the review and update must occur no less frequently than annually.

(ii) [Reserved]

(i) *Data management and maintenance.* (1) A bank holding company must have data management and maintenance systems that adequately support all aspects of its advanced systems and the timely and accurate reporting of risk-based capital requirements.

(2) A bank holding company must retain data using an electronic format that allows timely retrieval of data for analysis, validation, reporting, and disclosure purposes.

(3) A bank holding company must retain sufficient data elements related to key risk drivers to permit adequate monitoring, validation, and refinement of its advanced systems.

(j) *Control, oversight, and validation mechanisms.* (1) The bank holding company's senior management must ensure that all components of the bank holding company's advanced systems function effectively and comply with the qualification requirements in this section.

(2) The bank holding company's board of directors (or a designated committee of the board) must at least annually review the effectiveness of, and approve, the bank holding company's advanced systems.

(3) A bank holding company must have an effective system of controls and oversight that:

(i) Ensures ongoing compliance with the qualification requirements in this section;

(ii) Maintains the integrity, reliability, and accuracy of the bank holding company's advanced systems; and

(iii) Includes adequate governance and project management processes.

(4) The bank holding company must validate, on an ongoing basis, its advanced systems. The bank holding company's validation process must be independent of the advanced systems' development, implementation, and operation, or the validation process must be subjected to an independent review of its adequacy and effectiveness. Validation must include:

(i) An evaluation of the conceptual soundness of (including developmental evidence supporting) the advanced systems;

(ii) An ongoing monitoring process that includes verification of processes and benchmarking; and

(iii) An outcomes analysis process that includes back-testing.

(5) The bank holding company must have an internal audit function independent of business-line management that at least annually assesses the effectiveness of the controls supporting the bank holding company's advanced systems and reports its findings to the bank holding company's board of directors (or a committee thereof).

(6) The bank holding company must periodically stress test its advanced systems. The stress testing must include a consideration of how economic cycles, especially downturns, affect risk-based capital requirements (including migration across rating grades and segments and the credit risk mitigation benefits of double default treatment).

(k) *Documentation.* The bank holding company must adequately document all material aspects of its advanced systems.

Section 23. Ongoing Qualification

(a) *Changes to advanced systems.* A bank holding company must meet all the qualification requirements in section 22 of this appendix on an ongoing basis. A bank holding company must notify the Federal Reserve when the bank holding company makes any change to an advanced system that would result in a material change in the bank holding company's risk-weighted asset amount for an exposure type, or when the bank holding company makes any significant change to its modeling assumptions.

(b) *Failure to comply with qualification requirements.* (1) If the Federal Reserve determines that a bank holding company that uses this appendix and has conducted a satisfactory parallel run fails to comply with the qualification requirements in section 22 of this appendix, the Federal Reserve will notify the bank holding company in writing of the bank holding company's failure to comply.

(2) The bank holding company must establish and submit a plan satisfactory to the Federal Reserve to return to compliance with the qualification requirements.

(3) In addition, if the Federal Reserve determines that the bank holding company's risk-based capital requirements are not commensurate with the bank holding company's credit, market, operational, or other risks, the Federal Reserve may require such a bank holding company to calculate its risk-based capital requirements:

(i) Under 12 CFR part 225, appendix A; or

(ii) Under this appendix with any modifications provided by the Federal Reserve.

Section 24. Merger and Acquisition Transitional Arrangements

(a) *Mergers and acquisitions of companies without advanced systems.* If a bank holding company merges with or acquires a company that does not calculate its risk-based capital requirements using advanced systems, the bank holding company may use 12 CFR part 225, appendix A to determine the risk-weighted asset amounts for, and deductions from capital associated with, the merged or acquired company's exposures for up to 24 months after the calendar quarter during which the merger or acquisition consummates. The Federal Reserve may extend this transition period for up to an additional 12 months. Within 90 days of consummating the merger or acquisition, the bank holding company must submit to the Federal Reserve an implementation plan for using its advanced systems for the acquired company. During the period when 12 CFR part 225, appendix A apply to the merged or acquired company, any ALLL, net of allocated transfer risk reserves established pursuant to 12 U.S.C. 3904, associated with the merged or acquired company's exposures may be included in the acquiring bank holding company's tier 2 capital up to 1.25 percent of the acquired company's risk-weighted assets. All general allowances of the merged or acquired company must be excluded from the bank holding company's eligible credit reserves. In addition, the risk-weighted assets of the merged or acquired company are not included in the bank holding company's credit-risk-weighted assets but are included in total risk-weighted assets. If a bank holding company relies on this paragraph, the bank holding company must disclose publicly the amounts of risk-weighted assets and qualifying capital calculated under this appendix for the acquiring bank holding company and under 12 CFR part 225, appendix A for the acquired company.

(b) *Mergers and acquisitions of companies with advanced systems*—(1) If a bank holding company merges with or acquires a company that calculates its risk-based capital requirements using advanced systems, the bank holding company may use the acquired company's advanced systems to determine the risk-weighted asset amounts for, and deductions from capital associated with, the merged or acquired company's exposures for up to 24 months after the calendar quarter during which the acquisition or merger consummates. The Federal Reserve may extend this transition period for up to an additional 12 months. Within 90 days of consummating the merger or acquisition, the bank holding company must submit to the Federal Reserve an implementation plan for using its advanced systems for the merged or acquired company.

(2) If the acquiring bank holding company is not subject to the advanced approaches in this appendix at the time of acquisition or merger, during the period when 12 CFR part 225, appendix A apply to the acquiring bank holding company, the ALLL associated with the exposures of the merged or acquired company may not be directly included in tier 2 capital. Rather, any excess eligible credit reserves associated with the merged or acquired company's exposures may be included in the bank holding company's tier 2 capital up to 0.6 percent of the credit-risk-weighted assets associated with those exposures.

PART IV. RISK-WEIGHTED ASSETS FOR GENERAL CREDIT RISK

Section 31. Mechanics for Calculating Total Wholesale and Retail Risk-Weighted Assets

(a) *Overview.* A bank holding company must calculate its total wholesale and retail risk-weighted asset amount in four distinct phases:

(1) Phase 1—categorization of exposures;

(2) Phase 2—assignment of wholesale obligors and exposures to rating grades and segmentation of retail exposures;

(3) Phase 3—assignment of risk parameters to wholesale exposures and segments of retail exposures; and

(4) Phase 4—calculation of risk-weighted asset amounts.

(b) *Phase 1—Categorization.* The bank holding company must determine which of its exposures are wholesale exposures, retail exposures, securitization exposures, or equity exposures. The bank holding company must categorize each retail exposure as a residential mortgage exposure, a QRE, or an other retail exposure. The bank holding company must identify which wholesale exposures are HVCRE exposures, sovereign exposures, OTC derivative contracts, repo-style transactions, eligible margin loans, eligible purchased wholesale exposures, unsettled transactions to which section 35 of this appendix applies, and eligible guarantees or eligible credit derivatives that are used as credit risk mitigants. The bank holding company must identify any on-balance sheet asset that does not meet the definition of a wholesale, retail, equity, or securitization exposure, as well as any non-material portfolio of exposures described in paragraph (e)(4) of this section.

(c) *Phase 2—Assignment of wholesale obligors and exposures to rating grades and retail exposures to segments—(1) Assignment of wholesale obligors and exposures to rating grades.*

(i) The bank holding company must assign each obligor of a wholesale exposure to a single obligor rating grade and must assign each wholesale exposure to which it does not directly assign an LGD estimate to a loss severity rating grade.

(ii) The bank holding company must identify which of its wholesale obligors are in default.

(2) *Segmentation of retail exposures.* (i) The bank holding company must group the retail exposures in each retail subcategory into segments that have homogeneous risk characteristics.

(ii) The bank holding company must identify which of its retail exposures are in default. The bank holding company must segment defaulted retail exposures separately from non-defaulted retail exposures.

(iii) If the bank holding company determines the EAD for eligible margin loans using the approach in paragraph (b) of section 32 of this appendix, the bank holding company must identify which of its retail exposures are eligible margin loans for which the bank holding company uses this EAD approach and must segment such eligible margin loans separately from other retail exposures.

(3) *Eligible purchased wholesale exposures.* A bank holding company may group its eligible purchased wholesale exposures into segments that have homogeneous risk characteristics. A bank holding company must use the wholesale exposure formula in Table 2 in this section to determine the risk-based capital requirement for each segment of eligible purchased wholesale exposures.

(d) *Phase 3—Assignment of risk parameters to wholesale exposures and segments of retail exposures*—(1) *Quantification process.* Subject to the limitations in this paragraph (d), the bank holding company must:

(i) Associate a PD with each wholesale obligor rating grade;

(ii) Associate an LGD with each wholesale loss severity rating grade or assign an LGD to each wholesale exposure;

(iii) Assign an EAD and M to each wholesale exposure; and

(iv) Assign a PD, LGD, and EAD to each segment of retail exposures.

(2) *Floor on PD assignment.* The PD for each wholesale obligor or retail segment may not be less than 0.03 percent, except for exposures to or directly and unconditionally guaranteed by a sovereign entity, the Bank for International Settlements, the International Monetary Fund, the European Commission, the European Central Bank, or a multilateral development bank, to which the bank holding company assigns a rating grade associated with a PD of less than 0.03 percent.

(3) *Floor on LGD estimation.* The LGD for each segment of residential mortgage exposures (other than segments of residential mortgage exposures for which all or substantially all of the principal of each exposure is directly and unconditionally guaranteed by the full faith and credit of a sovereign entity) may not be less than 10 percent.

(4) *Eligible purchased wholesale exposures.* A bank holding company must assign a PD, LGD, EAD, and M to each segment of eligible purchased wholesale exposures. If the bank holding company can estimate ECL (but not PD or LGD) for a segment of eligible purchased wholesale exposures, the bank holding company must assume that the LGD of the segment equals 100 percent and that the PD of the segment equals ECL divided by EAD. The estimated ECL must be calculated for the exposures without regard to any assumption of recourse or guarantees from the seller or other parties.

(5) *Credit risk mitigation—credit derivatives, guarantees, and collateral.* (i) A bank holding company may take into account the risk reducing effects of eligible guarantees and eligible credit derivatives in support of a wholesale exposure by applying the PD substitution or LGD adjustment treatment to the exposure as provided in section 33 of this appendix or, if applicable, applying double default treatment to the exposure as provided in section 34 of this appendix. A bank holding company may decide separately for each wholesale exposure that qualifies for the double default treatment under section 34 of this appendix whether to apply the double default treatment or to use the PD substitution or LGD adjustment treatment without recognizing double default effects.

(ii) A bank holding company may take into account the risk reducing effects of guarantees and credit derivatives in support of retail exposures in a segment when quantifying the PD and LGD of the segment.

(iii) Except as provided in paragraph (d)(6) of this section, a bank holding company may take into account the risk reducing effects of collateral in support of a wholesale exposure when quantifying the LGD of the exposure and may take into account the risk reducing effects of collateral in support of retail exposures when quantifying the PD and LGD of the segment.

(6) *EAD for OTC derivative contracts, repo-style transactions, and eligible margin loans.* (i) A bank holding company must calculate its EAD for an OTC derivative contract as provided in paragraphs (c) and (d) of section 32 of this appendix. A bank holding company may take into account the risk-reducing effects of financial collateral in support of a repo-style transaction or eligible margin loan and of any collateral in support of a repo-style transaction that is included in the bank holding company's VaR-based measure under 12 CFR part 225, appendix E through an adjustment to EAD as provided in paragraphs (b) and (d) of section 32 of this appendix. A bank holding company that takes collateral into account through such an adjustment to EAD under section 32 of this appendix may not reflect such collateral in LGD.

(ii) A bank holding company may attribute an EAD of zero to:

(A) Derivative contracts that are publicly traded on an exchange that requires the daily receipt and payment of cash-variation margin;

(B) Derivative contracts and repo-style transactions that are outstanding with a qualifying central counterparty (but not for those transactions that a qualifying central counterparty has rejected); and

(C) Credit risk exposures to a qualifying central counterparty in the form of clearing deposits and posted collateral that arise from transactions described in paragraph (d)(6)(ii)(B) of this section.

(7) *Effective maturity*. An exposure's M must be no greater than five years and no less than one year, except that an exposure's M must be no less than one day if the exposure has an original maturity of less than one year and is not part of a bank holding company's ongoing financing of the obligor. An exposure is not part of a bank holding company's ongoing financing of the obligor if the bank holding company:

(i) Has a legal and practical ability not to renew or roll over the exposure in the event of credit deterioration of the obligor;

(ii) Makes an independent credit decision at the inception of the exposure and at every renewal or roll over; and

(iii) Has no substantial commercial incentive to continue its credit relationship with the obligor in the event of credit deterioration of the obligor.

(e) *Phase 4—Calculation of risk-weighted assets*—(1) *Non-defaulted exposures*. (i) A bank holding company must calculate the dollar risk-based capital requirement for each of its wholesale exposures to a non-defaulted obligor (except eligible guarantees and eligible credit derivatives that hedge another wholesale exposure and exposures to which the bank holding company applies the double default treatment in section 34 of this appendix) and segments of non-defaulted retail exposures by inserting the assigned risk parameters for the wholesale obligor and exposure or retail segment into the appropriate risk-based capital formula specified in Table 2 and multiplying the output of the formula (K) by the EAD of the exposure or segment. Alternatively, a bank holding company may apply a 300 percent risk weight to the EAD of an eligible margin loan if the bank holding company is not able to meet the agencies' requirements for estimation of PD and LGD for the margin loan.

Table 2 – IRB Risk-Based Capital Formulas for Wholesale Exposures to Non-Defaulted Obligors and Segments of Non-Defaulted Retail Exposures[1]

Retail	**Capital Requirement (K) Non-Defaulted Exposures**	$K = \left[LGD \times N\left(\frac{N^{-1}(PD) + \sqrt{R} \times N^{-1}(0.999)}{\sqrt{1-R}} \right) - (LGD \times PD) \right]$
	Correlation Factor (R)	For residential mortgage exposures: $R = 0.15$
		For qualifying revolving exposures: $R = 0.04$
		For other retail exposures: $R = 0.03 + 0.13 \times e^{-35 \times PD}$
Wholesale	**Capital Requirement (K) Non-Defaulted Exposures**	$K = \left[LGD \times N\left(\frac{N^{-1}(PD) + \sqrt{R} \times N^{-1}(0.999)}{\sqrt{1-R}} \right) - (LGD \times PD) \right] \times \left(\frac{1 + (M - 2.5) \times b}{1 - 1.5 \times b} \right)$
	Correlation Factor (R)	For HVCRE exposures: $R = 0.12 + 0.18 \times e^{-50 \times PD}$
		For wholesale exposures other than HVCRE exposures: $R = 0.12 + 0.12 \times e^{-50 \times PD}$
	Maturity Adjustment (b)	$b = (0.11852 - 0.05478 \times \ln(PD))^2$

[1]N(.) means the cumulative distribution function for a standard normal random variable. N^{-1}(.) means the inverse cumulative distribution function for a standard normal random variable. The symbol e refers to the base of the natural logarithms, and the function ln(.) refers to the natural logarithm of the expression within parentheses. The formulas apply when PD is greater than zero. If PD equals zero, the capital requirement K is set equal to zero.

(ii) The sum of all the dollar risk-based capital requirements for each wholesale exposure to a non-defaulted obligor and segment of non-defaulted retail exposures calculated in paragraph (e)(1)(i) of this section and in paragraph (e) of section 34 of this appendix equals the total dollar risk-based capital requirement for those exposures and segments.

(iii) The aggregate risk-weighted asset amount for wholesale exposures to non-defaulted obligors and segments of non-defaulted retail exposures equals the total dollar risk-based capital requirement calculated in paragraph (e)(1)(ii) of this section multiplied by 12.5.

(2) *Wholesale exposures to defaulted obligors and segments of defaulted retail exposures.* (i) The dollar risk-based capital requirement for each wholesale exposure to a defaulted obligor equals 0.08 multiplied by the EAD of the exposure.

(ii) The dollar risk-based capital requirement for a segment of defaulted retail exposures equals 0.08 multiplied by the EAD of the segment.

(iii) The sum of all the dollar risk-based capital requirements for each wholesale exposure to a defaulted obligor calculated in paragraph (e)(2)(i) of this section plus the dollar risk-based capital requirements for each segment of defaulted retail exposures calculated in paragraph (e)(2)(ii) of this section equals the total dollar risk-based capital requirement for those exposures and segments.

(iv) The aggregate risk-weighted asset amount for wholesale exposures to defaulted obligors and segments of defaulted retail exposures equals the total dollar risk-based capital requirement calculated in paragraph (e)(2)(iii) of this section multiplied by 12.5.

(3) *Assets not included in a defined exposure category*. (i) A bank holding company may assign a risk-weighted asset amount of zero to cash owned and held in all offices of subsidiary depository institutions or in transit and for gold bullion held in either a subsidiary depository institution's own vaults, or held in another depository institution's vaults on an allocated basis, to the extent the gold bullion assets are offset by gold bullion liabilities.

(ii) The risk-weighted asset amount for the residual value of a retail lease exposure equals such residual value.

(iii) The risk-weighted asset amount for any other on-balance-sheet asset that does not meet the definition of a wholesale, retail, securitization, or equity exposure equals the carrying value of the asset.

(4) *Non-material portfolios of exposures*. The risk-weighted asset amount of a portfolio of exposures for which the bank holding company has demonstrated to the Federal Reserve's satisfaction that the portfolio (when combined with all other portfolios of exposures that the bank holding company seeks to treat under this paragraph) is not material to the bank holding company is the sum of the carrying values of on-balance sheet exposures plus the notional amounts of off-balance sheet exposures in the portfolio. For purposes of this paragraph (e)(4), the notional amount of an OTC derivative contract that is not a credit derivative is the EAD of the derivative as calculated in section 32 of this appendix.

Section 32. Counterparty Credit Risk of Repo-Style Transactions, Eligible Margin Loans, and OTC Derivative Contracts

(a) *In General*. (1) This section describes two methodologies—a collateral haircut approach and an internal models methodology—that a bank holding company may use instead of an LGD estimation methodology to recognize the benefits of financial collateral in mitigating the counterparty credit risk of repo-style transactions, eligible margin loans, collateralized OTC derivative contracts, and single product netting sets of such transactions and to recognize the benefits of any collateral in mitigating the counterparty credit risk of repo-style transactions that are included in a bank holding company's VaR-based measure under 12 CFR part 225, appendix E. A third methodology, the simple VaR methodology, is available for single product netting sets of repo-style transactions and eligible margin loans.

(2) This section also describes the methodology for calculating EAD for an OTC derivative contract or a set of OTC derivative contracts subject to a qualifying master netting agreement. A bank holding company also may use the internal models methodology to estimate EAD for qualifying cross-product master netting agreements.

(3) A bank holding company may only use the standard supervisory haircut approach with a minimum 10-business-day holding period to recognize in EAD the benefits of conforming residential mortgage collateral that secures repo-style transactions (other than repo-style transactions included in the bank holding company's VaR-based measure under 12 CFR part 225, appendix E), eligible margin loans, and OTC derivative contracts.

(4) A bank holding company may use any combination of the three methodologies for collateral recognition; however, it must use the same methodology for similar exposures.

(b) *EAD for eligible margin loans and repo-style transactions*—(1) *General*. A bank holding company may recognize the credit risk mitigation benefits of financial collateral that secures an eligible margin loan, repo-style transaction, or single-product netting set of such transactions by factoring the collateral into its LGD estimates for the exposure. Alternatively, a bank holding company may estimate an unsecured LGD for the exposure, as well as for any repo-style transaction that is included in the bank holding company's VaR-based measure under 12 CFR part 225, appendix E, and determine the EAD of the exposure using:

(i) The collateral haircut approach described in paragraph (b)(2) of this section;

(ii) For netting sets only, the simple VaR methodology described in paragraph (b)(3) of this section; or

(iii) The internal models methodology described in paragraph (d) of this section.

(2) *Collateral haircut approach*—(i) *EAD equation*. A bank holding company may determine EAD for an eligible margin loan, repo-style transaction, or netting set by setting EAD equal to max $\{0, [(\Sigma E - \Sigma C) + \Sigma(Es \times Hs) + \Sigma(Efx \times Hfx)]\}$, where:

(A) ΣE equals the value of the exposure (the sum of the current market values of all instruments, gold, and cash the bank holding company has lent, sold subject to repurchase, or posted as collateral to the counterparty under the transaction (or netting set));

(B) ΣC equals the value of the collateral (the sum of the current market values of all instruments, gold, and cash the bank holding company has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction (or netting set));

(C) Es equals the absolute value of the net position in a given instrument or in gold (where the net position in a given instrument or in gold equals the sum of the current market values of the instrument or gold the bank holding company has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current market values of that same instrument or gold the bank holding company has borrowed, purchased subject to resale, or taken as collateral from the counterparty);

(D) Hs equals the market price volatility haircut appropriate to the instrument or gold referenced in Es;

(E) Efx equals the absolute value of the net position of instruments and cash in a currency that is different from the settlement currency (where the net position in a given currency equals the sum of the current market values of any instruments or cash in the currency the bank holding company has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current market values of any instruments or cash in the currency the bank holding company has borrowed, purchased subject to resale, or taken as collateral from the counterparty); and

(F) Hfx equals the haircut appropriate to the mismatch between the currency referenced in Efx and the settlement currency.

(ii) *Standard supervisory haircuts.* (A) Under the standard supervisory haircuts approach:

(*1*) A bank holding company must use the haircuts for market price volatility (Hs) in Table 3, as adjusted in certain circumstances as provided in paragraph (b)(2)(ii)(A)(*3*) and (*4*) of this section;

TABLE 3—STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUTS [1]

Applicable external rating grade category for debt securities	Residual maturity for debt securities	Issuers exempt from the 3 basis point floor	Other issuers
Two highest investment-grade rating categories for long-term ratings/highest investment-grade rating category for short-term ratings.	≤ 1 year >1 year, ≤ 5 years > 5 years	0.005 0.02 0.04	0.01 0.04 0.08
Two lowest investment-grade rating categories for both short- and long-term ratings.	≤ 1 year > 1 year, ≤ 5 years > 5 years	0.01 0.03 0.06	0.02 0.06 0.12
One rating category below investment grade	All	0.15	0.25
Main index equities (including convertible bonds) and gold		0.15	
Other publicly traded equities (including convertible bonds), conforming residential mortgages, and nonfinancial collateral.		0.25	
Mutual funds		Highest haircut applicable to any security in which the fund can invest.	
Cash on deposit with the bank holding company (including a certificate of deposit issued by the bank holding company).		0	

[1] The market price volatility haircuts in Table 3 are based on a ten-business-day holding period.

(*2*) For currency mismatches, a bank holding company must use a haircut for foreign exchange rate volatility (Hfx) of 8 percent, as adjusted in certain circumstances as provided in paragraph (b)(2)(ii)(A)(*3*) and (*4*) of this section.

(*3*) For repo-style transactions, a bank holding company may multiply the supervisory haircuts provided in paragraphs (b)(2)(ii)(A)(*1*) and (*2*) of this section by the square root of ½ (which equals 0.707107).

(*4*) A bank holding company must adjust the supervisory haircuts upward on the basis of a holding period longer than ten business days (for eligible margin loans) or five business days (for repo-style transactions) where and as appropriate to take into account the illiquidity of an instrument.

(iii) *Own internal estimates for haircuts.* With the prior written approval of the Federal Reserve, a bank holding company may calculate haircuts (Hs and Hfx) using its own internal estimates of the volatilities of market prices and foreign exchange rates.

(A) To receive Federal Reserve approval to use its own internal estimates, a bank holding company must satisfy the following minimum quantitative standards:

(*1*) A bank holding company must use a 99th percentile one-tailed confidence interval.

(*2*) The minimum holding period for a repo-style transaction is five business days and for an eligible margin loan is ten business days. When a bank holding company calculates an own-estimates haircut on a T_N-day holding period, which is different from the minimum holding period for the transaction type, the applicable haircut (H_M) is calculated using the following square root of time formula:

$$H_M = H_N \sqrt{\frac{T_M}{T_N}}\text{ , where}$$

(*i*) T_M equals 5 for repo-style transactions and 10 for eligible margin loans;

(*ii*) T_N equals the holding period used by the bank holding company to derive H_N; and

(*iii*) H_N equals the haircut based on the holding period T_N.

(*3*) A bank holding company must adjust holding periods upwards where and as appropriate to take into account the illiquidity of an instrument.

(*4*) The historical observation period must be at least one year.

(*5*) A bank holding company must update its data sets and recompute haircuts no less frequently than quarterly and must also reassess data sets and haircuts whenever market prices change materially.

(B) With respect to debt securities that have an applicable external rating of investment grade, a bank holding company may calculate haircuts for categories of securities. For a category of securities, the bank holding company must calculate the haircut on the basis of internal volatility estimates for securities in that category that are representative of the securities in that category that the bank holding company has lent, sold subject to repurchase, posted as collateral, borrowed, purchased subject to resale, or taken as collateral. In determining relevant categories, the bank holding company must at a minimum take into account:

(*1*) The type of issuer of the security;

(*2*) The applicable external rating of the security;

(*3*) The maturity of the security; and

(*4*) The interest rate sensitivity of the security.

(C) With respect to debt securities that have an applicable external rating of below investment grade and equity securities, a bank holding company must calculate a separate haircut for each individual security.

(D) Where an exposure or collateral (whether in the form of cash or securities) is denominated in a currency that differs from the settlement currency, the bank holding company must calculate a separate currency mismatch haircut for its net position in each mismatched currency based on estimated volatilities of foreign exchange rates between the mismatched currency and the settlement currency.

(E) A bank holding company's own estimates of market price and foreign exchange rate volatilities may not take into account the correlations among securities and foreign exchange rates on either the exposure or collateral side of a transaction (or netting set) or the correlations among securities and foreign exchange rates between the exposure and collateral sides of the transaction (or netting set).

(3) *Simple VaR methodology*. With the prior written approval of the Federal Reserve, a bank holding company may estimate EAD for a netting set using a VaR model that meets the requirements in paragraph (b)(3)(iii) of this section. In such event, the bank holding company must set EAD equal to max $\{0, [(\Sigma E—\Sigma C) + PFE]\}$, where:

(i) ΣE equals the value of the exposure (the sum of the current market values of all instruments, gold, and cash the bank holding company has lent, sold subject to repurchase, or posted as collateral to the counterparty under the netting set);

(ii) ΣC equals the value of the collateral (the sum of the current market values of all instruments, gold, and cash the bank holding company has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the netting set); and

(iii) PFE (potential future exposure) equals the bank holding company's empirically based best estimate of the 99th percentile, one-tailed confidence interval for an increase in the value of $(\Sigma E—\Sigma C)$ over a five-business-day holding period for repo-style transactions or over a ten-business-day holding period for eligible margin loans using a minimum one-year historical observation period of price data representing the instruments that the bank holding company has lent, sold subject to repurchase, posted as collateral, borrowed, purchased subject to resale, or taken as collateral. The bank holding company must validate its VaR model, including by establishing and maintaining a rigorous and regular back-testing regime.

(c) *EAD for OTC derivative contracts*. (1) A bank holding company must determine the EAD for an OTC derivative contract that is not subject to a qualifying master netting agreement using the current exposure methodology in paragraph (c)(5) of this section or using the internal models methodology described in paragraph (d) of this section.

(2) A bank holding company must determine the EAD for multiple OTC derivative contracts that are subject to a qualifying master netting agreement using the current exposure methodology in paragraph (c)(6) of this section or using the internal models methodology described in paragraph (d) of this section.

(3) *Counterparty credit risk for credit derivatives*. Notwithstanding the above, (i) A bank holding company that purchases a credit derivative that is recognized under section 33 or 34 of this appendix as a credit risk mitigant for an exposure that is not a covered position under 12 CFR part 225, appendix E need not compute a separate counterparty credit risk capital requirement under this section so long as the bank holding company

does so consistently for all such credit derivatives and either includes all or excludes all such credit derivatives that are subject to a master netting agreement from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

(ii) A bank holding company that is the protection provider in a credit derivative must treat the credit derivative as a wholesale exposure to the reference obligor and need not compute a counterparty credit risk capital requirement for the credit derivative under this section, so long as it does so consistently for all such credit derivatives and either includes all or excludes all such credit derivatives that are subject to a master netting agreement from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes (unless the bank holding company is treating the credit derivative as a covered position under 12 CFR part 225, appendix E, in which case the bank holding company must compute a supplemental counterparty credit risk capital requirement under this section).

(4) *Counterparty credit risk for equity derivatives.* A bank holding company must treat an equity derivative contract as an equity exposure and compute a risk-weighted asset amount for the equity derivative contract under part VI (unless the bank holding company is treating the contract as a covered position under 12 CFR part 225, appendix E). In addition, if the bank holding company is treating the contract as a covered position under 12 CFR part 225, appendix E and in certain other cases described in section 55 of this appendix, the bank holding company must also calculate a risk-based capital requirement for the counterparty credit risk of an equity derivative contract under this part.

(5) *Single OTC derivative contract.* Except as modified by paragraph (c)(7) of this section, the EAD for a single OTC derivative contract that is not subject to a qualifying master netting agreement is equal to the sum of the bank holding company's current credit exposure and potential future credit exposure (PFE) on the derivative contract.

(i) *Current credit exposure.* The current credit exposure for a single OTC derivative contract is the greater of the mark-to-market value of the derivative contract or zero.

(ii) *PFE.* The PFE for a single OTC derivative contract, including an OTC derivative contract with a negative mark-to-market value, is calculated by multiplying the notional principal amount of the derivative contract by the appropriate conversion factor in Table 4. For purposes of calculating either the PFE under this paragraph or the gross PFE under paragraph (c)(6) of this section for exchange rate contracts and other similar contracts in which the notional principal amount is equivalent to the cash flows, notional principal amount is the net receipts to each party falling due on each value date in each currency. For any OTC derivative contract that does not fall within one of the specified categories in Table 4, the PFE must be calculated using the ''other'' conversion factors. A bank holding company must use an OTC derivative contract's effective notional principal amount (that is, its apparent or stated notional principal amount multiplied by any multiplier in the OTC derivative contract) rather than its apparent or stated notional principal amount in calculating PFE. PFE of the protection provider of a credit derivative is capped at the net present value of the amount of unpaid premiums.

TABLE 4—CONVERSION FACTOR MATRIX FOR OTC DERIVATIVE CONTRACTS [1]

Remaining maturity [2]	Interest rate	Foreign exchange rate and gold	Credit (investment-grade reference obligor) [3]	Credit (non-investment-grade reference obligor)	Equity	Precious metals (except gold)	Other
One year or less	0.00	0.01	0.05	0.10	0.06	0.07	0.10
Over one to five years	0.005	0.05	0.05	0.10	0.08	0.07	0.12
Over five years	0.015	0.075	0.05	0.10	0.10	0.08	0.15

[1] For an OTC derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract.

[2] For an OTC derivative 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 equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

[3] A bank holding company must use the column labeled ''Credit (investment-grade reference obligor)'' for a credit derivative whose reference obligor has an outstanding unsecured long-term debt security without credit enhancement that has a long-term applicable external rating of at least investment grade. A bank holding company must use the column labeled ''Credit (non-investment-grade reference obligor)'' for all other credit derivatives.

(6) *Multiple OTC derivative contracts subject to a qualifying master netting agreement.* Except as modified by paragraph (c)(7) of this section, the EAD for multiple OTC derivative

contracts subject to a qualifying master netting agreement is equal to the sum of the net current credit exposure and the adjusted sum of the PFE exposure for all OTC derivative contracts subject to the qualifying master netting agreement.

(i) *Net current credit exposure.* The net current credit exposure is the greater of:

(A) The net sum of all positive and negative mark-to-market values of the individual OTC derivative contracts subject to the qualifying master netting agreement; or

(B) zero.

(ii) *Adjusted sum of the PFE.* The adjusted sum of the PFE, Anet, is calculated as Anet = (0.4×Agross)+(0.6×NGR×Agross), where:

(A) Agross = the gross PFE (that is, the sum of the PFE amounts (as determined under paragraph (c)(5)(ii) of this section) for each individual OTC derivative contract subject to the qualifying master netting agreement); and

(B) NGR = the net to gross ratio (that is, the ratio of the net current credit exposure to the gross current credit exposure). In calculating the NGR, the gross current credit exposure equals the sum of the positive current credit exposures (as determined under paragraph (c)(5)(i) of this section) of all individual OTC derivative contracts subject to the qualifying master netting agreement.

(7) *Collateralized OTC derivative contracts.* A bank holding company may recognize the credit risk mitigation benefits of financial collateral that secures an OTC derivative contract or single-product netting set of OTC derivatives by factoring the collateral into its LGD estimates for the contract or netting set. Alternatively, a bank holding company may recognize the credit risk mitigation benefits of financial collateral that secures such a contract or netting set that is marked to market on a daily basis and subject to a daily margin maintenance requirement by estimating an unsecured LGD for the contract or netting set and adjusting the EAD calculated under paragraph (c)(5) or (c)(6) of this section using the collateral haircut approach in paragraph (b)(2) of this section. The bank holding company must substitute the EAD calculated under paragraph (c)(5) or (c)(6) of this section for ΣE in the equation in paragraph (b)(2)(i) of this section and must use a ten-business-day minimum holding period ($T_M = 10$).

(d) *Internal models methodology.* (1) With prior written approval from the Federal Reserve, a bank holding company may use the internal models methodology in this paragraph (d) to determine EAD for counterparty credit risk for OTC derivative contracts (collateralized or uncollateralized) and single-product netting sets thereof, for eligible margin loans and single-product netting sets thereof, and for repo-style transactions and single-product netting sets thereof. A bank holding company that uses the internal models methodology for a particular transaction type (OTC derivative contracts, eligible margin loans, or repo-style transactions) must use the internal models methodology for all transactions of that transaction type. A bank holding company may choose to use the internal models methodology for one or two of these three types of exposures and not the other types. A bank holding company may also use the internal models methodology for OTC derivative contracts, eligible margin loans, and repo-style transactions subject to a qualifying cross-product netting agreement if:

(i) The bank holding company effectively integrates the risk mitigating effects of cross-product netting into its risk management and other information technology systems; and

(ii) The bank holding company obtains the prior written approval of the Federal Reserve. A bank holding company that uses the internal models methodology for a transaction type must receive approval from the Federal Reserve to cease using the methodology for that transaction type or to make a material change to its internal model.

(2) Under the internal models methodology, a bank holding company uses an internal model to estimate the expected exposure (EE) for a netting set and then calculates EAD based on that EE.

(i) The bank holding company must use its internal model's probability distribution for changes in the market value of a netting set that are attributable to changes in market variables to determine EE.

(ii) Under the internal models methodology, EAD = α × effective EPE, or, subject to Federal Reserve approval as provided in paragraph (d)(7), a more conservative measure of EAD.

$$\text{(A) EffectiveEPE}_{t_k} = \sum_{k=1}^{n} \text{EffectiveEE}_{t_k} \times \Delta t_k$$

(that is, effective EPE is the time-weighted average of effective EE where the weights are the proportion that an individual effective EE represents in a one-year time interval) where:

(*1*) Effective EE_{t_k} = max (Effective $EE_{t_{k-1}}$, EE_{t_k}) (that is, for a specific $date_{t_k}$, effective EE is the greater of EE at that date or the effective EE at the previous date); and

(*2*) t_k represents the kth future time period in the model and there are n time periods represented in the model over the first year; and

(B) α = 1.4 except as provided in paragraph (d)(6), or when the Federal Reserve has determined that the bank holding company must set α higher based on the bank holding company's specific characteristics of counterparty credit risk.

(iii) A bank holding company may include financial collateral currently posted by the counterparty as collateral (but may not include other forms of collateral) when calculating EE.

(iv) If a bank holding company hedges some or all of the counterparty credit risk associated with a netting set using an eligible credit derivative, the bank holding company may take the reduction in exposure to the counterparty into account when estimating EE. If the bank holding company recognizes this reduction in exposure to the counterparty in its estimate of EE, it must also use its internal model to estimate a separate EAD for the bank holding company's exposure to the protection provider of the credit derivative.

(3) To obtain Federal Reserve approval to calculate the distributions of exposures upon which the EAD calculation is based, the bank holding company must demonstrate to the satisfaction of the Federal Reserve that it has been using for at least one year an internal model that broadly meets the following minimum standards, with which the bank holding company must maintain compliance:

(i) The model must have the systems capability to estimate the expected exposure to the counterparty on a daily basis (but is not expected to estimate or report expected exposure on a daily basis).

(ii) The model must estimate expected exposure at enough future dates to reflect accurately all the future cash flows of contracts in the netting set.

(iii) The model must account for the possible non-normality of the exposure distribution, where appropriate.

(iv) The bank holding company must measure, monitor, and control current counterparty exposure and the exposure to the counterparty over the whole life of all contracts in the netting set.

(v) The bank holding company must be able to measure and manage current exposures gross and net of collateral held, where appropriate. The bank holding company must estimate expected exposures for OTC derivative contracts both with and without the effect of collateral agreements.

(vi) The bank holding company must have procedures to identify, monitor, and control specific wrong-way risk throughout the life of an exposure. Wrong-way risk in this context is the risk that future exposure to a counterparty will be high when the counterparty's probability of default is also high.

(vii) The model must use current market data to compute current exposures. When estimating model parameters based on historical data, at least three years of historical data that cover a wide range of economic conditions must be used and must be updated quarterly or more frequently if market conditions warrant. The bank holding company should consider using model parameters based on forward-looking measures, where appropriate.

(viii) A bank holding company must subject its internal model to an initial validation and annual model review process. The model review should consider whether the inputs and risk factors, as well as the model outputs, are appropriate.

(4) *Maturity*. (i) If the remaining maturity of the exposure or the longest-dated contract in the netting set is greater than one year, the bank holding company must set M for the exposure or netting set equal to the lower of five years or M(EPE),[3] where:

$$\text{(A)}\ M(EPE)=1+\frac{\sum_{t_k>1\,year}^{maturity} EE_k \times \Delta t_k \times df_k}{\sum_{k=1}^{t_k \le 1\,year} effectiveEE_k \times \Delta t_k \times df_k}$$

(B) df_k is the risk-free discount factor for future time period t_k; and

(C) $\Delta t_k = t_k - t_{k-1}$.

(ii) If the remaining maturity of the exposure or the longest-dated contract in the netting set is one year or less, the bank holding company must set M for the exposure or netting set equal to one year, except as provided in paragraph (d)(7) of section 31 of this appendix.

(5) *Collateral agreements*. A bank holding company may capture the effect on EAD of a collateral agreement that requires receipt of collateral when exposure to the counterparty increases but may not capture the effect on EAD of a collateral agreement that requires

[3] Alternatively, a bank holding company that uses an internal model to calculate a one-sided credit valuation adjustment may use the effective credit duration estimated by the model as M(EPE) in place of the formula in paragraph (d)(4).

receipt of collateral when counterparty credit quality deteriorates. For this purpose, a collateral agreement means a legal contract that specifies the time when, and circumstances under which, the counterparty is required to pledge collateral to the bank holding company for a single financial contract or for all financial contracts in a netting set and confers upon the bank holding company a perfected, first priority security interest (notwithstanding the prior security interest of any custodial agent), or the legal equivalent thereof, in the collateral posted by the counterparty under the agreement. This security interest must provide the bank holding company with a right to close out the financial positions and liquidate the collateral upon an event of default of, or failure to perform by, the counterparty under the collateral agreement. A contract would not satisfy this requirement if the bank holding company's exercise of rights under the agreement may be stayed or avoided under applicable law in the relevant jurisdictions. Two methods are available to capture the effect of a collateral agreement:

(i) With prior written approval from the Federal Reserve, a bank holding company may include the effect of a collateral agreement within its internal model used to calculate EAD. The bank holding company may set EAD equal to the expected exposure at the end of the margin period of risk. The margin period of risk means, with respect to a netting set subject to a collateral agreement, the time period from the most recent exchange of collateral with a counterparty until the next required exchange of collateral plus the period of time required to sell and realize the proceeds of the least liquid collateral that can be delivered under the terms of the collateral agreement and, where applicable, the period of time required to re-hedge the resulting market risk, upon the default of the counterparty. The minimum margin period of risk is five business days for repo-style transactions and ten business days for other transactions when liquid financial collateral is posted under a daily margin maintenance requirement. This period should be extended to cover any additional time between margin calls; any potential closeout difficulties; any delays in selling collateral, particularly if the collateral is illiquid; and any impediments to prompt re-hedging of any market risk.

(ii) A bank holding company that can model EPE without collateral agreements but cannot achieve the higher level of modeling sophistication to model EPE with collateral agreements can set effective EPE for a collateralized netting set equal to the lesser of:

(A) The threshold, defined as the exposure amount at which the counterparty is required to post collateral under the collateral agreement, if the threshold is positive, plus an add-on that reflects the potential increase in exposure of the netting set over the margin period of risk. The add-on is computed as the expected increase in the netting set's exposure beginning from current exposure of zero over the margin period of risk. The margin period of risk must be at least five business days for netting sets consisting only of repo-style transactions subject to daily remargining and daily marking-to-market, and ten business days for all other netting sets; or

(B) Effective EPE without a collateral agreement.

(6) *Own estimate of alpha.* With prior written approval of the Federal Reserve, a bank holding company may calculate alpha as the ratio of economic capital from a full simulation of counterparty exposure across counterparties that incorporates a joint simulation of market and credit risk factors (numerator) and economic capital based on EPE (denominator), subject to a floor of 1.2. For purposes of this calculation, economic capital is the unexpected losses for all counterparty credit risks measured at a 99.9 percent confidence level over a one-year horizon. To receive approval, the bank holding company must meet the following minimum standards to the satisfaction of the Federal Reserve:

(i) The bank holding company's own estimate of alpha must capture in the numerator the effects of:

(A) The material sources of stochastic dependency of distributions of market values of transactions or portfolios of transactions across counterparties;

(B) Volatilities and correlations of market risk factors used in the joint simulation, which must be related to the credit risk factor used in the simulation to reflect potential increases in volatility or correlation in an economic downturn, where appropriate; and

(C) The granularity of exposures (that is, the effect of a concentration in the proportion of each counterparty's exposure that is driven by a particular risk factor).

(ii) The bank holding company must assess the potential model uncertainty in its estimates of alpha.

(iii) The bank holding company must calculate the numerator and denominator of alpha in a consistent fashion with respect to modeling methodology, parameter specifications, and portfolio composition.

(iv) The bank holding company must review and adjust as appropriate its estimates of the numerator and denominator of alpha on at least a quarterly basis and more frequently when the composition of the portfolio varies over time.

(7) *Other measures of counterparty exposure.* With prior written approval of the Federal Reserve, a bank holding company may set EAD equal to a measure of counterparty

credit risk exposure, such as peak EAD, that is more conservative than an alpha of 1.4 (or higher under the terms of paragraph (d)(2)(ii)(B) of this section) times EPE for every counterparty whose EAD will be measured under the alternative measure of counterparty exposure. The bank holding company must demonstrate the conservatism of the measure of counterparty credit risk exposure used for EAD. For material portfolios of new OTC derivative products, the bank holding company may assume that the current exposure methodology in paragraphs (c)(5) and (c)(6) of this section meets the conservatism requirement of this paragraph for a period not to exceed 180 days. For immaterial portfolios of OTC derivative contracts, the bank holding company generally may assume that the current exposure methodology in paragraphs (c)(5) and (c)(6) of this section meets the conservatism requirement of this paragraph.

Section 33. Guarantees and Credit Derivatives: PD Substitution and LGD Adjustment Approaches

(a) *Scope.* (1) This section applies to wholesale exposures for which:

(i) Credit risk is fully covered by an eligible guarantee or eligible credit derivative; or

(ii) Credit risk is covered on a pro rata basis (that is, on a basis in which the bank holding company and the protection provider share losses proportionately) by an eligible guarantee or eligible credit derivative.

(2) Wholesale exposures on which there is a tranching of credit risk (reflecting at least two different levels of seniority) are securitization exposures subject to the securitization framework in part V.

(3) A bank holding company may elect to recognize the credit risk mitigation benefits of an eligible guarantee or eligible credit derivative covering an exposure described in paragraph (a)(1) of this section by using the PD substitution approach or the LGD adjustment approach in paragraph (c) of this section or, if the transaction qualifies, using the double default treatment in section 34 of this appendix. A bank holding company's PD and LGD for the hedged exposure may not be lower than the PD and LGD floors described in paragraphs (d)(2) and (d)(3) of section 31 of this appendix.

(4) If multiple eligible guarantees or eligible credit derivatives cover a single exposure described in paragraph (a)(1) of this section, a bank holding company may treat the hedged exposure as multiple separate exposures each covered by a single eligible guarantee or eligible credit derivative and may calculate a separate risk-based capital requirement for each separate exposure as described in paragraph (a)(3) of this section.

(5) If a single eligible guarantee or eligible credit derivative covers multiple hedged wholesale exposures described in paragraph (a)(1) of this section, a bank holding company must treat each hedged exposure as covered by a separate eligible guarantee or eligible credit derivative and must calculate a separate risk-based capital requirement for each exposure as described in paragraph (a)(3) of this section.

(6) A bank holding company must use the same risk parameters for calculating ECL as it uses for calculating the risk-based capital requirement for the exposure.

(b) *Rules of recognition.* (1) A bank holding company may only recognize the credit risk mitigation benefits of eligible guarantees and eligible credit derivatives.

(2) A bank holding company may only recognize the credit risk mitigation benefits of an eligible credit derivative to hedge an exposure that is different from the credit derivative's reference exposure used for determining the derivative's cash settlement value, deliverable obligation, or occurrence of a credit event if:

(i) The reference exposure ranks pari passu (that is, equally) with or is junior to the hedged exposure; and

(ii) The reference exposure and the hedged exposure are exposures to the same legal entity, and legally enforceable cross-default or cross-acceleration clauses are in place to assure payments under the credit derivative are triggered when the obligor fails to pay under the terms of the hedged exposure.

(c) *Risk parameters for hedged exposures*—(1) *PD substitution approach*—(i) *Full coverage.* If an eligible guarantee or eligible credit derivative meets the conditions in paragraphs (a) and (b) of this section and the protection amount (P) of the guarantee or credit derivative is greater than or equal to the EAD of the hedged exposure, a bank holding company may recognize the guarantee or credit derivative in determining the bank holding company's risk-based capital requirement for the hedged exposure by substituting the PD associated with the rating grade of the protection provider for the PD associated with the rating grade of the obligor in the risk-based capital formula applicable to the guarantee or credit derivative in Table 2 and using the appropriate LGD as described in paragraph (c)(1)(iii) of this section. If the bank holding company determines that full substitution of the protection provider's PD leads to an inappropriate degree of risk mitigation, the bank holding company may substitute a higher PD than that of the protection provider.

(ii) *Partial coverage.* If an eligible guarantee or eligible credit derivative meets the conditions in paragraphs (a) and (b) of this section and the protection amount (P) of the guarantee or credit derivative is less than the EAD of the hedged exposure, the bank holding company must treat the hedged exposure as two separate exposures (protected and unprotected) in order to recognize the credit risk mitigation benefit of the guarantee or credit derivative.

(A) The bank holding company must calculate its risk-based capital requirement for the protected exposure under section 31 of this appendix, where PD is the protection provider's PD, LGD is determined under paragraph (c)(1)(iii) of this section, and EAD is P. If the bank holding company determines that full substitution leads to an inappropriate degree of risk mitigation, the bank holding company may use a higher PD than that of the protection provider.

(B) The bank holding company must calculate its risk-based capital requirement for the unprotected exposure under section 31 of this appendix, where PD is the obligor's PD, LGD is the hedged exposure's LGD (not adjusted to reflect the guarantee or credit derivative), and EAD is the EAD of the original hedged exposure minus P.

(C) The treatment in this paragraph (c)(1)(ii) is applicable when the credit risk of a wholesale exposure is covered on a partial pro rata basis or when an adjustment is made to the effective notional amount of the guarantee or credit derivative under paragraph (d), (e), or (f) of this section.

(iii) *LGD of hedged exposures.* The LGD of a hedged exposure under the PD substitution approach is equal to:

(A) The lower of the LGD of the hedged exposure (not adjusted to reflect the guarantee or credit derivative) and the LGD of the guarantee or credit derivative, if the guarantee or credit derivative provides the bank holding company with the option to receive immediate payout upon triggering the protection; or

(B) The LGD of the guarantee or credit derivative, if the guarantee or credit derivative does not provide the bank holding company with the option to receive immediate payout upon triggering the protection.

(2) *LGD adjustment approach*—(i) *Full coverage.* If an eligible guarantee or eligible credit derivative meets the conditions in paragraphs (a) and (b) of this section and the protection amount (P) of the guarantee or credit derivative is greater than or equal to the EAD of the hedged exposure, the bank holding company's risk-based capital requirement for the hedged exposure is the greater of:

(A) The risk-based capital requirement for the exposure as calculated under section 31 of this appendix, with the LGD of the exposure adjusted to reflect the guarantee or credit derivative; or

(B) The risk-based capital requirement for a direct exposure to the protection provider as calculated under section 31 of this appendix, using the PD for the protection provider, the LGD for the guarantee or credit derivative, and an EAD equal to the EAD of the hedged exposure.

(ii) *Partial coverage.* If an eligible guarantee or eligible credit derivative meets the conditions in paragraphs (a) and (b) of this section and the protection amount (P) of the guarantee or credit derivative is less than the EAD of the hedged exposure, the bank holding company must treat the hedged exposure as two separate exposures (protected and unprotected) in order to recognize the credit risk mitigation benefit of the guarantee or credit derivative.

(A) The bank holding company's risk-based capital requirement for the protected exposure would be the greater of:

(*1*) The risk-based capital requirement for the protected exposure as calculated under section 31 of this appendix, with the LGD of the exposure adjusted to reflect the guarantee or credit derivative and EAD set equal to P; or

(*2*) The risk-based capital requirement for a direct exposure to the guarantor as calculated under section 31 of this appendix, using the PD for the protection provider, the LGD for the guarantee or credit derivative, and an EAD set equal to P.

(B) The bank holding company must calculate its risk-based capital requirement for the unprotected exposure under section 31 of this appendix, where PD is the obligor's PD, LGD is the hedged exposure's LGD (not adjusted to reflect the guarantee or credit derivative), and EAD is the EAD of the original hedged exposure minus P.

(3) *M of hedged exposures.* The M of the hedged exposure is the same as the M of the exposure if it were unhedged.

(d) *Maturity mismatch.* (1) A bank holding company that recognizes an eligible guarantee or eligible credit derivative in determining its risk-based capital requirement for a hedged exposure must adjust the effective notional amount of the credit risk mitigant to reflect any maturity mismatch between the hedged exposure and the credit risk mitigant.

(2) A maturity mismatch occurs when the residual maturity of a credit risk mitigant is less than that of the hedged exposure(s).

(3) The residual maturity of a hedged exposure is the longest possible remaining time before the obligor is scheduled to fulfill its obligation on the exposure. If a credit risk mitigant has embedded options that may reduce its term, the bank holding company (protection purchaser) must use the shortest possible residual maturity for the credit risk mitigant. If a call is at the discretion of the protection provider, the residual maturity of the credit risk mitigant is at the first call date. If the call is at the discretion of the bank holding company (protection purchaser), but the terms of the arrangement at origination of the credit risk mitigant contain a positive incentive for the bank holding company to call the transaction before contractual maturity, the remaining time to

the first call date is the residual maturity of the credit risk mitigant. For example, where there is a step-up in cost in conjunction with a call feature or where the effective cost of protection increases over time even if credit quality remains the same or improves, the residual maturity of the credit risk mitigant will be the remaining time to the first call.

(4) A credit risk mitigant with a maturity mismatch may be recognized only if its original maturity is greater than or equal to one year and its residual maturity is greater than three months.

(5) When a maturity mismatch exists, the bank holding company must apply the following adjustment to the effective notional amount of the credit risk mitigant: $Pm = E \times (t - 0.25)/(T - 0.25)$, where:

(i) Pm = effective notional amount of the credit risk mitigant, adjusted for maturity mismatch;

(ii) E = effective notional amount of the credit risk mitigant;

(iii) t = the lesser of T or the residual maturity of the credit risk mitigant, expressed in years; and

(iv) T = the lesser of five or the residual maturity of the hedged exposure, expressed in years.

(e) *Credit derivatives without restructuring as a credit event.* If a bank holding company recognizes an eligible credit derivative that does not include as a credit event a restructuring of the hedged exposure involving forgiveness or postponement of principal, interest, or fees that results in a credit loss event (that is, a charge-off, specific provision, or other similar debit to the profit and loss account), the bank holding company must apply the following adjustment to the effective notional amount of the credit derivative: $Pr = Pm \times 0.60$, where:

(1) Pr = effective notional amount of the credit risk mitigant, adjusted for lack of restructuring event (and maturity mismatch, if applicable); and

(2) Pm = effective notional amount of the credit risk mitigant adjusted for maturity mismatch (if applicable).

(f) *Currency mismatch.* (1) If a bank holding company recognizes an eligible guarantee or eligible credit derivative that is denominated in a currency different from that in which the hedged exposure is denominated, the bank holding company must apply the following formula to the effective notional amount of the guarantee or credit derivative: $Pc = Pr \times (1 - H_{FX})$, where:

(i) Pc = effective notional amount of the credit risk mitigant, adjusted for currency mismatch (and maturity mismatch and lack of restructuring event, if applicable);

(ii) Pr = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch and lack of restructuring event, if applicable); and

(iii) H_{FX} = haircut appropriate for the currency mismatch between the credit risk mitigant and the hedged exposure.

(2) A bank holding company must set H_{FX} equal to 8 percent unless it qualifies for the use of and uses its own internal estimates of foreign exchange volatility based on a ten-business-day holding period and daily marking-to-market and remargining. A bank holding company qualifies for the use of its own internal estimates of foreign exchange volatility if it qualifies for:

(i) The own-estimates haircuts in paragraph (b)(2)(iii) of section 32 of this appendix;

(ii) The simple VaR methodology in paragraph (b)(3) of section 32 of this appendix; or

(iii) The internal models methodology in paragraph (d) of section 32 of this appendix.

(3) A bank holding company must adjust H_{FX} calculated in paragraph (f)(2) of this section upward if the bank holding company revalues the guarantee or credit derivative less frequently than once every ten business days using the square root of time formula provided in paragraph (b)(2)(iii)(A)(*2*) of section 32 of this appendix.

Section 34. Guarantees and Credit Derivatives: Double Default Treatment

(a) *Eligibility and operational criteria for double default treatment.* A bank holding company may recognize the credit risk mitigation benefits of a guarantee or credit derivative covering an exposure described in paragraph (a)(1) of section 33 of this appendix by applying the double default treatment in this section if all the following criteria are satisfied.

(1) The hedged exposure is fully covered or covered on a pro rata basis by:

(i) An eligible guarantee issued by an eligible double default guarantor; or

(ii) An eligible credit derivative that meets the requirements of paragraph (b)(2) of section 33 of this appendix and is issued by an eligible double default guarantor.

(2) The guarantee or credit derivative is:

(i) An uncollateralized guarantee or uncollateralized credit derivative (for example, a credit default swap) that provides protection with respect to a single reference obligor; or

(ii) An nth-to-default credit derivative (subject to the requirements of paragraph (m) of section 42 of this appendix).

(3) The hedged exposure is a wholesale exposure (other than a sovereign exposure).

(4) The obligor of the hedged exposure is not:

(i) An eligible double default guarantor or an affiliate of an eligible double default guarantor; or

(ii) An affiliate of the guarantor.

(5) The bank holding company does not recognize any credit risk mitigation benefits of the guarantee or credit derivative for the

hedged exposure other than through application of the double default treatment as provided in this section.

(6) The bank holding company has implemented a process (which has received the prior, written approval of the Federal Reserve) to detect excessive correlation between the creditworthiness of the obligor of the hedged exposure and the protection provider. If excessive correlation is present, the bank holding company may not use the double default treatment for the hedged exposure.

(b) *Full coverage.* If the transaction meets the criteria in paragraph (a) of this section and the protection amount (P) of the guarantee or credit derivative is at least equal to the EAD of the hedged exposure, the bank holding company may determine its risk-weighted asset amount for the hedged exposure under paragraph (e) of this section.

(c) *Partial coverage.* If the transaction meets the criteria in paragraph (a) of this section and the protection amount (P) of the guarantee or credit derivative is less than the EAD of the hedged exposure, the bank holding company must treat the hedged exposure as two separate exposures (protected and unprotected) in order to recognize double default treatment on the protected portion of the exposure.

(1) For the protected exposure, the bank holding company must set EAD equal to P and calculate its risk-weighted asset amount as provided in paragraph (e) of this section.

(2) For the unprotected exposure, the bank holding company must set EAD equal to the EAD of the original exposure minus P and then calculate its risk-weighted asset amount as provided in section 31 of this appendix.

(d) *Mismatches.* For any hedged exposure to which a bank holding company applies double default treatment, the bank holding company must make applicable adjustments to the protection amount as required in paragraphs (d), (e), and (f) of section 33 of this appendix.

(e) *The double default dollar risk-based capital requirement.* The dollar risk-based capital requirement for a hedged exposure to which a bank holding company has applied double default treatment is K_{DD} multiplied by the EAD of the exposure. K_{DD} is calculated according to the following formula: $K_{DD} = K_o \times (0.15 + 160 \times PD_g)$,

Where:

(1)

$$K_O = LGD_g \times \left[N\left(\frac{N^{-1}(PD_o) + N^{-1}(0.999)\sqrt{\rho_{os}}}{\sqrt{1-\rho_{os}}} \right) - PD_o \right] \times \left[\frac{1 + (M - 2.5) \times b}{1 - 1.5 \times b} \right]$$

(2) PD_g = PD of the protection provider.

(3) PD_o = PD of the obligor of the hedged exposure.

(4) LGD_g = (i) The lower of the LGD of the hedged exposure (not adjusted to reflect the guarantee or credit derivative) and the LGD of the guarantee or credit derivative, if the guarantee or credit derivative provides the bank holding company with the option to receive immediate payout on triggering the protection; or

(ii) The LGD of the guarantee or credit derivative, if the guarantee or credit derivative does not provide the bank holding company with the option to receive immediate payout on triggering the protection.

(5) ρ_{OS} (asset value correlation of the obligor) is calculated according to the appropriate formula for (R) provided in Table 2 in section 31 of this appendix, with PD equal to PD_o.

(6) b (maturity adjustment coefficient) is calculated according to the formula for b provided in Table 2 in section 31 of this appendix, with PD equal to the lesser of PD_o and PD_g.

(7) M (maturity) is the effective maturity of the guarantee or credit derivative, which may not be less than one year or greater than five years.

Section 35. Risk-Based Capital Requirement for Unsettled Transactions

(a) *Definitions.* For purposes of this section:

(1) *Delivery-versus-payment (DvP) transaction* means a securities or commodities transaction in which the buyer is obligated to make payment only if the seller has made delivery of the securities or commodities and the seller is obligated to deliver the securities or commodities only if the buyer has made payment.

(2) *Payment-versus-payment (PvP) transaction* means a foreign exchange transaction in which each counterparty is obligated to make a final transfer of one or more currencies only if the other counterparty has made a final transfer of one or more currencies.

(3) *Normal settlement period.* A transaction has a *normal settlement period* if the contractual settlement period for the transaction is equal to or less than the market standard for

the instrument underlying the transaction and equal to or less than five business days.

(4) *Positive current exposure*. The positive current exposure of a bank holding company for a transaction is the difference between the transaction value at the agreed settlement price and the current market price of the transaction, if the difference results in a credit exposure of the bank holding company to the counterparty.

(b) *Scope*. This section applies to all transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. This section does not apply to:

(1) Transactions accepted by a qualifying central counterparty that are subject to daily marking-to-market and daily receipt and payment of variation margin;

(2) Repo-style transactions, including unsettled repo-style transactions (which are addressed in sections 31 and 32 of this appendix);

(3) One-way cash payments on OTC derivative contracts (which are addressed in sections 31 and 32 of this appendix); or

(4) Transactions with a contractual settlement period that is longer than the normal settlement period (which are treated as OTC derivative contracts and addressed in sections 31 and 32 of this appendix).

(c) *System-wide failures*. In the case of a system-wide failure of a settlement or clearing system, the Federal Reserve may waive risk-based capital requirements for unsettled and failed transactions until the situation is rectified.

(d) *Delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions*. A bank holding company must hold risk-based capital against any DvP or PvP transaction with a normal settlement period if the bank holding company's counterparty has not made delivery or payment within five business days after the settlement date. The bank holding company must determine its risk-weighted asset amount for such a transaction by multiplying the positive current exposure of the transaction for the bank holding company by the appropriate risk weight in Table 5.

TABLE 5—RISK WEIGHTS FOR UNSETTLED DVP AND PVP TRANSACTIONS

Number of business days after contractual settlement date	Risk weight to be applied to positive current exposure (percent)
From 5 to 15	100
From 16 to 30	625
From 31 to 45	937.5
46 or more	1,250

(e) *Non-DvP/non-PvP (non-delivery-versus-payment/non-payment-versus-payment) transactions*. (1) A bank holding company must hold risk-based capital against any non-DvP/non-PvP transaction with a normal settlement period if the bank holding company has delivered cash, securities, commodities, or currencies to its counterparty but has not received its corresponding deliverables by the end of the same business day. The bank holding company must continue to hold risk-based capital against the transaction until the bank holding company has received its corresponding deliverables.

(2) From the business day after the bank holding company has made its delivery until five business days after the counterparty delivery is due, the bank holding company must calculate its risk-based capital requirement for the transaction by treating the current market value of the deliverables owed to the bank holding company as a wholesale exposure.

(i) A bank holding company may assign an obligor rating to a counterparty for which it is not otherwise required under this appendix to assign an obligor rating on the basis of the applicable external rating of any outstanding unsecured long-term debt security without credit enhancement issued by the counterparty.

(ii) A bank holding company may use a 45 percent LGD for the transaction rather than estimating LGD for the transaction provided the bank holding company uses the 45 percent LGD for all transactions described in paragraphs (e)(1) and (e)(2) of this section.

(iii) A bank holding company may use a 100 percent risk weight for the transaction provided the bank holding company uses this risk weight for all transactions described in paragraphs (e)(1) and (e)(2) of this section.

(3) If the bank holding company has not received its deliverables by the fifth business day after the counterparty delivery was due, the bank holding company must deduct the current market value of the deliverables owed to the bank holding company 50 percent from tier 1 capital and 50 percent from tier 2 capital.

(f) *Total risk-weighted assets for unsettled transactions*. Total risk-weighted assets for unsettled transactions is the sum of the risk-weighted asset amounts of all DvP, PvP, and non-DvP/non-PvP transactions.

PART V. RISK-WEIGHTED ASSETS FOR SECURITIZATION EXPOSURES

Section 41. Operational Criteria for Recognizing the Transfer of Risk

(a) *Operational criteria for traditional securitizations*. A bank holding company that transfers exposures it has originated or purchased to a securitization SPE or other third party in connection with a traditional securitization may exclude the exposures from the calculation of its risk-weighted assets only if each of the conditions in this paragraph (a) is satisfied. A bank holding company that meets these conditions must hold risk-based capital against any securitization exposures it retains in connection with the securitization. A bank holding company that fails to meet these conditions must hold risk-based capital against the transferred exposures as if they had not been securitized and must deduct from tier 1 capital any after-tax gain-on-sale resulting from the transaction. The conditions are:

(1) The transfer is considered a sale under GAAP;

(2) The bank holding company has transferred to third parties credit risk associated with the underlying exposures; and

(3) Any clean-up calls relating to the securitization are eligible clean-up calls.

(b) *Operational criteria for synthetic securitizations.* For synthetic securitizations, a bank holding company may recognize for risk-based capital purposes the use of a credit risk mitigant to hedge underlying exposures only if each of the conditions in this paragraph (b) is satisfied. A bank holding company that fails to meet these conditions must hold risk-based capital against the underlying exposures as if they had not been synthetically securitized. The conditions are:

(1) The credit risk mitigant is financial collateral, an eligible credit derivative from an eligible securitization guarantor or an eligible guarantee from an eligible securitization guarantor;

(2) The bank holding company transfers credit risk associated with the underlying exposures to third parties, and the terms and conditions in the credit risk mitigants employed do not include provisions that:

(i) Allow for the termination of the credit protection due to deterioration in the credit quality of the underlying exposures;

(ii) Require the bank holding company to alter or replace the underlying exposures to improve the credit quality of the pool of underlying exposures;

(iii) Increase the bank holding company's cost of credit protection in response to deterioration in the credit quality of the underlying exposures;

(iv) Increase the yield payable to parties other than the bank holding company in response to a deterioration in the credit quality of the underlying exposures; or

(v) Provide for increases in a retained first loss position or credit enhancement provided by the bank holding company after the inception of the securitization;

(3) The bank holding company obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions; and

(4) Any clean-up calls relating to the securitization are eligible clean-up calls.

Section 42. Risk-Based Capital Requirement for Securitization Exposures

(a) *Hierarchy of approaches.* Except as provided elsewhere in this section:

(1) A bank holding company must deduct from tier 1 capital any after-tax gain-on-sale resulting from a securitization and must deduct from total capital in accordance with paragraph (c) of this section the portion of any CEIO that does not constitute gain-on-sale.

(2) If a securitization exposure does not require deduction under paragraph (a)(1) of this section and qualifies for the Ratings-Based Approach in section 43 of this appendix, a bank holding company must apply the Ratings-Based Approach to the exposure.

(3) If a securitization exposure does not require deduction under paragraph (a)(1) of this section and does not qualify for the Ratings-Based Approach, the bank holding company may either apply the Internal Assessment Approach in section 44 of this appendix to the exposure (if the bank holding company, the exposure, and the relevant ABCP program qualify for the Internal Assessment Approach) or the Supervisory Formula Approach in section 45 of this appendix to the exposure (if the bank holding company and the exposure qualify for the Supervisory Formula Approach).

(4) If a securitization exposure does not require deduction under paragraph (a)(1) of this section and does not qualify for the Ratings-Based Approach, the Internal Assessment Approach, or the Supervisory Formula Approach, the bank holding company must deduct the exposure from total capital in accordance with paragraph (c) of this section.

(5) If a securitization exposure is an OTC derivative contract (other than a credit derivative) that has a first priority claim on the cash flows from the underlying exposures (notwithstanding amounts due under interest rate or currency derivative contracts, fees due, or other similar payments), with approval of the Federal Reserve, a bank holding company may choose to set the risk-weighted asset amount of the exposure equal to the amount of the exposure as determined in paragraph (e) of this section rather than apply the hierarchy of approaches described in paragraphs (a) (1) through (4) of this section.

(b) *Total risk-weighted assets for securitization exposures.* A bank holding company's total risk-weighted assets for securitization exposures is equal to the sum of its risk-weighted assets calculated using the Ratings-Based Approach in section 43 of this appendix, the Internal Assessment Approach in section 44 of this appendix, and the Supervisory Formula Approach in section 45 of this appendix, and its risk-weighted assets amount for early amortization provisions calculated in section 47 of this appendix.

(c) *Deductions*. (1) If a bank holding company must deduct a securitization exposure from total capital, the bank holding company must take the deduction 50 percent from tier 1 capital and 50 percent from tier 2 capital. If the amount deductible from tier 2 capital exceeds the bank holding company's tier 2 capital, the bank holding company must deduct the excess from tier 1 capital.

(2) A bank holding company may calculate any deduction from tier 1 capital and tier 2 capital for a securitization exposure net of any deferred tax liabilities associated with the securitization exposure.

(d) *Maximum risk-based capital requirement*. Regardless of any other provisions of this part, unless one or more underlying exposures does not meet the definition of a wholesale, retail, securitization, or equity exposure, the total risk-based capital requirement for all securitization exposures held by a single bank holding company associated with a single securitization (including any risk-based capital requirements that relate to an early amortization provision of the securitization but excluding any risk-based capital requirements that relate to the bank holding company's gain-on-sale or CEIOs associated with the securitization) may not exceed the sum of:

(1) The bank holding company's total risk-based capital requirement for the underlying exposures as if the bank holding company directly held the underlying exposures; and

(2) The total ECL of the underlying exposures.

(e) *Amount of a securitization exposure*. (1) The amount of an on-balance sheet securitization exposure that is not a repo-style transaction, eligible margin loan, or OTC derivative contract (other than a credit derivative) is:

(i) The bank holding company's carrying value minus any unrealized gains and plus any unrealized losses on the exposure, if the exposure is a security classified as available-for-sale; or

(ii) The bank holding company's carrying value, if the exposure is not a security classified as available-for-sale.

(2) The amount of an off-balance sheet securitization exposure that is not an OTC derivative contract (other than a credit derivative) is the notional amount of the exposure. For an off-balance-sheet securitization exposure to an ABCP program, such as a liquidity facility, the notional amount may be reduced to the maximum potential amount that the bank holding company could be required to fund given the ABCP program's current underlying assets (calculated without regard to the current credit quality of those assets).

(3) The amount of a securitization exposure that is a repo-style transaction, eligible margin loan, or OTC derivative contract (other than a credit derivative) is the EAD of the exposure as calculated in section 32 of this appendix.

(f) *Overlapping exposures*. If a bank holding company has multiple securitization exposures that provide duplicative coverage of the underlying exposures of a securitization (such as when a bank holding company provides a program-wide credit enhancement and multiple pool-specific liquidity facilities to an ABCP program), the bank holding company is not required to hold duplicative risk-based capital against the overlapping position. Instead, the bank holding company may apply to the overlapping position the applicable risk-based capital treatment that results in the highest risk-based capital requirement.

(g) *Securitizations of non-IRB exposures*. If a bank holding company has a securitization exposure where any underlying exposure is not a wholesale exposure, retail exposure, securitization exposure, or equity exposure, the bank holding company must:

(1) If the bank holding company is an originating bank holding company, deduct from tier 1 capital any after-tax gain-on-sale resulting from the securitization and deduct from total capital in accordance with paragraph (c) of this section the portion of any CEIO that does not constitute gain-on-sale;

(2) If the securitization exposure does not require deduction under paragraph (g)(1), apply the RBA in section 43 of this appendix to the securitization exposure if the exposure qualifies for the RBA;

(3) If the securitization exposure does not require deduction under paragraph (g)(1) and does not qualify for the RBA, apply the IAA in section 44 of this appendix to the exposure (if the bank holding company, the exposure, and the relevant ABCP program qualify for the IAA); and

(4) If the securitization exposure does not require deduction under paragraph (g)(1) and does not qualify for the RBA or the IAA, deduct the exposure from total capital in accordance with paragraph (c) of this section.

(h) *Implicit support*. If a bank holding company provides support to a securitization in excess of the bank holding company's contractual obligation to provide credit support to the securitization (implicit support):

(1) The bank holding company must hold regulatory capital against all of the underlying exposures associated with the securitization as if the exposures had not been securitized and must deduct from tier 1 capital any after-tax gain-on-sale resulting from the securitization; and

(2) The bank holding company must disclose publicly:

(i) That it has provided implicit support to the securitization; and

(ii) The regulatory capital impact to the bank holding company of providing such implicit support.

(i) *Eligible servicer cash advance facilities*. Regardless of any other provisions of this part, a bank holding company is not required to hold risk-based capital against the undrawn portion of an eligible servicer cash advance facility.

(j) *Interest-only mortgage-backed securities*. Regardless of any other provisions of this part, the risk weight for a non-credit-enhancing interest-only mortgage-backed security may not be less than 100 percent.

(k) *Small-business loans and leases on personal property transferred with recourse*. (1) Regardless of any other provisions of this appendix, a bank holding company that has transferred small-business loans and leases on personal property (small-business obligations) with recourse must include in risk-weighted assets only the contractual amount of retained recourse if all the following conditions are met:

(i) The transaction is a sale under GAAP.

(ii) The bank holding company establishes and maintains, pursuant to GAAP, a non-capital reserve sufficient to meet the bank holding company's reasonably estimated liability under the recourse arrangement.

(iii) The loans and leases are 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 (15 U.S.C. 632).

(iv) The bank holding company is well capitalized, as defined in the Federal Reserve's prompt corrective action regulation at 12 CFR part 208, Subpart D. For purposes of determining whether a bank holding company is well capitalized for purposes of this paragraph, the bank holding company's capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (k)(1) of this section.

(2) The total outstanding amount of recourse retained by a bank holding company on transfers of small-business obligations receiving the capital treatment specified in paragraph (k)(1) of this section cannot exceed 15 percent of the bank holding company's total qualifying capital.

(3) If a bank holding company ceases to be well capitalized or exceeds the 15 percent capital limitation, the preferential capital treatment specified in paragraph (k)(1) of this section will continue to apply to any transfers of small-business obligations with recourse that occurred during the time that the bank holding company was well capitalized and did not exceed the capital limit.

(4) The risk-based capital ratios of the bank holding company must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (k)(1) of this section as provided in 12 CFR part 225, appendix A.

(l) *Nth-to-default credit derivatives*—(1) *First-to-default credit derivatives*—(i) *Protection purchaser*. A bank holding company that obtains credit protection on a group of underlying exposures through a first-to-default credit derivative must determine its risk-based capital requirement for the underlying exposures as if the bank holding company synthetically securitized the underlying exposure with the lowest risk-based capital requirement and had obtained no credit risk mitigant on the other underlying exposures.

(ii) *Protection provider*. A bank holding company that provides credit protection on a group of underlying exposures through a first-to-default credit derivative must determine its risk-weighted asset amount for the derivative by applying the RBA in section 43 of this appendix (if the derivative qualifies for the RBA) or, if the derivative does not qualify for the RBA, by setting its risk-weighted asset amount for the derivative equal to the product of:

(A) The protection amount of the derivative;

(B) 12.5; and

(C) The sum of the risk-based capital requirements of the individual underlying exposures, up to a maximum of 100 percent.

(2) *Second-or-subsequent-to-default credit derivatives*—(i) *Protection purchaser*. (A) A bank holding company that obtains credit protection on a group of underlying exposures through a nth-to-default credit derivative (other than a first-to-default credit derivative) may recognize the credit risk mitigation benefits of the derivative only if:

(*1*) The bank holding company also has obtained credit protection on the same underlying exposures in the form of first-through-(n-1)-to-default credit derivatives; or

(*2*) If n-1 of the underlying exposures have already defaulted.

(B) If a bank holding company satisfies the requirements of paragraph (m)(2)(i)(A) of this section, the bank holding company must determine its risk-based capital requirement for the underlying exposures as if the bank holding company had only synthetically securitized the underlying exposure with the nth lowest risk-based capital requirement and had obtained no credit risk mitigant on the other underlying exposures.

(ii) *Protection provider*. A bank holding company that provides credit protection on a group of underlying exposures through a nth-to-default credit derivative (other than a first-to-default credit derivative) must determine its risk-weighted asset amount for the derivative by applying the RBA in section 43 of this appendix (if the derivative qualifies for the RBA) or, if the derivative does not qualify for the RBA, by setting its risk-weighted asset amount for the derivative equal to the product of:

(A) The protection amount of the derivative;

(B) 12.5; and

(C) The sum of the risk-based capital requirements of the individual underlying exposures (excluding the n-1 underlying exposures with the lowest risk-based capital requirements), up to a maximum of 100 percent.

Section 43. Ratings-Based Approach (RBA)

(a) *Eligibility requirements for use of the RBA*—(1) *Originating bank holding company.* An originating bank holding company must use the RBA to calculate its risk-based capital requirement for a securitization exposure if the exposure has two or more external ratings or inferred ratings (and may not use the RBA if the exposure has fewer than two external ratings or inferred ratings).

(2) *Investing bank holding company.* An investing bank holding company must use the RBA to calculate its risk-based capital requirement for a securitization exposure if the exposure has one or more external or inferred ratings (and may not use the RBA if the exposure has no external or inferred ratings).

(b) *Ratings-based approach.* (1) A bank holding company must determine the risk-weighted asset amount for a securitization exposure by multiplying the amount of the exposure (as defined in paragraph (e) of section 42 of this appendix) by the appropriate risk weight provided in Table 6 and Table 7.

(2) A bank holding company must apply the risk weights in Table 6 when the securitization exposure's applicable external or applicable inferred rating represents a long-term credit rating, and must apply the risk weights in Table 7 when the securitization exposure's applicable external or applicable inferred rating represents a short-term credit rating.

(i) A bank holding company must apply the risk weights in column 1 of Table 6 or Table 7 to the securitization exposure if:

(A) N (as calculated under paragraph (e)(6) of section 45 of this appendix) is six or more (for purposes of this section only, if the notional number of underlying exposures is 25 or more or if all of the underlying exposures are retail exposures, a bank holding company may assume that N is six or more unless the bank holding company knows or has reason to know that N is less than six); and

(B) The securitization exposure is a senior securitization exposure.

(ii) A bank holding company must apply the risk weights in column 3 of Table 6 or Table 7 to the securitization exposure if N is less than six, regardless of the seniority of the securitization exposure.

(iii) Otherwise, a bank holding company must apply the risk weights in column 2 of Table 6 or Table 7.

TABLE 6—LONG-TERM CREDIT RATING RISK WEIGHTS UNDER RBA AND IAA

Applicable external or inferred rating (Illustrative rating example)	Column 1	Column 2	Column 3
	Risk weights for senior securitization exposures backed by granular pools	Risk weights for non-senior securitization exposures backed by granular pools	Risk weights for securitization exposures backed by non-granular pools
Highest investment grade (for example, AAA)	7%	12%	20%
Second highest investment grade (for example, AA)	8%	15%	25%
Third-highest investment grade—positive designation (for example, A+)	10%	18%	35%
Third-highest investment grade (for example, A)	12%	20%	
Third-highest investment grade—negative designation (for example, A−)	20%	35%	
Lowest investment grade—positive designation (for example, BBB+)	35%	50%	
Lowest investment grade (for example, BBB)	60%	75%	
Lowest investment grade—negative designation (for example, BBB−)	100%		
One category below investment grade—positive designation (for example, BB+)	250%		
One category below investment grade (for example, BB)	425%		
One category below investment grade—negative designation (for example, BB−)	650%		
More than one category below investment grade	Deduction from tier 1 and tier 2 capital.		

TABLE 7—SHORT-TERM CREDIT RATING RISK WEIGHTS UNDER RBA AND IAA

Applicable external or inferred rating (Illustrative rating example)	Column 1 Risk weights for senior securitization exposures backed by granular pools	Column 2 Risk weights for non-senior securitization exposures backed by granular pools	Column 3 Risk weights for securitization exposures backed by non-granular pools
Highest investment grade (for example, A1)	7%	12%	20%
Second highest investment grade (for example, A2)	12%	20%	35%
Third highest investment grade (for example, A3)	60%	75%	75%
All other ratings	Deduction from tier 1 and tier 2 capital.		

Section 44. Internal Assessment Approach (IAA)

(a) *Eligibility requirements.* A bank holding company may apply the IAA to calculate the risk-weighted asset amount for a securitization exposure that the bank holding company has to an ABCP program (such as a liquidity facility or credit enhancement) if the bank holding company, the ABCP program, and the exposure qualify for use of the IAA.

(1) *Bank holding company qualification criteria.* A bank holding company qualifies for use of the IAA if the bank holding company has received the prior written approval of the Federal Reserve. To receive such approval, the bank holding company must demonstrate to the Federal Reserve's satisfaction that the bank holding company's internal assessment process meets the following criteria:

(i) The bank holding company's internal credit assessments of securitization exposures must be based on publicly available rating criteria used by an NRSRO.

(ii) The bank holding company's internal credit assessments of securitization exposures used for risk-based capital purposes must be consistent with those used in the bank holding company's internal risk management process, management information reporting systems, and capital adequacy assessment process.

(iii) The bank holding company's internal credit assessment process must have sufficient granularity to identify gradations of risk. Each of the bank holding company's internal credit assessment categories must correspond to an external rating of an NRSRO.

(iv) The bank holding company's internal credit assessment process, particularly the stress test factors for determining credit enhancement requirements, must be at least as conservative as the most conservative of the publicly available rating criteria of the NRSROs that have provided external ratings to the commercial paper issued by the ABCP program.

(A) Where the commercial paper issued by an ABCP program has an external rating from two or more NRSROs and the different NRSROs' benchmark stress factors require different levels of credit enhancement to achieve the same external rating equivalent, the bank holding company must apply the NRSRO stress factor that requires the highest level of credit enhancement.

(B) If any NRSRO that provides an external rating to the ABCP program's commercial paper changes its methodology (including stress factors), the bank holding company must evaluate whether to revise its internal assessment process.

(v) The bank holding company must have an effective system of controls and oversight that ensures compliance with these operational requirements and maintains the integrity and accuracy of the internal credit assessments. The bank holding company must have an internal audit function independent from the ABCP program business line and internal credit assessment process that assesses at least annually whether the controls over the internal credit assessment process function as intended.

(vi) The bank holding company must review and update each internal credit assessment whenever new material information is available, but no less frequently than annually.

(vii) The bank holding company must validate its internal credit assessment process on an ongoing basis and at least annually.

(2) *ABCP-program qualification criteria.* An ABCP program qualifies for use of the IAA if all commercial paper issued by the ABCP program has an external rating.

(3) *Exposure qualification criteria.* A securitization exposure qualifies for use of the IAA if the exposure meets the following criteria:

(i) The bank holding company initially rated the exposure at least the equivalent of investment grade.

(ii) The ABCP program has robust credit and investment guidelines (that is, underwriting standards) for the exposures underlying the securitization exposure.

(iii) The ABCP program performs a detailed credit analysis of the sellers of the exposures underlying the securitization exposure.

(iv) The ABCP program's underwriting policy for the exposures underlying the securitization exposure establishes minimum asset eligibility criteria that include the prohibition of the purchase of assets that are significantly past due or of assets that are defaulted (that is, assets that have been charged off or written down by the seller prior to being placed into the ABCP program or assets that would be charged off or written down under the program's governing contracts), as well as limitations on concentration to individual obligors or geographic areas and the tenor of the assets to be purchased.

(v) The aggregate estimate of loss on the exposures underlying the securitization exposure considers all sources of potential risk, such as credit and dilution risk.

(vi) Where relevant, the ABCP program incorporates structural features into each purchase of exposures underlying the securitization exposure to mitigate potential credit deterioration of the underlying exposures. Such features may include wind-down triggers specific to a pool of underlying exposures.

(b) *Mechanics.* A bank holding company that elects to use the IAA to calculate the risk-based capital requirement for any securitization exposure must use the IAA to calculate the risk-based capital requirements for all securitization exposures that qualify for the IAA approach. Under the IAA, a bank holding company must map its internal assessment of such a securitization exposure to an equivalent external rating from an NRSRO. Under the IAA, a bank holding company must determine the risk-weighted asset amount for such a securitization exposure by multiplying the amount of the exposure (as defined in paragraph (e) of section 42 of this appendix) by the appropriate risk weight in Table 6 and Table 7 in paragraph (b) of section 43 of this appendix.

Section 45. Supervisory Formula Approach (SFA)

(a) *Eligibility requirements.* A bank holding company may use the SFA to determine its risk-based capital requirement for a securitization exposure only if the bank holding company can calculate on an ongoing basis each of the SFA parameters in paragraph (e) of this section.

(b) *Mechanics.* Under the SFA, a securitization exposure incurs a deduction from total capital (as described in paragraph (c) of section 42 of this appendix) and/or an SFA risk-based capital requirement, as determined in paragraph (c) of this section. The risk-weighted asset amount for the securitization exposure equals the SFA risk-based capital requirement for the exposure multiplied by 12.5.

(c) *The SFA risk-based capital requirement.* (1) If K_{IRB} is greater than or equal to L + T, the entire exposure must be deducted from total capital.

(2) If K_{IRB} is less than or equal to L, the exposure's SFA risk-based capital requirement is UE multiplied by TP multiplied by the greater of:

(i) $0.0056 * T$; or

(ii) $S[L + T] - S[L]$.

(3) If K_{IRB} is greater than L and less than L + T, the bank holding company must deduct from total capital an amount equal to $UE*TP*(K_{IRB} - L)$, and the exposure's SFA risk-based capital requirement is UE multiplied by TP multiplied by the greater of:

(i) $0.0056 * (T - (K_{IRB} - L))$; or

(ii) $S[L + T] - S[K_{IRB}]$.

(d) *The supervisory formula:*

$$(1)\ S[Y] = \begin{cases} Y & \text{when } Y \le K_{IRB} \\ K_{IRB} + K[Y] - K[K_{IRB}] + \dfrac{d \cdot K_{IRB}}{20}\left(1 - e^{\frac{20\cdot(K_{IRB} - Y)}{K_{IRB}}}\right) & \text{when } Y > K_{IRB} \end{cases}$$

$$(2)\ K[Y] = (1-h)\cdot\left[(1-\beta[Y;a,b])\cdot Y + \beta[Y;a+1,b]\cdot c\right]$$

$$(3)\ h = \left(1 - \frac{K_{IRB}}{EWALGD}\right)^{N}$$

$$(4)\ a = g \cdot c$$

$$(5)\ b = g \cdot (1-c)$$

$$(6)\ c = \frac{K_{IRB}}{1-h}$$

$$(7)\ g = \frac{(1-c)\cdot c}{f} - 1$$

$$(8)\ f = \frac{v + K_{IRB}^{\ 2}}{1-h} - c^2 + \frac{(1-K_{IRB})\cdot K_{IRB} - v}{(1-h)\cdot 1000}$$

$$(9)\ v = K_{IRB} \cdot \frac{(EWALGD - K_{IRB}) + .25\cdot(1 - EWALGD)}{N}$$

$$(10)\ d = 1 - (1-h)\cdot(1 - \beta[K_{IRB};a,b]).$$

(11) In these expressions, β[Y; a, b] refers to the cumulative beta distribution with parameters a and b evaluated at Y. In the case where N = 1 and EWALGD = 100 percent, S[Y] in formula (1) must be calculated with K[Y] set equal to the product of K_{IRB} and Y, and d set equal to 1 − K_{IRB}.

(e) *SFA parameters*—(1) *Amount of the underlying exposures (UE).* UE is the EAD of any underlying exposures that are wholesale and retail exposures (including the amount of any funded spread accounts, cash collateral accounts, and other similar funded credit enhancements) plus the amount of any underlying exposures that are securitization exposures (as defined in paragraph (e) of section 42 of this appendix) plus the adjusted carrying value of any underlying exposures that are equity exposures (as defined in paragraph (b) of section 51 of this appendix).

(2) *Tranche percentage (TP).* TP is the ratio of the amount of the bank holding company's securitization exposure to the amount of the tranche that contains the securitization exposure.

(3) *Capital requirement on underlying exposures (K_{IRB}).* (i) K_{IRB} is the ratio of:

(A) The sum of the risk-based capital requirements for the underlying exposures plus the expected credit losses of the underlying exposures (as determined under this appendix as if the underlying exposures were directly held by the bank holding company); to

(B) UE.

(ii) The calculation of K_{IRB} must reflect the effects of any credit risk mitigant applied to the underlying exposures (either to an individual underlying exposure, to a group of underlying exposures, or to the entire pool of underlying exposures).

(iii) All assets related to the securitization are treated as underlying exposures, including assets in a reserve account (such as a cash collateral account).

(4) *Credit enhancement level (L).* (i) L is the ratio of:

(A) The amount of all securitization exposures subordinated to the tranche that contains the bank holding company's securitization exposure; to

(B) UE.

(ii) A bank holding company must determine L before considering the effects of any tranche-specific credit enhancements.

(iii) Any gain-on-sale or CEIO associated with the securitization may not be included in L.

(iv) Any reserve account funded by accumulated cash flows from the underlying exposures that is subordinated to the tranche that contains the bank holding company's securitization exposure may be included in the numerator and denominator of L to the extent cash has accumulated in the account. Unfunded reserve accounts (that is, reserve accounts that are to be funded from future cash flows from the underlying exposures) may not be included in the calculation of L.

(v) In some cases, the purchase price of receivables will reflect a discount that provides credit enhancement (for example, first loss protection) for all or certain tranches of the securitization. When this arises, L should be calculated inclusive of this discount if the discount provides credit enhancement for the securitization exposure.

(5) *Thickness of tranche (T).* T is the ratio of:

(i) The amount of the tranche that contains the bank holding company's securitization exposure; to

(ii) UE.

(6) *Effective number of exposures (N).* (i) Unless the bank holding company elects to use the formula provided in paragraph (f) of this section,

$$N = \frac{(\sum_i EAD_i)^2}{\sum_i EAD_i^2}$$

where EAD_i represents the EAD associated with the ith instrument in the pool of underlying exposures.

(ii) Multiple exposures to one obligor must be treated as a single underlying exposure.

(iii) In the case of a re-securitization (that is, a securitization in which some or all of the underlying exposures are themselves securitization exposures), the bank holding company must treat each underlying exposure as a single underlying exposure and must not look through to the originally securitized underlying exposures.

(7) *Exposure-weighted average loss given default (EWALGD).* EWALGD is calculated as:

$$EWALGD = \frac{\sum_i LGD_i \cdot EAD_i}{\sum_i EAD_i}$$

where LGD_i represents the average LGD associated with all exposures to the ith obligor. In the case of a re-securitization, an LGD of 100 percent must be assumed for the underlying exposures that are themselves securitization exposures.

(f) *Simplified method for computing N and EWALGD.* (1) If all underlying exposures of a securitization are retail exposures, a bank holding company may apply the SFA using the following simplifications:

(i) h = 0; and

(ii) v = 0.

(2) Under the conditions in paragraphs (f)(3) and (f)(4) of this section, a bank holding company may employ a simplified method for calculating N and EWALGD.

(3) If C_1 is no more than 0.03, a bank holding company may set EWALGD = 0.50 if none of the underlying exposures is a securitization exposure or EWALGD = 1 if one or more of the underlying exposures is a securitization exposure, and may set N equal to the following amount:

$$N = \frac{1}{C_1 C_m + \left(\frac{C_m - C_1}{m-1} \right) \max(1 - mC_1, 0)}$$

where:

(i) C_m is the ratio of the sum of the amounts of the 'm' largest underlying exposures to UE; and

(ii) The level of m is to be selected by the bank holding company.

(4) Alternatively, if only C_1 is available and C_1 is no more than 0.03, the bank holding company may set EWALGD = 0.50 if none of the underlying exposures is a securitization exposure or EWALGD = 1 if one or more of the underlying exposures is a securitization exposure and may set N = $1/C_1$.

Section 46. Recognition of Credit Risk Mitigants for Securitization Exposures

(a) *General.* An originating bank holding company that has obtained a credit risk mitigant to hedge its securitization exposure to a synthetic or traditional securitization that satisfies the operational criteria in section 41 of this appendix may recognize the credit risk mitigant, but only as provided in this section. An investing bank holding company that has obtained a credit risk mitigant to hedge a securitization exposure may recognize the credit risk mitigant, but only as provided in this section. A bank holding company that has used the RBA in section 43 of this appendix or the IAA in section 44 of this appendix to calculate its risk-based capital requirement for a securitization exposure whose external or inferred rating (or equivalent internal rating under the IAA) reflects the benefits of a credit risk mitigant provided to the associated securitization or that supports some or all of the underlying exposures may not use the credit risk mitigation rules in this section to further reduce its risk-based capital requirement for the exposure to reflect that credit risk mitigant.

(b) *Collateral*—(1) *Rules of recognition.* A bank holding company may recognize financial collateral in determining the bank holding company's risk-based capital requirement for a securitization exposure (other than a repo-style transaction, an eligible margin loan, or an OTC derivative contract for which the bank holding company has reflected collateral in its determination of exposure amount under section 32 of this appendix) as follows. The bank holding company's risk-based capital requirement for the collateralized securitization exposure is equal to the risk-based capital requirement for the securitization exposure as calculated under the RBA in section 43 of this appendix or under the SFA in section 45 of this appendix multiplied by the ratio of adjusted exposure amount (SE*) to original exposure amount (SE), where:

(i) SE* = max {0, [SE—C×(1 − Hs − Hfx)]};

(ii) SE = the amount of the securitization exposure calculated under paragraph (e) of section 42 of this appendix;

(iii) C = the current market value of the collateral;

(iv) Hs = the haircut appropriate to the collateral type; and

(v) Hfx = the haircut appropriate for any currency mismatch between the collateral and the exposure.

(2) *Mixed collateral.* Where the collateral is a basket of different asset types or a basket of assets denominated in different currencies, the haircut on the basket will be

$$\mathrm{H} = \sum_{\mathrm{i}} \mathrm{a_i H_i},$$

where a_i is the current market value of the asset in the basket divided by the current market value of all assets in the basket and H_i is the haircut applicable to that asset.

(3) *Standard supervisory haircuts.* Unless a bank holding company qualifies for use of and uses own-estimates haircuts in paragraph (b)(4) of this section:

(i) A bank holding company must use the collateral type haircuts (Hs) in Table 3;

(ii) A bank holding company must use a currency mismatch haircut (Hfx) of 8 percent if the exposure and the collateral are denominated in different currencies;

(iii) A bank holding company must multiply the supervisory haircuts obtained in paragraphs (b)(3)(i) and (ii) by the square root of 6.5 (which equals 2.549510); and

(iv) A bank holding company must adjust the supervisory haircuts upward on the basis of a holding period longer than 65 business days where and as appropriate to take into account the illiquidity of the collateral.

(4) *Own estimates for haircuts.* With the prior written approval of the Federal Reserve, a bank holding company may calculate haircuts using its own internal estimates of market price volatility and foreign exchange volatility, subject to paragraph (b)(2)(iii) of section 32 of this appendix. The minimum holding period (TM) for securitization exposures is 65 business days.

(c) *Guarantees and credit derivatives*—(1) *Limitations on recognition.* A bank holding company may only recognize an eligible guarantee or eligible credit derivative provided by an eligible securitization guarantor in determining the bank holding company's risk-based capital requirement for a securitization exposure.

(2) *ECL for securitization exposures.* When a bank holding company recognizes an eligible guarantee or eligible credit derivative provided by an eligible securitization guarantor in determining the bank holding company's risk-based capital requirement for a securitization exposure, the bank holding company must also:

(i) Calculate ECL for the protected portion of the exposure using the same risk parameters that it uses for calculating the risk-weighted asset amount of the exposure as described in paragraph (c)(3) of this section; and

(ii) Add the exposure's ECL to the bank holding company's total ECL.

(3) *Rules of recognition.* A bank holding company may recognize an eligible guarantee or eligible credit derivative provided by an eligible securitization guarantor in determining the bank holding company's risk-based capital requirement for the securitization exposure as follows:

(i) *Full coverage.* If the protection amount of the eligible guarantee or eligible credit derivative equals or exceeds the amount of the securitization exposure, the bank holding company may set the risk-weighted asset amount for the securitization exposure equal to the risk-weighted asset amount for a direct exposure to the eligible securitization guarantor (as determined in the wholesale risk weight function described in section 31 of this appendix), using the bank holding company's PD for the guarantor, the bank holding company's LGD for the guarantee or credit derivative, and an EAD equal to the amount of the securitization exposure (as determined in paragraph (e) of section 42 of this appendix).

(ii) *Partial coverage.* If the protection amount of the eligible guarantee or eligible credit derivative is less than the amount of the securitization exposure, the bank holding company may set the risk-weighted asset amount for the securitization exposure equal to the sum of:

(A) *Covered portion.* The risk-weighted asset amount for a direct exposure to the eligible securitization guarantor (as determined in the wholesale risk weight function described in section 31 of this appendix), using the bank holding company's PD for the guarantor, the bank holding company's LGD for the guarantee or credit derivative, and an EAD equal to the protection amount of the credit risk mitigant; and

(B) *Uncovered portion.* (*1*) 1.0 minus the ratio of the protection amount of the eligible guarantee or eligible credit derivative to the amount of the securitization exposure); multiplied by

(*2*) The risk-weighted asset amount for the securitization exposure without the credit risk mitigant (as determined in sections 42–45 of this appendix).

(4) *Mismatches.* The bank holding company must make applicable adjustments to the protection amount as required in paragraphs (d), (e), and (f) of section 33 of this appendix for any hedged securitization exposure and any more senior securitization exposure that benefits from the hedge. In the context of a synthetic securitization, when an eligible guarantee or eligible credit derivative covers multiple hedged exposures that have different residual maturities, the bank holding company must use the longest residual maturity of any of the hedged exposures as the residual maturity of all the hedged exposures.

Section 47. Risk-Based Capital Requirement for Early Amortization Provisions

(a) *General.* (1) An originating bank holding company must hold risk-based capital against the sum of the originating bank holding company's interest and the investors' interest in a securitization that:

(i) Includes one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit; and

(ii) Contains an early amortization provision.

(2) For securitizations described in paragraph (a)(1) of this section, an originating bank holding company must calculate the risk-based capital requirement for the originating bank holding company's interest under sections 42–45 of this appendix, and the risk-based capital requirement for the investors' interest under paragraph (b) of this section.

(b) *Risk-weighted asset amount for investors' interest.* The originating bank holding company's risk-weighted asset amount for the investors' interest in the securitization is equal to the product of the following 5 quantities:

(1) The investors' interest EAD;

(2) The appropriate conversion factor in paragraph (c) of this section;

(3) K_{IRB} (as defined in paragraph (e)(3) of section 45 of this appendix);

(4) 12.5; and

(5) The proportion of the underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit.

(c) *Conversion factor.* (1) (i) Except as provided in paragraph (c)(2) of this section, to calculate the appropriate conversion factor, a bank holding company must use Table 8 for a securitization that contains a controlled early amortization provision and must use Table 9 for a securitization that contains a non-controlled early amortization provision. In circumstances where a securitization contains a mix of retail and nonretail exposures or a mix of committed and uncommitted exposures, a bank holding company may take a pro rata approach to determining the conversion factor for the securitization's early amortization provision. If a pro rata approach is not feasible, a bank holding company must treat the mixed securitization as a securitization of nonretail exposures if a single underlying exposure is a nonretail exposure and must treat the mixed securitization as a securitization of committed exposures if a single underlying exposure is a committed exposure.

(ii) To find the appropriate conversion factor in the tables, a bank holding company must divide the three-month average annualized excess spread of the securitization by the excess spread trapping point in the securitization structure. In securitizations that do not require excess spread to be trapped, or that specify trapping points based primarily on performance measures other than the three-month average annualized excess spread, the excess spread trapping point is 4.5 percent.

TABLE 8—CONTROLLED EARLY AMORTIZATION PROVISIONS

	Uncommitted	Committed
Retail Credit Lines	Three-month average annualized excess spread Conversion Factor (CF). 133.33% of trapping point or more, 0% CF. less than 133.33% to 100% of trapping point, 1% CF. less than 100% to 75% of trapping point, 2% CF. less than 75% to 50% of trapping point, 10% CF. less than 50% to 25% of trapping point, 20% CF. less than 25% of trapping point, 40% CF.	90% CF
Non-retail Credit Lines	90% CF	90% CF

TABLE 9—NON-CONTROLLED EARLY AMORTIZATION PROVISIONS

	Uncommitted	Committed
Retail Credit Lines	Three-month average annualized excess spread Conversion Factor (CF). 133.33% of trapping point or more, 0% CF. less than 133.33% to 100% of trapping point, 5% CF. less than 100% to 75% of trapping point, 15% CF. less than 75% to 50% of trapping point, 50% CF. less than 50% of trapping point, 100% CF.	100% CF
Non-retail Credit Lines	100% CF	100% CF

(2) For a securitization for which all or substantially all of the underlying exposures are residential mortgage exposures, a bank holding company may calculate the appropriate conversion factor using paragraph (c)(1) of this section or may use a conversion factor of 10 percent. If the bank holding company chooses to use a conversion factor of 10 percent, it must use that conversion factor for all securitizations for which all or substantially all of the underlying exposures are residential mortgage exposures.

PART VI. RISK-WEIGHTED ASSETS FOR EQUITY EXPOSURES

Section 51. Introduction and Exposure Measurement

(a) *General.* To calculate its risk-weighted asset amounts for equity exposures that are not equity exposures to investment funds, a bank holding company may apply either the Simple Risk Weight Approach (SRWA) in section 52 of this appendix or, if it qualifies to do so, the Internal Models Approach (IMA) in section 53 of this appendix. A bank holding company must use the look-through approaches in section 54 of this appendix to calculate its risk-weighted asset amounts for equity exposures to investment funds.

(b) *Adjusted carrying value.* For purposes of this part, the adjusted carrying value of an equity exposure is:

(1) For the on-balance sheet component of an equity exposure, the bank holding company's carrying value of the exposure reduced by any unrealized gains on the exposure that are reflected in such carrying value but excluded from the bank holding company's tier 1 and tier 2 capital; and

(2) For the off-balance sheet component of an equity exposure, the effective notional principal amount of the exposure, the size of which is equivalent to a hypothetical on-balance sheet position in the underlying equity instrument that would evidence the same change in fair value (measured in dollars) for a given small change in the price of the underlying equity instrument, minus the adjusted carrying value of the on-balance sheet

component of the exposure as calculated in paragraph (b)(1) of this section. For unfunded equity commitments that are unconditional, the effective notional principal amount is the notional amount of the commitment. For unfunded equity commitments that are conditional, the effective notional principal amount is the bank holding company's best estimate of the amount that would be funded under economic downturn conditions.

Section 52. Simple Risk Weight Approach (SRWA)

(a) *General.* Under the SRWA, a bank holding company's aggregate risk-weighted asset amount for its equity exposures is equal to the sum of the risk-weighted asset amounts for each of the bank holding company's individual equity exposures (other than equity exposures to an investment fund) as determined in this section and the risk-weighted asset amounts for each of the bank holding company's individual equity exposures to an investment fund as determined in section 54 of this appendix.

(b) *SRWA computation for individual equity exposures.* A bank holding company must determine the risk-weighted asset amount for an individual equity exposure (other than an equity exposure to an investment fund) by multiplying the adjusted carrying value of the equity exposure or the effective portion and ineffective portion of a hedge pair (as defined in paragraph (c) of this section) by the lowest applicable risk weight in this paragraph (b).

(1) *0 percent risk weight equity exposures.* An equity exposure to an entity whose credit exposures are exempt from the 0.03 percent PD floor in paragraph (d)(2) of section 31 of this appendix is assigned a 0 percent risk weight.

(2) *20 percent risk weight equity exposures.* An equity exposure to a Federal Home Loan Bank or Farmer Mac is assigned a 20 percent risk weight.

(3) *100 percent risk weight equity exposures.* The following equity exposures are assigned a 100 percent risk weight:

(i) *Community development equity exposures.* An equity exposure that qualifies as a community development investment under 12 U.S.C. 24 (Eleventh), excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

(ii) *Effective portion of hedge pairs.* The effective portion of a hedge pair.

(iii) *Non-significant equity exposures.* Equity exposures, excluding exposures to an investment firm that would meet the definition of a traditional securitization were it not for the Federal Reserve's application of paragraph (8) of that definition and has greater than immaterial leverage, to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of the bank holding company's tier 1 capital plus tier 2 capital.

(A) To compute the aggregate adjusted carrying value of a bank holding company's equity exposures for purposes of this paragraph (b)(3)(iii), the bank holding company may exclude equity exposures described in paragraphs (b)(1), (b)(2), (b)(3)(i), and (b)(3)(ii) of this section, the equity exposure in a hedge pair with the smaller adjusted carrying value, and a proportion of each equity exposure to an investment fund equal to the proportion of the assets of the investment fund that are not equity exposures or that meet the criterion of paragraph (b)(3)(i) of this section. If a bank holding company does not know the actual holdings of the investment fund, the bank holding company may calculate the proportion of the assets of the fund that are not equity exposures based on the terms of the prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. If the sum of the investment limits for all exposure classes within the fund exceeds 100 percent, the bank holding company must assume for purposes of this paragraph (b)(3)(iii) that the investment fund invests to the maximum extent possible in equity exposures.

(B) When determining which of a bank holding company's equity exposures qualify for a 100 percent risk weight under this paragraph, a bank holding company first must include equity exposures to unconsolidated small business investment companies or held through consolidated small business investment companies described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682), then must include publicly traded equity exposures (including those held indirectly through investment funds), and then must include non-publicly traded equity exposures (including those held indirectly through investment funds).

(4) *300 percent risk weight equity exposures.* A publicly traded equity exposure (other than an equity exposure described in paragraph (b)(6) of this section and including the ineffective portion of a hedge pair) is assigned a 300 percent risk weight.

(5) *400 percent risk weight equity exposures.* An equity exposure (other than an equity exposure described in paragraph (b)(6) of this section) that is not publicly traded is assigned a 400 percent risk weight.

(6) *600 percent risk weight equity exposures.* An equity exposure to an investment firm that:

(i) Would meet the definition of a traditional securitization were it not for the Federal Reserve's application of paragraph (8) of that definition; and

(ii) Has greater than immaterial leverage is assigned a 600 percent risk weight.

(c) *Hedge transactions*—(1) *Hedge pair.* A hedge pair is two equity exposures that form an effective hedge so long as each equity exposure is publicly traded or has a return that is primarily based on a publicly traded equity exposure.

(2) *Effective hedge.* Two equity exposures form an effective hedge if the exposures either have the same remaining maturity or each has a remaining maturity of at least three months; the hedge relationship is formally documented in a prospective manner (that is, before the bank holding company acquires at least one of the equity exposures); the documentation specifies the measure of effectiveness (E) the bank holding company will use for the hedge relationship throughout the life of the transaction; and the hedge relationship has an E greater than or equal to 0.8. A bank holding company must measure E at least quarterly and must use one of three alternative measures of E:

(i) Under the dollar-offset method of measuring effectiveness, the bank holding company must determine the ratio of value change (RVC). The RVC is the ratio of the cumulative sum of the periodic changes in value of one equity exposure to the cumulative sum of the periodic changes in the value of the other equity exposure. If RVC is positive, the hedge is not effective and E equals 0. If RVC is negative and greater than or equal to −1 (that is, between zero and −1), then E equals the absolute value of RVC. If RVC is negative and less than −1, then E equals 2 plus RVC.

(ii) Under the variability-reduction method of measuring effectiveness:

$$E = 1 - \frac{\sum_{t=1}^{T}\left(X_t - X_{t-1}\right)^2}{\sum_{t=1}^{T}\left(A_t - A_{t-1}\right)^2}, \text{ where}$$

(A) $X_t = A_t - B_t$;

(B) A_t = the value at time t of one exposure in a hedge pair; and

(C) B_t = the value at time t of the other exposure in a hedge pair.

(iii) Under the regression method of measuring effectiveness, E equals the coefficient of determination of a regression in which the change in value of one exposure in a hedge pair is the dependent variable and the change in value of the other exposure in a hedge pair is the independent variable. However, if the estimated regression coefficient is positive, then the value of E is zero.

(3) The effective portion of a hedge pair is E multiplied by the greater of the adjusted carrying values of the equity exposures forming a hedge pair.

(4) The ineffective portion of a hedge pair is (1–E) multiplied by the greater of the adjusted carrying values of the equity exposures forming a hedge pair.

Section 53. Internal Models Approach (IMA)

(a) *General.* A bank holding company may calculate its risk-weighted asset amount for equity exposures using the IMA by modeling publicly traded and non-publicly traded equity exposures (in accordance with paragraph (c) of this section) or by modeling only publicly traded equity exposures (in accordance with paragraph (d) of this section).

(b) *Qualifying criteria.* To qualify to use the IMA to calculate risk-based capital requirements for equity exposures, a bank holding company must receive prior written approval from the Federal Reserve. To receive such approval, the bank holding company must demonstrate to the Federal Reserve's satisfaction that the bank holding company meets the following criteria:

(1) The bank holding company must have one or more models that:

(i) Assess the potential decline in value of its modeled equity exposures;

(ii) Are commensurate with the size, complexity, and composition of the bank holding company's modeled equity exposures; and

(iii) Adequately capture both general market risk and idiosyncratic risk.

(2) The bank holding company's model must produce an estimate of potential losses for its modeled equity exposures that is no less than the estimate of potential losses produced by a VaR methodology employing a 99.0 percent, one-tailed confidence interval of the distribution of quarterly returns for a benchmark portfolio of equity exposures comparable to the bank holding company's modeled equity exposures using a long-term sample period.

(3) The number of risk factors and exposures in the sample and the data period used for quantification in the bank holding company's model and benchmarking exercise must be sufficient to provide confidence in

the accuracy and robustness of the bank holding company's estimates.

(4) The bank holding company's model and benchmarking process must incorporate data that are relevant in representing the risk profile of the bank holding company's modeled equity exposures, and must include data from at least one equity market cycle containing adverse market movements relevant to the risk profile of the bank holding company's modeled equity exposures. In addition, the bank holding company's benchmarking exercise must be based on daily market prices for the benchmark portfolio. If the bank holding company's model uses a scenario methodology, the bank holding company must demonstrate that the model produces a conservative estimate of potential losses on the bank holding company's modeled equity exposures over a relevant long-term market cycle. If the bank holding company employs risk factor models, the bank holding company must demonstrate through empirical analysis the appropriateness of the risk factors used.

(5) The bank holding company must be able to demonstrate, using theoretical arguments and empirical evidence, that any proxies used in the modeling process are comparable to the bank holding company's modeled equity exposures and that the bank holding company has made appropriate adjustments for differences. The bank holding company must derive any proxies for its modeled equity exposures and benchmark portfolio using historical market data that are relevant to the bank holding company's modeled equity exposures and benchmark portfolio (or, where not, must use appropriately adjusted data), and such proxies must be robust estimates of the risk of the bank holding company's modeled equity exposures.

(c) *Risk-weighted assets calculation for a bank holding company modeling publicly traded and non-publicly traded equity exposures.* If a bank holding company models publicly traded and non-publicly traded equity exposures, the bank holding company's aggregate risk-weighted asset amount for its equity exposures is equal to the sum of:

(1) The risk-weighted asset amount of each equity exposure that qualifies for a 0 percent, 20 percent, or 100 percent risk weight under paragraphs (b)(1) through (b)(3)(i) of section 52 (as determined under section 52 of this appendix) and each equity exposure to an investment fund (as determined under section 54 of this appendix); and

(2) The greater of:

(i) The estimate of potential losses on the bank holding company's equity exposures (other than equity exposures referenced in paragraph (c)(1) of this section) generated by the bank holding company's internal equity exposure model multiplied by 12.5; or

(ii) The sum of:

(A) 200 percent multiplied by the aggregate adjusted carrying value of the bank holding company's publicly traded equity exposures that do not belong to a hedge pair, do not qualify for a 0 percent, 20 percent, or 100 percent risk weight under paragraphs (b)(1) through (b)(3)(i) of section 52 of this appendix, and are not equity exposures to an investment fund;

(B) 200 percent multiplied by the aggregate ineffective portion of all hedge pairs; and

(C) 300 percent multiplied by the aggregate adjusted carrying value of the bank holding company's equity exposures that are not publicly traded, do not qualify for a 0 percent, 20 percent, or 100 percent risk weight under paragraphs (b)(1) through (b)(3)(i) of section 52 of this appendix, and are not equity exposures to an investment fund.

(d) *Risk-weighted assets calculation for a bank holding company using the IMA only for publicly traded equity exposures.* If a bank holding company models only publicly traded equity exposures, the bank holding company's aggregate risk-weighted asset amount for its equity exposures is equal to the sum of:

(1) The risk-weighted asset amount of each equity exposure that qualifies for a 0 percent, 20 percent, or 100 percent risk weight under paragraphs (b)(1) through (b)(3)(i) of section 52 (as determined under section 52 of this appendix), each equity exposure that qualifies for a 400 percent risk weight under paragraph (b)(5) of section 52 or a 600 percent risk weight under paragraph (b)(6) of section 52 (as determined under section 52 of this appendix), and each equity exposure to an investment fund (as determined under section 54 of this appendix); and

(2) The greater of:

(i) The estimate of potential losses on the bank holding company's equity exposures (other than equity exposures referenced in paragraph (d)(1) of this section) generated by the bank holding company's internal equity exposure model multiplied by 12.5; or

(ii) The sum of:

(A) 200 percent multiplied by the aggregate adjusted carrying value of the bank holding company's publicly traded equity exposures that do not belong to a hedge pair, do not qualify for a 0 percent, 20 percent, or 100 percent risk weight under paragraphs (b)(1) through (b)(3)(i) of section 52 of this appendix, and are not equity exposures to an investment fund; and

(B) 200 percent multiplied by the aggregate ineffective portion of all hedge pairs.

Section 54. Equity Exposures to Investment Funds

(a) *Available approaches.* (1) Unless the exposure meets the requirements for a community development equity exposure in paragraph (b)(3)(i) of section 52 of this appendix, a bank holding company must determine the risk-weighted asset amount of an equity exposure to an investment fund under the Full Look-Through Approach in paragraph (b) of this section, the Simple Modified Look-Through Approach in paragraph (c) of this section, the Alternative Modified Look-Through Approach in paragraph (d) of this section, or, if the investment fund qualifies for the Money Market Fund Approach, the Money Market Fund Approach in paragraph (e) of this section.

(2) The risk-weighted asset amount of an equity exposure to an investment fund that meets the requirements for a community development equity exposure in paragraph (b)(3)(i) of section 52 of this appendix is its adjusted carrying value.

(3) If an equity exposure to an investment fund is part of a hedge pair and the bank holding company does not use the Full Look-Through Approach, the bank holding company may use the ineffective portion of the hedge pair as determined under paragraph (c) of section 52 of this appendix as the adjusted carrying value for the equity exposure to the investment fund. The risk-weighted asset amount of the effective portion of the hedge pair is equal to its adjusted carrying value.

(b) *Full Look-Through Approach.* A bank holding company that is able to calculate a risk-weighted asset amount for its proportional ownership share of each exposure held by the investment fund (as calculated under this appendix as if the proportional ownership share of each exposure were held directly by the bank holding company) may either:

(1) Set the risk-weighted asset amount of the bank holding company's exposure to the fund equal to the product of:

(i) The aggregate risk-weighted asset amounts of the exposures held by the fund as if they were held directly by the bank holding company; and

(ii) The bank holding company's proportional ownership share of the fund; or

(2) Include the bank holding company's proportional ownership share of each exposure held by the fund in the bank holding company's IMA.

(c) *Simple Modified Look-Through Approach.* Under this approach, the risk-weighted asset amount for a bank holding company's equity exposure to an investment fund equals the adjusted carrying value of the equity exposure multiplied by the highest risk weight in Table 10 that applies to any exposure the fund is permitted to hold under its prospectus, partnership agreement, or similar contract that defines the fund's permissible investments (excluding derivative contracts that are used for hedging rather than speculative purposes and that do not constitute a material portion of the fund's exposures).

TABLE 10—MODIFIED LOOK-THROUGH APPROACHES FOR EQUITY EXPOSURES TO INVESTMENT FUNDS

Risk weight	Exposure class
0 percent	Sovereign exposures with a long-term applicable external rating in the highest investment-grade rating category and sovereign exposures of the United States.
20 percent	Non-sovereign exposures with a long-term applicable external rating in the highest or second-highest investment-grade rating category; exposures with a short-term applicable external rating in the highest investment-grade rating category; and exposures to, or guaranteed by, depository institutions, foreign banks (as defined in 12 CFR 211.2), or securities firms subject to consolidated supervision and regulation comparable to that imposed on U.S. securities broker-dealers that are repo-style transactions or bankers' acceptances.
50 percent	Exposures with a long-term applicable external rating in the third-highest investment-grade rating category or a short-term applicable external rating in the second-highest investment-grade rating category.
100 percent	Exposures with a long-term or short-term applicable external rating in the lowest investment-grade rating category.
200 percent	Exposures with a long-term applicable external rating one rating category below investment grade.
300 percent	Publicly traded equity exposures.
400 percent	Non-publicly traded equity exposures; exposures with a long-term applicable external rating two rating categories or more below investment grade; and exposures without an external rating (excluding publicly traded equity exposures).
1,250 percent	OTC derivative contracts and exposures that must be deducted from regulatory capital or receive a risk weight greater than 400 percent under this appendix.

(d) *Alternative Modified Look-Through Approach.* Under this approach, a bank holding company may assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to different risk weight categories in Table 10 based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. The risk-weighted asset amount for the bank holding company's equity exposure to the investment fund equals the sum of each portion of the adjusted carrying value assigned to an exposure class multiplied by the applicable risk weight. If the sum of the investment limits for exposure classes within the fund exceeds 100 percent, the bank holding company must assume that the fund invests to the maximum extent permitted under its investment limits in the exposure class with the highest risk weight under Table 10, and continues to make investments in order of the exposure class with the next highest risk weight under Table 10 until the maximum total investment level is reached. If more than one exposure class applies to an exposure, the bank holding company must use the highest applicable risk weight. A bank holding company may exclude derivative contracts held by the fund that are used for hedging rather than for speculative purposes and do not constitute a material portion of the fund's exposures.

(e) *Money Market Fund Approach.* The risk-weighted asset amount for a bank holding company's equity exposure to an investment fund that is a money market fund subject to 17 CFR 270.2a–7 and that has an applicable external rating in the highest investment-grade rating category equals the adjusted carrying value of the equity exposure multiplied by 7 percent.

Section 55. Equity Derivative Contracts

Under the IMA, in addition to holding risk-based capital against an equity derivative contract under this part, a bank holding company must hold risk-based capital against the counterparty credit risk in the equity derivative contract by also treating the equity derivative contract as a wholesale exposure and computing a supplemental risk-weighted asset amount for the contract under part IV. Under the SRWA, a bank holding company may choose not to hold risk-based capital against the counterparty credit risk of equity derivative contracts, as long as it does so for all such contracts. Where the equity derivative contracts are subject to a qualified master netting agreement, a bank holding company using the SRWA must either include all or exclude all of the contracts from any measure used to determine counterparty credit risk exposure.

PART VII. RISK-WEIGHTED ASSETS FOR OPERATIONAL RISK

Section 61. Qualification Requirements for Incorporation of Operational Risk Mitigants

(a) *Qualification to use operational risk mitigants.* A bank holding company may adjust its estimate of operational risk exposure to reflect qualifying operational risk mitigants if:

(1) The bank holding company's operational risk quantification system is able to generate an estimate of the bank holding company's operational risk exposure (which does not incorporate qualifying operational risk mitigants) and an estimate of the bank holding company's operational risk exposure adjusted to incorporate qualifying operational risk mitigants; and

(2) The bank holding company's methodology for incorporating the effects of insurance, if the bank holding company uses insurance as an operational risk mitigant, captures through appropriate discounts to the amount of risk mitigation:

(i) The residual term of the policy, where less than one year;

(ii) The cancellation terms of the policy, where less than one year;

(iii) The policy's timeliness of payment;

(iv) The uncertainty of payment by the provider of the policy; and

(v) Mismatches in coverage between the policy and the hedged operational loss event.

(b) *Qualifying operational risk mitigants.* Qualifying operational risk mitigants are:

(1) Insurance that:

(i) Is provided by an unaffiliated company that has a claims payment ability that is rated in one of the three highest rating categories by a NRSRO;

(ii) Has an initial term of at least one year and a residual term of more than 90 days;

(iii) Has a minimum notice period for cancellation by the provider of 90 days;

(iv) Has no exclusions or limitations based upon regulatory action or for the receiver or liquidator of a failed depository institution; and

(v) Is explicitly mapped to a potential operational loss event; and

(2) Operational risk mitigants other than insurance for which the Federal Reserve has given prior written approval. In evaluating an operational risk mitigant other than insurance, the Federal Reserve will consider whether the operational risk mitigant covers potential operational losses in a manner equivalent to holding regulatory capital.

Section 62. Mechanics of Risk-Weighted Asset Calculation

(a) If a bank holding company does not qualify to use or does not have qualifying operational risk mitigants, the bank holding company's dollar risk-based capital requirement for operational risk is its operational risk exposure minus eligible operational risk offsets (if any).

(b) If a bank holding company qualifies to use operational risk mitigants and has qualifying operational risk mitigants, the bank holding company's dollar risk-based capital requirement for operational risk is the greater of:

(1) The bank holding company's operational risk exposure adjusted for qualifying operational risk mitigants minus eligible operational risk offsets (if any); or

(2) 0.8 multiplied by the difference between:

(i) The bank holding company's operational risk exposure; and

(ii) Eligible operational risk offsets (if any).

(c) The bank holding company's risk-weighted asset amount for operational risk equals the bank holding company's dollar risk-based capital requirement for operational risk determined under paragraph (a) or (b) of this section multiplied by 12.5.

PART VIII. DISCLOSURE

Section 71. Disclosure Requirements

(a) Each bank holding company must publicly disclose each quarter its total and tier 1 risk-based capital ratios and their components (that is, tier 1 capital, tier 2 capital, total qualifying capital, and total risk-weighted assets).[4]

(b)(1) Each consolidated bank holding company that is not a subsidiary of a non-U.S. banking organization that is subject to comparable public disclosure requirements in its home jurisdiction and has successfully completed its parallel run must provide timely public disclosures each calendar quarter of the information in tables 11.1–11.11 below. If a significant change occurs, such that the most recent reported amounts are no longer reflective of the bank holding company's capital adequacy and risk profile, then a brief discussion of this change and its likely impact must be provided as soon as practicable thereafter. Qualitative disclosures that typically do not change each quarter (for example, a general summary of the bank holding company's risk management objectives and policies, reporting system, and definitions) may be disclosed annually, provided any significant changes to these are disclosed in the interim. Management is encouraged to provide all of the disclosures required by this appendix in one place on the bank holding company's public Web site.[5] The bank holding company must make these disclosures publicly available for each of the last three years (that is, twelve quarters) or such shorter period since it began its first floor period.

(2) Each bank holding company is required to have a formal disclosure policy approved by the board of directors that addresses its approach for determining the disclosures it makes. The policy must address the associated internal controls and disclosure controls and procedures. The board of directors and senior management are responsible for establishing and maintaining an effective internal control structure over financial reporting, including the disclosures required by this appendix, and must ensure that appropriate review of the disclosures takes place. One or more senior officers of the bank holding company must attest that the disclosures meet the requirements of this appendix.

(3) If a bank holding company believes that disclosure of specific commercial or financial information would prejudice seriously its position by making public information that is either proprietary or confidential in nature, the bank holding company need not disclose those specific items, but must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed.

TABLE 11.1—SCOPE OF APPLICATION

Qualitative Disclosures	(a) The name of the top corporate entity in the group to which the appendix applies.
	(b) An outline of differences in the basis of consolidation for accounting and regulatory purposes, with a brief description of the entities[6] within the group that are fully consolidated; that are deconsolidated and deducted; for which the regulatory capital requirement is deducted; and that are neither consolidated nor deducted (for example, where the investment is risk-weighted).
	(c) Any restrictions, or other major impediments, on transfer of funds or regulatory capital within the group.
Quantitative Disclosures	(d) The aggregate amount of surplus capital of insurance subsidiaries (whether deducted or subjected to an alternative method) included in the regulatory capital of the consolidated group.

[4] Other public disclosure requirements continue to apply—for example, Federal securities law and regulatory reporting requirements.

[5] Alternatively, a bank holding company may provide the disclosures in more than one place, as some of them may be included in public financial reports (for example, in Management's Discussion and Analysis included in SEC filings) or other regulatory reports. The bank holding company must provide a summary table on its public Web site that specifically indicates where all the disclosures may be found (for example, regulatory report schedules, page numbers in annual reports).

TABLE 11.1—SCOPE OF APPLICATION—Continued

	(e) The aggregate amount by which actual regulatory capital is less than the minimum regulatory capital requirement in all subsidiaries with regulatory capital requirements and the name(s) of the subsidiaries with such deficiencies.

[6] Entities include securities, insurance and other financial subsidiaries, commercial subsidiaries (where permitted), and significant minority equity investments in insurance, financial and commercial entities.

TABLE 11.2—CAPITAL STRUCTURE

Qualitative Disclosures	(a) Summary information on the terms and conditions of the main features of all capital instruments, especially in the case of innovative, complex or hybrid capital instruments.
Quantitative Disclosures	(b) The amount of tier 1 capital, with separate disclosure of: • Common stock/surplus; • Retained earnings; • Minority interests in the equity of subsidiaries; • Restricted core capital elements as defined in 12 CFR part 225, appendix A; • Regulatory calculation differences deducted from tier 1 capital; [7] and • Other amounts deducted from tier 1 capital, including goodwill and certain intangibles. (c) The total amount of tier 2 capital. (d) Other deductions from capital. [8] (e) Total eligible capital.

[7] Representing 50 percent of the amount, if any, by which total expected credit losses as calculated within the IRB approach exceed eligible credit reserves, which must be deducted from tier 1 capital.
[8] Including 50 percent of the amount, if any, by which total expected credit losses as calculated within the IRB approach exceed eligible credit reserves, which must be deducted from tier 2 capital.

TABLE 11.3—CAPITAL ADEQUACY

Qualitative Disclosures	(a) A summary discussion of the bank holding company's approach to assessing the adequacy of its capital to support current and future activities.

Quantitative Disclosures	(b) Risk-weighted assets for credit risk from:
	• Wholesale exposures;
	• Residential mortgage exposures;
	• Qualifying revolving exposures;
	• Other retail exposures;
	• Securitization exposures;
	• Equity exposures
	  • Equity exposures subject to the simple risk weight approach; and
	  • Equity exposures subject to the internal models approach.
	(c) Risk-weighted assets for market risk as calculated under [the market risk rule]: [9]
	• Standardized approach for specific risk; and
	• Internal models approach for specific risk.
	(d) Risk-weighted assets for operational risk.
	(e) Total and tier 1 risk-based capital ratios: [10]
	• For the top consolidated group; and
	• For each DI subsidiary.

[9] Risk-weighted assets determined under [the market risk rule] are to be disclosed only for the approaches used.
[10] Total risk-weighted assets should also be disclosed.

GENERAL QUALITATIVE DISCLOSURE REQUIREMENT

For each separate risk area described in tables 11.4 through 11.11, the bank holding company must describe its risk management objectives and policies, including:

• Strategies and processes;

• The structure and organization of the relevant risk management function;

• The scope and nature of risk reporting and/or measurement systems;

• Policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.

TABLE 11.4[11]—CREDIT RISK: GENERAL DISCLOSURES

Qualitative Disclosures	(a) The general qualitative disclosure requirement with respect to credit risk (excluding counterparty credit risk disclosed in accordance with Table 11.6), including: • Definitions of past due and impaired (for accounting purposes); • Description of approaches followed for allowances, including statistical methods used where applicable; and • Discussion of the bank holding company's credit risk management policy.
Quantitative Disclosures	(b) Total credit risk exposures and average credit risk exposures, after accounting offsets in accordance with GAAP,[12] and without taking into account the effects of credit risk mitigation techniques (for example, collateral and netting), over the period broken down by major types of credit exposure.[13] (c) Geographic[14] distribution of exposures, broken down in significant areas by major types of credit exposure. (d) Industry or counterparty type distribution of exposures, broken down by major types of credit exposure. (e) Remaining contractual maturity breakdown (for example, one year or less) of the whole portfolio, broken down by major types of credit exposure. (f) By major industry or counterparty type: • Amount of impaired loans; • Amount of past due loans;[15] • Allowances; and • Charge-offs during the period. (g) Amount of impaired loans and, if available, the amount of past due loans broken down by significant geographic areas including, if practical, the amounts of allowances related to each geographical area.[16] (h) Reconciliation of changes in the allowance for loan and lease losses.[17]

[11] Table 4 does not include equity exposures.
[12] For example, FASB Interpretations 39 and 41.
[13] For example, bank holding companies could apply a breakdown similar to that used for accounting purposes. Such a breakdown might, for instance, be (a) loans, off-balance sheet commitments, and other non-derivative off-balance sheet exposures, (b) debt securities, and (c) OTC derivatives.
[14] Geographical areas may comprise individual countries, groups of countries, or regions within countries. A bank holding company might choose to define the geographical areas based on the way the company's portfolio is geographically managed. The criteria used to allocate the loans to geographical areas must be specified.
[15] A bank holding company is encouraged also to provide an analysis of the aging of past-due loans.
[16] The portion of general allowance that is not allocated to a geographical area should be disclosed separately.
[17] The reconciliation should include the following: A description of the allowance; the opening balance of the allowance; charge-offs taken against the allowance during the period; amounts provided (or reversed) for estimated probable loan losses during the period; any other adjustments (for example, exchange rate differences, business combinations, acquisitions and disposals of subsidiaries), including transfers between allowances; and the closing balance of the allowance. Charge-offs and recoveries that have been recorded directly to the income statement should be disclosed separately.

TABLE 11.5—CREDIT RISK: DISCLOSURES FOR PORTFOLIOS SUBJECT TO IRB RISK-BASED CAPITAL FORMULAS

Qualitative Disclosures	(a) Explanation and review of the:
	• Structure of internal rating systems and relation between internal and external ratings;
	• Use of risk parameter estimates other than for regulatory capital purposes;
	• Process for managing and recognizing credit risk mitigation (see table 11.7); and
	• Control mechanisms for the rating system, including discussion of independence, accountability, and rating systems review.
	(b) Description of the internal ratings process, provided separately for the following:
	• Wholesale category;
	• Retail subcategories;
	  • Residential mortgage exposures;
	  • Qualifying revolving exposures; and
	  • Other retail exposures.
	For each category and subcategory the description should include:
	• The types of exposure included in the category/subcategories; and

TABLE 11.5—CREDIT RISK: DISCLOSURES FOR PORTFOLIOS SUBJECT TO IRB RISK-BASED CAPITAL FORMULAS—Continued

	• The definitions, methods and data for estimation and validation of PD, LGD, and EAD, including assumptions employed in the derivation of these variables.[18]
Quantitative Disclosures: Risk assessment	(c) For wholesale exposures, present the following information across a sufficient number of PD grades (including default) to allow for a meaningful differentiation of credit risk:[19] • Total EAD;[20] • Exposure-weighted average LGD (percentage); • Exposure-weighted average risk weight; and • Amount of undrawn commitments and exposure-weighted average EAD for wholesale exposures. For each retail subcategory, present the disclosures outlined above across a sufficient number of segments to allow for a meaningful differentiation of credit risk.
Quantitative Disclosures: Historical results	(d) Actual losses in the preceding period for each category and subcategory and how this differs from past experience. A discussion of the factors that impacted the loss experience in the preceding period—for example, has the bank holding company experienced higher than average default rates, loss rates or EADs. (e) Bank holding company's estimates compared against actual outcomes over a longer period.[21] At a minimum, this should include information on estimates of losses against actual losses in the wholesale category and each retail subcategory over a period sufficient to allow for a meaningful assessment of the performance of the internal rating processes for each category/subcategory.[22] Where appropriate, the bank holding company should further decompose this to provide analysis of PD, LGD, and EAD outcomes against estimates provided in the quantitative risk assessment disclosures above.[23]

[18] This disclosure does not require a detailed description of the model in full—it should provide the reader with a broad overview of the model approach, describing definitions of the variables and methods for estimating and validating those variables set out in the quantitative risk disclosures below. This should be done for each of the four category/subcategories. The bank holding company should disclose any significant differences in approach to estimating these variables within each category/subcategories.

[19] The PD, LGD and EAD disclosures in Table 11.5(c) should reflect the effects of collateral, qualifying master netting agreements, eligible guarantees and eligible credit derivatives as defined in part I. Disclosure of each PD grade should include the exposure-weighted average PD for each grade. Where a bank holding company aggregates PD grades for the purposes of disclosure, this should be a representative breakdown of the distribution of PD grades used for regulatory capital purposes.

[20] Outstanding loans and EAD on undrawn commitments can be presented on a combined basis for these disclosures.

[21] These disclosures are a way of further informing the reader about the reliability of the information provided in the "quantitative disclosures: risk assessment" over the long run. The disclosures are requirements from year-end 2010; in the meantime, early adoption is encouraged. The phased implementation is to allow a bank holding company sufficient time to build up a longer run of data that will make these disclosures meaningful.

[22] This regulation is not prescriptive about the period used for this assessment. Upon implementation, it might be expected that a bank holding company would provide these disclosures for as long run of data as possible—for example, if a bank holding company has 10 years of data, it might choose to disclose the average default rates for each PD grade over that 10-year period. Annual amounts need not be disclosed.

[23] A bank holding company should provide this further decomposition where it will allow users greater insight into the reliability of the estimates provided in the "quantitative disclosures: risk assessment." In particular, it should provide this information where there are material differences between its estimates of PD, LGD or EAD compared to actual outcomes over the long run. The bank holding company should also provide explanations for such differences.

TABLE 11.6—GENERAL DISCLOSURE FOR COUNTERPARTY CREDIT RISK OF OTC DERIVATIVE CONTRACTS, REPO-STYLE TRANSACTIONS, AND ELIGIBLE MARGIN LOANS

Qualitative Disclosures	(a) The general qualitative disclosure requirement with respect to OTC derivatives, eligible margin loans, and repo-style transactions, including: • Discussion of methodology used to assign economic capital and credit limits for counterparty credit exposures; • Discussion of policies for securing collateral, valuing and managing collateral, and establishing credit reserves; • Discussion of the primary types of collateral taken; • Discussion of policies with respect to wrong-way risk exposures; and

TABLE 11.6—GENERAL DISCLOSURE FOR COUNTERPARTY CREDIT RISK OF OTC DERIVATIVE CONTRACTS, REPO-STYLE TRANSACTIONS, AND ELIGIBLE MARGIN LOANS—Continued

	• Discussion of the impact of the amount of collateral the bank holding company would have to provide if the bank holding company were to receive a credit rating downgrade.
Quantitative Disclosures	(b) Gross positive fair value of contracts, netting benefits, netted current credit exposure, collateral held (including type, for example, cash, government securities), and net unsecured credit exposure.[24] Also report measures for EAD used for regulatory capital for these transactions, the notional value of credit derivative hedges purchased for counterparty credit risk protection, and, for bank holding companies not using the internal models methodology in section 32(d) of this appendix, the distribution of current credit exposure by types of credit exposure.[25]
	(c) Notional amount of purchased and sold credit derivatives, segregated between use for the bank holding company's own credit portfolio and for its intermediation activities, including the distribution of the credit derivative products used, broken down further by protection bought and sold within each product group.
	(d) The estimate of alpha if the bank holding company has received supervisory approval to estimate alpha.

[24] Net unsecured credit exposure is the credit exposure after considering the benefits from legally enforceable netting agreements and collateral arrangements, without taking into account haircuts for price volatility, liquidity, etc.

[25] This may include interest rate derivative contracts, foreign exchange derivative contracts, equity derivative contracts, credit derivatives, commodity or other derivative contracts, repo-style transactions, and eligible margin loans.

TABLE 11.7—CREDIT RISK MITIGATION [26,27,28]

Qualitative Disclosures	(a) The general qualitative disclosure requirement with respect to credit risk mitigation including: • Policies and processes for, and an indication of the extent to which the bank holding company uses, on- and off-balance sheet netting; • Policies and processes for collateral valuation and management; • A description of the main types of collateral taken by the bank holding company; • The main types of guarantors/credit derivative counterparties and their creditworthiness; and • Information about (market or credit) risk concentrations within the mitigation taken.
Quantitative Disclosures	(b) For each separately disclosed portfolio, the total exposure (after, where applicable, on-or off-balance sheet netting) that is covered by guarantees/credit derivatives.

[26] At a minimum, a bank holding company must provide the disclosures in Table 11.7 in relation to credit risk mitigation that has been recognized for the purposes of reducing capital requirements under this appendix. Where relevant, bank holding companies are encouraged to give further information about mitigants that have not been recognized for that purpose.

[27] Credit derivatives that are treated, for the purposes of this appendix, as synthetic securitization exposures should be excluded from the credit risk mitigation disclosures and included within those relating to securitization.

[28] Counterparty credit risk-related exposures disclosed pursuant to Table 11.6 should be excluded from the credit risk mitigation disclosures in Table 11.7.

TABLE 11.8—SECURITIZATION

Qualitative Disclosures	(a) The general qualitative disclosure requirement with respect to securitization (including synthetics), including a discussion of: • The bank holding company's objectives relating to securitization activity, including the extent to which these activities transfer credit risk of the underlying exposures away from the bank holding company to other entities; • The roles played by the bank holding company in the securitization process[29] and an indication of the extent of the bank holding company's involvement in each of them; and • The regulatory capital approaches (for example, RBA, IAA and SFA) that the bank holding company follows for its securitization activities.

TABLE 11.8—SECURITIZATION—Continued

	(b) Summary of the bank holding company's accounting policies for securitization activities, including: • Whether the transactions are treated as sales or financings; • Recognition of gain-on-sale; • Key assumptions for valuing retained interests, including any significant changes since the last reporting period and the impact of such changes; and • Treatment of synthetic securitizations. (c) Names of NRSROs used for securitizations and the types of securitization exposure for which each agency is used.
Quantitative Disclosures	(d) The total outstanding exposures securitized by the bank holding company in securitizations that meet the operational criteria in section 41 of this appendix (broken down into traditional/synthetic), by underlying exposure type.[30,31,32] (e) For exposures securitized by the bank holding company in securitizations that meet the operational criteria in Section 41 of this appendix: • Amount of securitized assets that are impaired/past due; and • Losses recognized by the bank holding company during the current period[33] broken down by exposure type. (f) Aggregate amount of securitization exposures broken down by underlying exposure type. (g) Aggregate amount of securitization exposures and the associated IRB capital requirements for these exposures broken down into a meaningful number of risk weight bands. Exposures that have been deducted from capital should be disclosed separately by type of underlying asset. (h) For securitizations subject to the early amortization treatment, the following items by underlying asset type for securitized facilities: • The aggregate drawn exposures attributed to the seller's and investors' interests; and • The aggregate IRB capital charges incurred by the bank holding company against the investors' shares of drawn balances and undrawn lines. (i) Summary of current year's securitization activity, including the amount of exposures securitized (by exposure type), and recognized gain or loss on sale by asset type.

[29] For example: originator, investor, servicer, provider of credit enhancement, sponsor of asset backed commercial paper facility, liquidity provider, or swap provider.

[30] Underlying exposure types may include, for example, one- to four-family residential loans, home equity lines, credit card receivables, and auto loans.

[31] Securitization transactions in which the originating bank holding company does not retain any securitization exposure should be shown separately but need only be reported for the year of inception.

[32] Where relevant, a bank holding company is encouraged to differentiate between exposures resulting from activities in which they act only as sponsors, and exposures that result from all other bank holding company securitization activities.

[33] For example, charge-offs/allowances (if the assets remain on the bank holding company's balance sheet) or write-downs of I/O strips and other residual interests.

TABLE 11.9—OPERATIONAL RISK

Qualitative Disclosures	(a) The general qualitative disclosure requirement for operational risk. (b) Description of the AMA, including a discussion of relevant internal and external factors considered in the bank holding company's measurement approach. (c) A description of the use of insurance for the purpose of mitigating operational risk.

TABLE 11.10—EQUITIES NOT SUBJECT TO MARKET RISK RULE

Qualitative Disclosures	(a) The general qualitative disclosure requirement with respect to equity risk, including: • Differentiation between holdings on which capital gains are expected and those held for other objectives, including for relationship and strategic reasons; and • Discussion of important policies covering the valuation of and accounting for equity holdings in the banking book. This includes the accounting techniques and valuation methodologies used, including key assumptions and practices affecting valuation as well as significant changes in these practices.

TABLE 11.10—EQUITIES NOT SUBJECT TO MARKET RISK RULE—Continued

Quantitative Disclosures	(b) Value disclosed in the balance sheet of investments, as well as the fair value of those investments; for quoted securities, a comparison to publicly-quoted share values where the share price is materially different from fair value. (c) The types and nature of investments, including the amount that is: • Publicly traded; and • Non-publicly traded. (d) The cumulative realized gains (losses) arising from sales and liquidations in the reporting period. (e) • Total unrealized gains (losses) [34] • Total latent revaluation gains (losses) [35] • Any amounts of the above included in tier 1 and/or tier 2 capital. (f) Capital requirements broken down by appropriate equity groupings, consistent with the bank holding company's methodology, as well as the aggregate amounts and the type of equity investments subject to any supervisory transition regarding regulatory capital requirements. [36]

[34] Unrealized gains (losses) recognized in the balance sheet but not through earnings.
[35] Unrealized gains (losses) not recognized either in the balance sheet or through earnings.
[36] This disclosure should include a breakdown of equities that are subject to the 0 percent, 20 percent, 100 percent, 300 percent, 400 percent, and 600 percent risk weights, as applicable.

TABLE 11.11—INTEREST RATE RISK FOR NON-TRADING ACTIVITIES

Qualitative Disclosures	(a) The general qualitative disclosure requirement, including the nature of interest rate risk for non-trading activities and key assumptions, including assumptions regarding loan prepayments and behavior of non-maturity deposits, and frequency of measurement of interest rate risk for non-trading activities.
Quantitative Disclosures	(b) The increase (decline) in earnings or economic value (or relevant measure used by management) for upward and downward rate shocks according to management's method for measuring interest rate risk for non-trading activities, broken down by currency (as appropriate).

PART IX—TRANSITION PROVISIONS

Section 81—Optional Transition Provisions Related to the Implementation of, Consolidation Requirements Under FAS 167

(a) *Scope, applicability, and purpose.* This section 81 provides optional transition provisions for a bank holding company that is required for financial and regulatory reporting purposes, as a result of its implementation of Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167), to consolidate certain variable interest entities (VIEs) as defined under GAAP. These transition provisions apply through the end of the fourth quarter following the date of a bank holding company's implementation of FAS 167 (implementation date).

(b) *Exclusion period.*

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

(i) Subject to the limitations in paragraph (d) of this section 81, assets held by a VIE, provided that the following conditions are met:

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

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

(C) The bank holding company must consolidate the VIE on its balance sheet beginning as of the implementation date as a result of its implementation of FAS 167, and

(D) The bank holding company excludes all assets held by VIEs described in paragraphs (b)(1)(i)(A) through (C) of this section 81; and

(ii) Subject to the limitations in paragraph (d) of this section 81, assets held by a VIE that is a consolidated ABCP program, provided that the following conditions are met:

(A) The bank holding company is the sponsor of the ABCP program,

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

(C) The bank holding company chooses to exclude all assets held by ABCP program VIEs described in paragraphs (b)(1)(ii)(A) and (B) of this section 81.

(2) *Risk-weighted assets during exclusion period.* During the exclusion period, including for the two calendar quarter-end regulatory

report dates within the exclusion period, a bank holding company adopting the optional provisions in paragraph (b) of this section must calculate risk-weighted assets for its contractual exposures to the VIEs referenced in paragraph (b)(1) of this section 81 on the implementation date and include this calculated amount in risk-weighted assets. Such contractual exposures may include direct-credit substitutes, recourse obligations, residual interests, liquidity facilities, and loans.

(3) *Inclusion of ALLL in Tier 2 capital for the first and second quarters.* During the exclusion period, including for the two calendar quarter-end regulatory report dates within the exclusion period, a bank holding company that excludes VIE assets from risk-weighted assets pursuant to paragraph (b)(1) of this section 81 may include in Tier 2 capital the full amount of the ALLL calculated as of the implementation date that is attributable to the assets it excludes pursuant to paragraph (b)(1) of this section 81 (inclusion amount). The amount of ALLL includable in Tier 2 capital in accordance with this paragraph shall not be subject to the limitations set forth in section 13(a)(2) and (b) of this Appendix.

(c) *Phase-in period.*

(1) *Exclusion amount.* For purposes of this paragraph (c), exclusion amount is defined as the amount of risk-weighted assets excluded in paragraph (b)(1) of this section as of the implementation date.

(2) *Risk-weighted assets for the third and fourth quarters.* A bank holding company that excludes assets of consolidated VIEs from risk-weighted assets pursuant to paragraph (b)(1) of this section may, for the third and fourth quarters after the implementation date (phase-in period), including for the two calendar quarter-end regulatory report dates within those quarters, exclude from risk-weighted assets 50 percent of the exclusion amount, provided that the bank holding company may not include in risk-weighted assets pursuant to this paragraph an amount less than the aggregate risk-weighted assets calculated pursuant to paragraph (b)(2) of this section 81.

(3) *Inclusion of ALLL in Tier 2 capital for the third and fourth quarters.* A bank holding company that excludes assets of consolidated VIEs from risk-weighted assets pursuant to paragraph (c)(2) of this section may, for the phase-in period, include in Tier 2 capital 50 percent of the inclusion amount it included in Tier 2 capital during the exclusion period, notwithstanding the limit on including ALLL in Tier 2 capital in section 13(a)(2) and (b) of this Appendix.

(d) *Implicit recourse limitation.* Notwithstanding any other provision in this section 81, assets held by a VIE to which the bank holding company has provided recourse through credit enhancement beyond any contractual obligation to support assets it has sold may not be excluded from risk-weighted assets.

[72 FR 69396, 69431, Dec. 7, 2007, Reg. Y, 73 FR 21690, Apr. 22, 2008; 75 FR 4649, Jan. 28, 2010; 76 FR 37628, June 28, 2011]

PART 226—TRUTH IN LENDING (REGULATION Z)

Subpart A—General

Sec.

Subpart B—Open-End Credit

Subpart C—Closed-End Credit

Subpart D—Miscellaneous

Subpart E—Special Rules for Certain Home Mortgage Transactions