Dated: August 16, 2000.

Robert deV. Frierson,

Associate Secretary of the Board.

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FEDERAL RESERVE SYSTEM

Differences in Capital and Accounting Standards Among the Federal Banking and Thrift Agencies; Report to Congressional Committees

AGENCY: Board of Governors of the Federal Reserve System (FRB).

ACTION: Notice of report to the Committee on Banking, Housing, and Urban Affairs of the United States Senate and to the Committee on Banking and Financial Services of the United States House of Representatives.

SUMMARY: This report was prepared by the FRB pursuant to section 121 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 1831n(c)). Section 121 requires each Federal banking and thrift agency to report annually to the above specified Congressional Committees regarding any differences between the accounting or capital standards used by such agency and the accounting or capital standards used by other banking and thrift agencies. The report must be published in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT: Norah Barger, Assistant Director (202/452–2402), Barbara Bouchard, Manager (202/452–3072), Charles Holm, Manager (202/452–3502), or Anna Lee Hewko, Financial Analyst (202/530–6260), Division of Banking Supervision and Regulation. For the hearing impaired *only,* Telecommunication Device for the Deaf (TDD), Janice Simms (202/872–4984), Board of Governors of the Federal Reserve System, 20th & C Streets, NW, Washington DC 20551.

SUPPLEMENTARY INFORMATION: The text of the report follows:

Report to the Congressional Committees Regarding Differences in Capital and Accounting Standards Among the Federal Banking and Thrift Agencies

Introduction and Overview

Section 121 of the Federal Deposit Insurance Corporation Improvement Act of 1991, 12 U.S.C. 1831n(c)) requires each Federal banking and thrift agency to report annually to the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate and to the Committee on Banking and Financial Services of the U.S. House of Representatives regarding any differences between the accounting or capital standards used by such agency and the accounting or capital standards used by other banking and thrift agencies. The report must be published in the **Federal Register**.

This is the tenth annual report on the differences in capital standards and accounting practices that currently exist among the three banking agencies (the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC)) and the Office of Thrift Supervision (OTS).

As stated in the previous reports to Congress, the three bank regulatory agencies have, for a number of years, employed a common regulatory framework that establishes minimum capital adequacy ratios for commercial banking organizations. In 1989, all three banking agencies and the OTS adopted risk-based capital frameworks that were based upon the international capital accord (Basel Accord) developed by the Basel Committee on Banking Regulations and Supervisory Practices (Basel Supervisors Committee) and endorsed by the central bank governors of the G–10 countries.

The risk-based capital framework establishes minimum ratios of capital to risk-weighted assets. The Basel Accord requires banking organizations to have total capital (tier 1 plus tier 2) equal to at least eight percent, and tier one capital equal to at least four percent, of risk-weighted assets. Tier 1 capital includes common stock and surplus, retained earnings, qualifying perpetual preferred stock and surplus, and minority interest in consolidated subsidiaries, less disallowed intangibles such as goodwill. Tier 2 capital includes certain supplementary capital items such as general loan loss reserves, subordinated debt, and certain other preferred stock and convertible debt capital instruments, subject to appropriate limitations and conditions. The amount of tier 2 includable in total regulatory capital is limited to 100 percent of tier 1. In addition, institutions that incorporate market risk exposure into their risk-based capital requirements may use limited amounts of ‘‘tier 3’’ capital (*i.e.,* short-term subordinated debt with certain restrictions on repayment provisions) to support their exposure to market risk. Risk-weighted assets are calculated by assigning risk weights of zero, 20, 50, and 100 percent to broad categories of assets and off-balance sheet items based upon their relative credit risk. The OTS has adopted a risk-based capital standard that in most respects is similar to the framework adopted by the banking agencies. Differences between the OTS capital rules and those of the banking agencies are noted elsewhere in this report.

The measurement of capital adequacy in the present framework is mainly directed toward assessing capital in relation to credit risk. In December 1995, the G–10 Governors endorsed an amendment to the Basel Accord that, in January 1998, required internationally-active banks to measure and hold capital to support their market risk exposure. Specifically, certain banks are required to hold capital against their exposure to general market risk associated with changes in interest rates, equity prices, exchange rates, and commodity prices, as well as for exposure to specific risk associated with equity positions and certain debt positions in the trading portfolio. The FRB, FDIC, and OCC issued in August 1996 amendments to their respective risk-based capital standards that implemented the market risk amendment to the Basel Accord. The banking agencies' amendments generally require institutions with trading assets and liabilities greater than or equal to either ten percent of assets or $1 billion to apply the market risk rules. The OTS did not amend its capital rules in this regard since savings institutions do not have such significant levels of trading activity.

The three U.S. banking agencies are represented on the Basel Supervisors Committee, which in June 1999 issued a consultative paper outlining a proposed new capital adequacy framework. The new framework, which is still under development, is designed to improve the way regulatory capital requirements reflect underlying risks. As eventual changes to the Accord are implemented in the United States, the agencies will continue to work together to ensure consistent implementation across regulated entities.

In addition to the risk-based capital requirements, the agencies also have established leverage standards setting forth minimum ratios of capital to total assets. The three banking agencies have long employed uniform leverage standards, whereas the OTS established, pursuant to FIRREA, a somewhat different standard. As discussed below, in March 1999, the agencies issued a final rule making the OTS's leverage capital requirements more consistent with those of the banking agencies.

All of the agencies view the risk-based capital standards as a minimum supervisory benchmark. In part, this is because the risk-based capital framework focuses primarily on credit risk; it does not take full or explicit account of certain other banking risks, such as exposure to operational risk. The full range of risks to which depository institutions are exposed are reviewed and evaluated carefully during on-site examinations. In view of these risks, most banking organizations are expected to, and generally do, maintain capital levels well above the minimum risk-based and leverage capital requirements.

The staffs of the agencies meet regularly to identify and address differences and inconsistencies in the application of their capital standards. The agencies are committed to continuing this process in an effort to achieve full uniformity in their capital standards. In addition, the agencies have considered the remaining differences as part of a regulatory review undertaken to comply with section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Riegle Act), which specifies that the agencies ''make uniform all regulations and guidelines implementing common statutory or supervisory policies.'' Going forward, the agencies will continue to work together closely on areas of common interest as they implement the Gramm-Leach-Bliley Act.

Efforts to Achieve Uniformity

Leverage Capital Ratio

The three banking agencies employ leverage standards based upon the common definition of tier 1 capital contained in their risk-based capital guidelines. These standards, established in the second half of 1990 and early in 1991, require the most highly-rated institutions to meet a minimum tier 1 capital leverage ratio of 3.0 percent. On March 2, 1999, the agencies issued a final rule to require all other institutions to meet a minimum tier 1 leverage ratio of 4.0 percent. This final rule, which became effective April 1, 1999, also made the OTS's leverage capital standards more consistent with those of the banking agencies. As required by FIRREA, the OTS has established a capital ratio of 3.0 or 4.0 percent, depending upon a thrift's financial condition, and a 1.5 percent tangible capital leverage requirement for thrift institutions. Certain adjustments discussed in this report apply to the core capital definition used by savings associations.

Risk-Based Capital Ratio

The agencies issued a final rule on March 2, 1999, to eliminate interagency differences in the risk-based capital treatment of presold residential properties, junior liens on 1- to 4-family residential properties, and investments in mutual funds. This rule, which became effective April 1, 1999, established the following risk-based capital treatments:

Construction Loans on Presold Residential Property

The agencies agreed to assign a qualifying loan to a builder to finance the construction of a presold 1- to 4-family residential property to the 50 percent risk category once the property is sold, whether the sale occurs before or after the construction loan has been made.

Junior Liens on 1- to 4- Family Residential Properties

In some cases, a banking organization may make two loans on a single residential property, one secured by a first lien, the other by a second lien. In such a situation, the agencies agreed to view these two transactions as a single loan secured by a first lien, provided there are no intervening liens. The total amount of these transactions is assigned to either the 50 percent or the 100 percent risk weight category, depending on whether certain other criteria are met. One criterion is that the loan must be made in accordance with prudent underwriting standards, including an appropriate ratio of the loan balance to the value of the property (the loan-to-value ratio or LTV). When considering whether a loan is consistent with prudent underwriting standards, the agencies evaluate the LTV ratio based on the combined loan amount. If the combined loan amount satisfies prudent underwriting standards and the loan is considered to be performing adequately, both the first and second lien are assigned to the 50 percent risk category. Otherwise, both liens are risk-weighted at 100 percent.

Mutual Funds

The agencies agreed generally to assign all of a bank's holding in a mutual fund to the risk category appropriate to the asset with the highest risk weight that a particular mutual fund is permitted to hold under its prospectus. The agencies also agreed, on a case-by-case basis, to permit an institution's investment to be allocated on a pro rata basis among the risk categories based on a pro rata distribution of allowable investments under the fund's prospectus.

Elimination of Previous Differences in Accounting Standards

Commercial banks file Uniform Reports of Condition and Income (Call Reports) with the three banking agencies using accounting standards for recognition and measurement purposes that are consistent with GAAP. Savings associations file Thrift Financial Reports with the OTS using accounting standards that are also consistent with GAAP. Accordingly, there are no material differences in the accounting standards used for regulatory reports filed with the three banking agencies and the OTS.

Capital Differences

Remaining differences among the risk-based capital standards of the OTS and the three banking agencies are discussed below.

Certain Collateralized Transactions

The FRB permits certain collateralized transactions to be risk-weighted at zero percent. This preferential treatment is available only for claims fully collateralized by cash on deposit in the bank or by securities issued or guaranteed by OECD central governments or U.S. government agencies. A positive margin of collateral must be maintained and the collateral must be marked to market daily. Other collateralized claims, or portions thereof, are risk-weighted at 20 percent.

The OCC rule incorporates similar conditions on collateralized claims eligible for a zero percent risk weight. The OCC's rule, however, permits portions of claims collateralized by cash or OECD government securities to receive a zero percent risk weight. Under the FDIC's and OTS's rules, portions of claims collateralized by cash or OECD government securities receive a 20 percent risk weight; a zero percent risk weight is not available for collateralized transactions.

On August 16, 1996, the four agencies published a joint proposed rulemaking that would, if implemented, make uniform the agencies' risk-based capital treatment for these types of collateralized transactions. Under the proposed rule, portions of claims collateralized by cash or OECD government securities could be assigned a zero percent risk weight, provided the transactions meet certain criteria, including daily mark to market and positive collateral margin requirements. Agency staffs are working to finalize this outstanding proposal as soon as possible.

FSLIC/FDIC-Covered Assets (Assets Subject to Guarantee Arrangements by the FSLIC or FDIC)

The three banking agencies generally place these assets in the 20 percent risk category, the same category to which claims on depository institutions and government-sponsored agencies are assigned. The OTS places these assets in the zero percent risk category.

Limitation of Subordinated Debt and Limited-Life Preferred Stock

The three banking agencies limit the amount of subordinated debt and limited-life preferred stock that may be included in tier 2 capital to 50 percent of tier 1 capital. In addition, maturing capital instruments must be discounted by 20 percent in each of the last five years prior to maturity. The OTS has no limitation on the total amount of limited-life preferred stock or maturing capital instruments that may be included within tier 2 capital. The OTS also allows savings institutions the option of: (1) Discounting maturing capital instruments issued on or after November 7, 1989, by 20 percent a year over the last 5 years of their term, or (2) including the full amount of such instruments, provided that the amount maturing in any of the next seven years does not exceed 20 percent of the thrift's total capital.

Subsidiaries

Consistent with the Basel Accord and long-standing supervisory practices, the three banking agencies generally consolidate all significant majority-owned subsidiaries of the parent organization for capital purposes. This consolidation assures that the capital requirements are related to all of the risks to which the banking organization is exposed. As with most other bank subsidiaries, banking and finance subsidiaries generally are consolidated for regulatory capital purposes. However, in cases where banking and finance subsidiaries are not consolidated, the FRB, consistent with the Basel Accord, generally deducts investments in such subsidiaries in determining the adequacy of the parent bank's capital.

The FRB's risk-based capital guidelines provide a degree of flexibility in the capital treatment of unconsolidated subsidiaries (other than banking and finance subsidiaries) and investments in joint ventures and associated companies. For example, the FRB may deduct investments in such subsidiaries from an organization's capital, apply an appropriate risk-weighted capital charge against the proportionate share of the assets of the entity, require a line-by-line consolidation of the entity, or otherwise require that the parent organization maintain a level of capital above the minimum standard that is sufficient to compensate for any risk associated with the investment.

The guidelines also permit the deduction of investments in subsidiaries that, while consolidated for accounting purposes, are not consolidated for certain specified supervisory or regulatory purposes. The FDIC accords similar treatment to securities subsidiaries of state nonmember banks established pursuant to Section 337.4 of the FDIC regulations.

Similarly, in accordance with Section 325.5(f) of the FDIC regulations, a state nonmember bank must deduct investments in, and extensions of credit to, certain mortgage banking subsidiaries in computing the parent bank's capital. The FRB does not have a similar requirement with regard to mortgage banking subsidiaries. The OCC does not have requirements dealing specifically with the capital treatment of either mortgage banking or securities subsidiaries. The OCC does, however, reserve the right to require a national bank to deduct from capital, on a case-by-case basis, investments in, and extensions of credit to, any nonbanking subsidiary.

The deduction of investments in subsidiaries from the parent's capital is designed to ensure that the capital supporting the subsidiary is not also used as the basis of further leveraging and risk-taking by the parent banking organization. In deducting investments in, and advances to, certain subsidiaries from the parent's capital, the FRB expects the parent banking organization to meet or exceed minimum regulatory capital standards without reliance on the capital invested in the particular subsidiary. In assessing the overall capital adequacy of banking organizations, the FRB also considers the organization's fully consolidated capital position.

Under the OTS capital guidelines, a distinction, mandated by FIRREA, is drawn between subsidiaries that are engaged in activities permissible for national banks and subsidiaries that are engaged in activities ''impermissible'' for national banks. Subsidiaries of thrift institutions that engage only in impermissible activities are consolidated on a line-by-line basis if ownership is between 5 and 50 percent. As a general rule, investments, including loans, in subsidiaries that engage in impermissible activities are deducted in determining the capital adequacy of the parent.

Mortgage-Backed Securities (MBS)

The three banking agencies, in general, place privately-issued MBS in a risk category appropriate to the underlying assets but in no case in the zero percent risk category. In the case of privately-issued MBS, where the direct underlying assets are mortgages, this treatment generally results in a risk weight of 50 percent or 100 percent. Privately-issued MBS that have government agency or government-sponsored agency securities as their direct underlying assets are generally assigned to the 20 percent risk category.

The OTS assigns privately-issued high quality mortgage-related securities to the 20 percent risk category. These are, generally, privately-issued MBS with AA or better investment ratings.

Both the banking and the thrift agencies automatically assign to the 100 percent risk weight category certain MBS, including interest-only strips, residuals, and similar instruments, that can absorb more than their pro rata share of loss.

Pledged Deposits and Nonwithdrawable Accounts

The capital guidelines of the OTS permit thrift institutions to include in capital certain pledged deposits and nonwithdrawable accounts that meet the criteria of the OTS. Income Capital Certificates and Mutual Capital Certificates held by the OTS may also be included in capital by thrift institutions. These instruments are not relevant to commercial banks and, therefore, are not addressed in the banking agencies' capital rules.

By order of the Board of Governors of the Federal Reserve System, August 14, 2000.

Jennifer J. Johnson,

Secretary of the Board.

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DEPARTMENT OF HEALTH AND HUMAN SERVICES

Agency for Healthcare Research and Quality

Contract Review Meeting

In accordance with section 10(a) of the Federal Advisory Committee Act as amended (5 U.S.C., Appendix 2), announcement is made of an Agency for Healthcare Research and Quality (AHRQ) Technical Review Committee (TRC) meeting. This TRC's charge is to provide review of contract proposals and recommendations to the Director, AHRQ, regarding the technical merit of proposals submitted in response to a Request for Proposals (RFPs) regarding ''Development of Standard Measures''. The RFP was published in the Commerce Business Daily on July 6, 2000.