

individual savings association. In all cases, savings associations should hold capital commensurate with the level and nature of all risks, including the volume and severity of problems loans, to which they are exposed.

Dated: April 17, 1997.

The Office of Thrift Supervision.

**Nicolas P. Retsinas,**

*Director.*

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## FEDERAL RESERVE SYSTEM

### 12 CFR Part 225

[Regulation Y; Docket No. R-0948]

#### **Risk-Based Capital Standards: Construction Loans on Presold Residential Properties; Junior Liens on 1- to 4-Family Residential Properties; and Mutual Funds and Leverage Capital Standards: Tier 1 Leverage Ratio**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Board of Governors of the Federal Reserve System is proposing to amend its risk-based capital guidelines for bank holding companies by revising the treatment for junior liens on 1- to 4-family residential properties and mutual funds and the language for construction loans on presold residential properties, and to simplify the leverage capital guidelines for bank holding companies. The proposal, which was developed on an interagency basis, would implement part of section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994, which requires the Federal banking agencies to work jointly to make uniform their regulations and guidelines implementing common statutory or supervisory policies. The effect of the proposal would be that the bank holding company risk-based capital treatment for construction loans on presold residential properties, real estate loans secured by junior liens on 1- to 4-family residential properties, and investments in mutual funds would be consistent with the risk-based capital treatment of the other Federal banking and thrift regulatory agencies, and the bank holding company Tier 1 leverage standards would be simplified and revised to take into account the market risk capital rule.

**DATES:** Comments must be received on or before December 26, 1997.

**ADDRESSES:** Comments should refer to Docket No. R-0948 and may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington D.C., 20551. Comments may also be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or the guard station in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room MP-500 of the Martin Building between 9 a.m. and 5 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's Rules Regarding Availability of Information.

**FOR FURTHER INFORMATION CONTACT:** Roger Cole, Associate Director (202/452-2618); Norah Barger, Assistant Director (202/452-2402); or Barbara Bouchard, Senior Supervisory Financial Analyst (202/452-3072), Division of Banking Supervision and Regulation. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452-3544).

**SUPPLEMENTARY INFORMATION:** The Federal Reserve, along with the other bank and thrift regulatory agencies (that is, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the Agencies)), issued a joint notice of proposed rulemaking, published elsewhere in today's **Federal Register**, under Docket No. R-0947. In that joint notice, the Agencies have proposed several amendments to their risk-based capital standards that would eliminate inconsistencies among the capital rules for banks and thrifts. In particular, the Agencies have proposed amendments to the risk-based capital treatment of construction loans on presold residential properties, loans secured by junior liens on 1- to 4-family residential property, and investments in mutual funds. The agencies also have proposed a streamlining revision to their leverage capital rules. The Federal Reserve, in this notice, is proposing conforming amendments to its risk-based capital guidelines for bank holding companies, as well as a streamlining revision to its leverage capital guidelines for such organizations, that takes into account the market risk capital rule (12 CFR part 225, appendix E).

#### **Proposed Amendments to the Risk-Based Capital Guidelines**

With regard to construction loans on presold residential properties, the Board

is not proposing any substantive change to its rule, but is proposing a revision to the regulatory language to provide guidance on the characteristics of loans to builders that will be considered prudently underwritten. This change would conform the discussion of qualifying construction loans to builders to the existing language of the FDIC. For junior liens on 1-to 4-family properties, the Board is proposing to treat all first and second liens separately, even if the lending institution holds both liens and no party holds an intervening lien. Under the proposed treatment, qualifying first liens would be risk weighted at 50 percent, and non-qualifying first liens and all junior liens would be risk weighted at 100 percent. The Federal Reserve is proposing to retain its general treatment for investments in mutual funds, that is, generally assigning an institution's investment in a mutual fund to the highest risk-weight category applicable to any asset the fund is authorized to hold in accordance with its prospectus. The Federal Reserve is also proposing to allow an institution, at its option, to allocate its investment in a mutual fund among the risk-weight categories based on the maximum percentage of the mutual fund's portfolio that may consist of higher risk-weighted assets under its prospectus. These proposed revisions are consistent with the Federal Reserve's proposed amendments for state member banks that are set forth in the earlier referenced interagency notice of proposed rulemaking.

#### **Proposed Amendment to the Tier 1 Leverage Guidelines**

The Federal Reserve's capital adequacy guidelines for bank holding companies set forth the following minimum levels of Tier 1 capital to total assets (leverage ratio): a 3 percent minimum for organizations rated a composite 1 under the BOPEC<sup>1</sup> rating system for bank holding companies and a minimum of 3 percent plus 100 to 200 basis points for all other organizations. The Federal Reserve is proposing to amend its guidelines to set forth a minimum 3 percent leverage ratio for bank holding companies that are BOPEC 1-rated or have implemented the risk-based capital market risk measure set forth in the Board's capital adequacy guidelines (12 CFR part 225, appendix E). All other bank holding companies would be subject to a 4 percent minimum Tier 1 leverage ratio. Higher

<sup>1</sup> The BOPEC rating system is used by supervisors to summarize their evaluations of the strength and soundness of bank holding companies in a comprehensive and uniform manner.

capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. Institutions with supervisory, financial, or operational weaknesses would continue to be expected to operate well above minimum capital levels. Organizations experiencing or anticipating significant growth also would be expected to maintain capital ratios, including tangible capital positions, well above the minimum.

The Federal Reserve notes that this proposed amendment would lower the minimum Tier 1 leverage ratio for institutions that have implemented the market risk capital rule. While the Federal Reserve believes it is desirable for bank holding companies to maintain a minimum base of capital to total assets, it also recognizes that the leverage ratio can be an inexact measure of capital adequacy for many bank holding companies, particularly for very large organizations that have significant trading portfolios and are extensively engaged in fee-generating off-balance-sheet activity. Accordingly, in light of the revisions to the risk-based capital measure to capture market risk as well as credit risk, the Federal Reserve believes it is appropriate to lower the minimum Tier 1 leverage ratio to 3 percent for bank holding companies that have implemented the market risk rule.

The Federal Reserve requests comment on all aspects of this proposal. With regard to the proposed treatment for first and second liens, the Board notes that it continues to believe its current approach of merging first and second liens more appropriately reflects the risk of those transactions. This is because, in terms of an institution's collateral position, funds advanced on both the first and second note are effectively secured by a first lien and timely payment in accordance with the terms of both loans depends on the same borrower's financial ability to pay. Furthermore, the Board believes that merging these liens is consistent with general industry practice. Thus, the Board requests, in particular, comment on the proposed treatment for first and second liens.

**Regulatory Flexibility Act Analysis**

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board does not believe the proposed rule would have a significant impact on a substantial number of small business entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). Accordingly, a regulatory flexibility analysis is not required. In addition, because the risk-

based capital guidelines generally do not apply to bank holding companies with consolidated assets of less than \$150 million, the proposed rule would not affect such companies. The effect of the proposed rule would be to reduce regulatory burden on bank holding companies by unifying the Agencies' risk-based capital treatment for presold construction loans, junior liens, and investments in mutual funds, and simplifying the Tier 1 leverage standards.

**Paperwork Reduction Act**

The Board has determined that the proposed rule does not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

**List of Subjects in 12 CFR Part 225**

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, part 225 of chapter II of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

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

1. The authority citation for part 225 is revised to read as follows:

**Authority:** 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. In appendix A to part 225, section III.A., footnote 24 is revised to read as follows:

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

\* \* \* \* \*  
 III. \* \* \*  
 A. \* \* \* 24

<sup>24</sup> An investment in shares of a mutual fund whose portfolio consists solely 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 as set forth in the prospectus. The organization may, at its option, assign the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in any mutual fund be assigned to a risk weight less than 20 percent. 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,

\* \* \* \* \*  
 3. In appendix A to part 225, section III.C.3. is amended by removing and reserving footnote 37 and by adding a new sentence to the end of the footnote 38 to read as follows:

\* \* \* \* \*  
 III. \* \* \*  
 C. \* \* \*  
 3. \* \* \*<sup>38</sup> \* \* \*  
 \* \* \* \* \*

4. In appendix D to part 225, section II.a. is revised to read as follows:

**APPENDIX D TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: TIER 1 LEVERAGE MEASURE**

\* \* \* \* \*  
 II. \* \* \*  
 a. For a strong banking organization (rated composite 1 under the BOPEC rating system of bank holding companies or has implemented the Board's risk-based capital measure for market risk as set forth in appendices A and E of this part) the minimum ratio of Tier 1 capital to total assets is 3.0 percent. Such organizations must not be anticipating or experiencing significant growth, are expected to have well diversified risk (including no undue interest rate risk exposure), excellent asset quality, high liquidity, good earnings, and in general be considered a strong banking organization. In addition, organizations are expected to maintain capital ratios, including tangible capital positions, well above minimum levels. For all other bank holding companies, the minimum ratio is 4.0 percent. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. In all cases, bank holding companies should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.  
 \* \* \* \* \*

highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities generally will be disregarded in determining the risk category into which the organization's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual 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 the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

<sup>38</sup> \* \* \* Such loans to builders will be considered prudently underwritten only if the bank holding company has obtained sufficient documentation that the buyer of the home intends to purchase the home (i.e., has a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (i.e., has a firm written commitment for permanent financing of the home upon completion).

By order of the Board of Governors of the  
Federal Reserve System, October 21, 1997.

**William W. Wiles,**

*Secretary of the Board.*

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