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

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

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

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

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

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

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

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

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

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

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

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

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

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

[Reg. H, 63 FR 37658, July 13, 1998. Redesignated at 65 FR 14814, Mar. 20, 2000. Redesignated further at 65 FR 75841, Dec. 4, 2000. Redesignated further at 75 FR 44688, July 28, 2010; 75 FR 44692, July 28, 2010; 78 FR 62284, Oct. 11, 2013]

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

### *I. Overview*

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

[18] *See* footnote 8 in paragraph (d) of this section.

banks.[1] The principal objectives of this measure are to: (i) Make regulatory capital requirements more sensitive to differences in risk profiles among banks; (ii) factor off-balance sheet exposures into the assessment of capital adequacy; (iii) minimize disincentives to holding liquid, low-risk assets; and (iv) achieve greater consistency in the evaluation of the capital adequacy of major banks throughout the world.[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. A bank's risk-based capital ratio is calculated by dividing its qualifying capital (the numerator of the ratio) by its weighted risk assets (the denominator).[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 banks that engage in trading activities calculate their risk-based capital ratio under this appendix A, they must also refer to appendix E of this part, which incorporates capital charges for certain market risks into the risk-based capital ratio. When calculating their risk-based capital ratio under this appendix A, such banks are required to refer to appendix E of this part for supplemental rules to determine qualifying and excess capital, calculate risk-weighted assets, calculate market risk equivalent assets, and calculate risk-based capital ratios adjusted for market risk.

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

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

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

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

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

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

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

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

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

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

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

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

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

#### A. The Components of Qualifying Capital

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

(i) Common stockholders' equity;

(ii) Qualifying noncumulative perpetual preferred stock (including related surplus); and

(iii) Minority interest in the equity accounts of consolidated subsidiaries.

Tier 1 capital is generally defined as the sum of core capital elements[5] less any amounts of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted in accordance with section II.B. of this appendix A.

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

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

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

[5] [Reserved]

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

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

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

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

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

(i) Allowance for loan and lease losses (subject to limitations discussed below);

(ii) Perpetual preferred stock and related surplus (subject to conditions discussed below);

(iii) Hybrid capital instruments (as defined below), and mandatory convertible debt securities;

(iv) Term subordinated debt and intermediate-term preferred stock, including related surplus (subject to limitations discussed below);

(v) Unrealized holding gains on equity securities (subject to limitations discussed in section II.A.2.e. of this appendix).

The maximum amount of tier 2 capital that may be included in a bank's qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted in accordance with section II.B. of this appendix A).

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

a. *Allowance for loan and lease losses.* Allowances for loan and lease losses are reserves that have been established through a charge against earnings to absorb future losses on loans or lease financing receivables. Allowances for loan and lease losses exclude "allocated transfer risk reserves,"[9] 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.[10]

[6] [Reserved]

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

[8] [Reserved]

[9] 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.

[10] The amount of the allowance for loan and lease losses that may be included in Tier

*Continued*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Deductions from Capital and Other Adjustments

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

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

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

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

(ii) Investments in banking and finance subsidiaries that are not consolidated for accounting or supervisory purposes and, on a case-by-case basis, investments in other designated subsidiaries or associated companies at the discretion of the Federal Reserve—deducted from total capital components.

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

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

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

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

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

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

c. *Credit-enhancing interest-only strips receivables (I/Os).* i. Credit-enhancing I/Os are on-balance sheet assets that, in form or in substance, represent the contractual right to receive some or all of the interest due on transferred assets and expose the bank to credit risk directly or indirectly associated with transferred assets that exceeds a *pro rata* share of the bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Such I/Os, whether purchased or retained, including other similar ''spread'' assets, may be included in, that is, not deducted from, a bank's capital subject to the limitations described below in sections II.B.1.d. and e. of this appendix.

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

[13] Any assets deducted from capital in computing the numerator of the ratio are not included in weighted risk assets in computing the denominator of the ratio.

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

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

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

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

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

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

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

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

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

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

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

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

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

The Federal Reserve will not automatically deduct investments in other consolidated subsidiaries or investments in joint ventures and associated companies.[17] Nonetheless, the resources invested in these entities, like investments in unconsolidated banking and finance subsidiaries, support assets not consolidated with the rest of the bank's activities and, therefore, may not be generally available to support additional leverage or absorb losses elsewhere in the bank. Moreover, experience has shown that banks stand behind the losses of affiliated institutions, such as joint ventures and associated companies, in order to protect the reputation of the organization as a whole. In some cases, this has led to losses that have exceeded the investments in such organizations.

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

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

(1) The bank has significant influence over the financial or managerial policies or operations of the subsidiary, joint venture, or associated company;

(2) The bank is the largest investor in the affiliated company; or

(3) Other circumstances prevail that appear to closely tie the activities of the affiliated company to the bank.

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

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

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

[17] The definition of such entities is contained in the instructions to the commercial bank Call Report. Under regulatory reporting procedures, associated companies and joint ventures generally are defined as companies in which the bank owns 20 to 50 percent of the voting stock.

[18] See 12 CFR part 225, appendix A for instruments that qualify as Tier 1 and Tier 2 capital for bank holding companies.

Board does not intend to require banks to deduct non-reciprocal holdings of such capital instruments.[19]

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

i. The amount of these deferred-tax assets that the bank is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year,[20] or

ii. 10 percent of tier 1 capital.

b. The reported amount of deferred-tax assets, net of any valuation allowance for deferred-tax assets, in excess of the lesser of these two amounts is to be deducted from a bank's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os, any disallowed deferred-tax assets, and any 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 must deduct from its core capital elements the sum of the appropriate percentages (as determined below) of the adjusted carrying value of all nonfinancial equity investments held by the bank or by its direct or indirect subsidiaries. For purposes of this section II.B.5, investments held by a bank include all investments held directly or indirectly by the bank or any of its subsidiaries.

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

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

TABLE 1—DEDUCTION FOR NONFINANCIAL EQUITY INVESTMENTS

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

[19] 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.

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

[21] An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in an SBIC that is not consolidated with the bank is treated as a nonfinancial equity investment.

TABLE 1—DEDUCTION FOR NONFINANCIAL EQUITY INVESTMENTS—Continued

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

[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 bank's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank equals 20 percent of the Tier 1 capital of the bank, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the bank's Tier 1 capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the bank's Tier 1 capital.

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

iv. As noted in section I, this appendix establishes *minimum* risk-based capital ratios and banks are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a bank from nonfinancial equity investments increases with its concentration in such investments and strong capital levels above the minimum requirements are particularly important when a bank has a high degree of concentration in nonfinancial equity investments (*e.g.*, in excess of 50 percent of Tier 1 capital). The Federal Reserve intends to monitor banks and apply heightened supervision to equity investment activities as appropriate, including where the bank has a high degree of concentration in nonfinancial equity investments, to ensure that each bank maintains capital levels that are appropriate in light of its equity investment activities. The Federal Reserve also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the bank, or other information, indicate that a higher minimum capital requirement is appropriate.

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

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

[22] 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.

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

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

e. *Transition provisions.* No deduction under this section II.B.5 is required to be made with respect to the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that was made by the bank prior to March 13, 2000, or that was made by the bank after such date pursuant to a binding written commitment[24] entered into prior to March 13, 2000, provided that in either case the bank has continuously held the investment since the relevant investment date.[25] For purposes of this section II.B.5.e., a nonfinancial equity investment made prior to March 13, 2000, includes any shares or other interests received by the bank through a stock split or stock dividend on an investment made prior to March 13, 2000, provided the bank provides no consideration for the shares or interests received and the transaction does not materially increase the bank's proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired prior to March 13, 2000, is *not* considered to be an investment made prior to March 13, 2000, if the bank provides any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.5.e. must be included in determining the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital for purposes of Table 1. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.5.e. will be assigned a 100-percent risk weight and included in the bank's consolidated risk-weighted assets.

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

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

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

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

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

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

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

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

#### A. Procedures

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

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

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

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

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

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

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

B. Collateral, Guarantees, and Other Considerations

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

With regard to collateralized claims that may be assigned to the 20 percent risk-weight category, the extent to which qualifying securities are recognized as collateral is determined by their current market value. If such a claim is only partially secured, that is, the market value of the pledged securities is less than the face amount of a balance-sheet asset or an off-balance-sheet item, the portion that is covered by the market value of the qualifying collateral is assigned to the 20 percent risk category, and the portion of the claim that is not covered by collateral in the form of cash or a qualifying security is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor. For example, to the extent that a claim on a private sector obligor is collateralized by the current market value of U.S. Government securities, it would be placed in the 20 percent risk category, and the balance would be assigned to the 100 percent risk category.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

*6.* Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Mortgage servicer cash advances that meet the 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 are not direct credit substitutes; and

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

*1.* It has been externally rated by more than one NRSRO;

*2.* It has received an external rating on a long-term position that is one grade below investment grade or better or on a short-term position that is investment grade by all NRSROs providing a rating;

*3.* The ratings are publicly available; and

*4.* The ratings are based on the same criteria used to rate traded positions.

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

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

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

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

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

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

| Rating category | Examples | Risk weight (In percent) |
|---|---|---|
| Highest or second highest investment grade. | AAA,AA .... | 100 |
| Third highet 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 and the bank is able to demonstrate to the satisfaction of the Federal Reserve, prior to relying upon its use, that the bank's internal credit risk rating system is adequate. Adequate internal credit risk rating systems usually contain the following criteria:

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

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

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

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

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

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

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

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

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

ii. *Program Ratings.* A direct credit substitute or recourse obligation (other than a residual interest) is assumed or retained in connection with a structured finance program and a NRSRO has reviewed the terms of the program and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal credit enhancements and other relevant factors, and the NRSRO specifies ranges of rating categories to them, the bank may apply the rating category that corresponds to the bank's position. In order to rely on a program rating, the bank must demonstrate to the Federal Reserve's satisfaction that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The bank must also demonstrate to the Federal Reserve's satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular position. If a bank participates in a securitization sponsored by another party, the Federal Reserve may authorize the bank to use this approach based on a programmatic rating obtained by the sponsor of the program.

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

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

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

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

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

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

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

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

d. The risk-based capital ratios of the bank shall be calculated without regard to the preferential capital treatment for transfers of small business obligations with recourse specified in section III.B.5.a. of this appendix A for purposes of:

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

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

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

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

C. Risk Weights

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

1. *Category 1: zero percent.* This category includes cash (domestic and foreign) owned and held in all offices of the bank or in transit and gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis, to the extent it is offset by gold bullion liabilities.[29] 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[30] of the OECD countries and U.S. Government agencies,[31] as well as all direct local currency claims on, and the portions of local currency claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that the bank has liabilities booked in that currency. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. Government or its agencies that are actively traded in financial markets, such as GNMA securities, are considered to be unconditionally guaranteed.

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

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

[29] All other holdings of bullion are assigned to the 100 percent risk category.

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

[31] 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).

(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[32] by, U.S. depository institutions[33] and foreign banks;[34] and long-term claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions and OECD banks.[35]

b. This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. Government agencies, as well as the portions of local currency claims that are conditionally guaranteed by non-OECD central governments, to the extent that the bank has liabilities booked in that currency. In addition, this category also includes claims on, and the portions of claims that are guaranteed by, U.S. government-sponsored[36] 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.[37]

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

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

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

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

[35] 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.

[36] 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.

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

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

(1) Is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed using standard industry documentation;

(2) Is collateralized by debt or equity securities that are liquid and readily marketable;

(3) Is marked-to-market daily;

(4) Is subject to a daily margin maintenance requirement under the standard industry documentation; and

(5) Can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or avoided, under applicable law of the relevant jurisdiction.[40]

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

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

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

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

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

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

The instructions to the Call Report also discuss the treatment of loans, including multifamily housing loans, that are sold subject to a pro rata loss sharing arrangement. Such an arrangement should be treated by the selling bank as sold (and excluded from balance sheet assets) to the extent that the sales agreement provides for the purchaser of the loan to share in any loss incurred on the loan on a pro rata basis with the selling bank. In such a transaction, from the standpoint of the selling bank, the portion of the loan that is treated as sold is not subject to criteria.[43] Loans included in this category must have been made in accordance with prudent underwriting standards;[44] 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 based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in this category are privately-issued mortgage-backed securities provided that:

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

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

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

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

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

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

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

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

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

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

[43] 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.

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

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

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

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

e. Subject to the requirements below, a bank may assign an asset not included in the categories above to the risk weight category applicable under the capital guidelines for bank holding companies (*See* 12 CFR part 225, appendix A), provided that all of the following conditions apply

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

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

D. Off-Balance Sheet Items

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

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,[48] and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

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

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

[46] 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.

[47] 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.

[48] Forward forward deposits accepted are treated as interest rate contracts.

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

d. In the case of direct credit substitutes in which a risk participation[49] 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.[50] 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.[51]

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

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

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

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

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

[50] 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.

[51] 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.

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

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

*Continued*

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

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

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

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

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

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

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

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

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

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

[54] [Reserved]

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

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

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

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

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

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

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

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

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

CONVERSION FACTORS

[In percent]

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

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

e. For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest rate, 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 bank would have a claim to receive, or obligation to pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to any of the following events: default, insolvency, liquidation, or similar circumstances.

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

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

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

*3.* The law that governs the netting contract.

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

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

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.[55]

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

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

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

[55] 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.

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

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

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

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

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

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

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

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

4. *Risk Weights*. Once the credit equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral.[57] However, the maximum risk weight applicable to the credit equivalent amount of such contracts is 50 percent.

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

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

### *IV. Minimum Supervisory Ratios and Standards*

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

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

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

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

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

A. Minimum Risk-Based Ratio After Transition Period

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

Qualifying total capital is calculated by adding Tier 1 capital and Tier 2 capital (limited to 100 percent of Tier 1 capital) and then deducting from this sum certain investments in banking or finance subsidiaries that are not consolidated for accounting or supervisory purposes, reciprocal holdings of banking organization capital securities, or other items at the direction of the Federal Reserve. These deductions are discussed above in section II(B).

B. Transition Arrangements

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

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

## Attachment I—Sample Calculation of Risk-Based Capital Ratio for State Member Banks

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

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

To compute the bank's weighted risk assets:

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

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

This bank's ratio of total capital to weighted risk assets (risk-based capital ratio) would be: ($6,000/$80,500)=7.45%

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

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

#### 1. Exclusion Period

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

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

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

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

(*3*) The bank must consolidate the VIE on its balance sheet beginning as of the implementation date as a result of its implementation of FAS 167, and

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

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

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

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

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

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

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

2. Phase-In Period

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

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

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

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

[54 FR 4198, Jan. 27, 1989]

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

EFFECTIVE DATE NOTE: At 78 FR 62284, Oct. 11, 2013, appendix A to part 208 was removed and reserved, effective Jan. 1, 2015.

APPENDIX B TO PART 208—CAPITAL ADEQUACY GUIDELINES FOR STATE MEMBER BANKS: TIER 1 LEVERAGE MEASURE
LISHED AT 78 FR 62284, OCT. 11, 2013.

I. OVERVIEW

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

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

II. THE TIER 1 LEVERAGE RATIO

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

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

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