DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 3
[Docket No. 99-01]
RIN 1557-AB14

FEDERAL RESERVE SYSTEM
12 CFR Part 208
[Regulation H; Docket No. R-0947]

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 325
RIN 3064-AB 96

DEPARTMENT OF THE TREASURY
Office of Thrift Supervision
12 CFR Part 567
[Docket No. 98-125]
RIN 1550-AB11

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

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Final rule.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are amending their respective risk-based and leverage capital standards for banks and thrifts (institutions).[1] This final rule represents a significant step in implementing section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994, which requires the agencies to work jointly to make uniform their regulations and guidelines implementing common statutory or supervisory policies. The intended effect of this final rule is to make the risk-based capital treatments 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 consistent among the agencies. It is also intended to simplify and make uniform the agencies= Tier 1 leverage capital standards.

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[1] An amended risk-based capital standard for bank holding companies is included in a separate Board notice published elsewhere in today=s Federal Register; references to Ainstitutions@ in this final rule generally do not apply to bank holding companies.

EFFECTIVE DATE: This final rule is effective April 1, 1999. The agencies will not object if an institution wishes to apply the provisions of this final rule beginning with the date it is published in the Federal Register.

FOR FURTHER INFORMATION CONTACT:

OCC: Roger Tufts, Senior Economic Advisor (202/874-5070), Capital Policy Division; or Ronald Shimabukuro, Senior Attorney (202/874-5090), Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, DC 20219.

Board: Norah Barger, Assistant Director (202/452-2402), Barbara Bouchard, Manager (202/452-3072), T. Kirk Odegard, Financial Analyst (202/530-6225), Division of Banking Supervision and Regulation. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, DC 20551.

FDIC: For supervisory issues, Stephen G. Pfeifer, Examination Specialist (202/898-8904), or Carol L. Liquori, Examination Specialist (202/898-7289), Accounting Section, Division of Supervision; for legal issues, Jamey Basham, Counsel, Legal Division (202/898-7265), Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, DC 20429.

OTS: Michael D. Solomon, Senior Program Manager for Capital Policy (202/906-5654), Supervision Policy; or Vern McKinley, Senior Attorney (202/906-6241), Regulations and Legislation Division, Office of the Chief Counsel, Office of Thrift Supervision, 1700 G Street, N.W., Washington, DC 20552.

SUPPLEMENTARY INFORMATION

I. Background

Section 303(a)(1) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4803(a)) (CDRI Act) requires the agencies to review their regulations and policies and to streamline those regulations where possible. Section 303(a)(3) of the CDRI Act directs the agencies, consistent with the principles of safety and soundness, statutory law and policy, and the public interest, to work jointly to make uniform all regulations and guidelines implementing common statutory or supervisory policies. Although the agencies' risk-based and leverage capital standards are already very similar, the agencies have nevertheless reviewed these standards, internally and on an interagency basis, to fulfill the CDRI Act section 303 mandate and identify areas where they have different capital treatments or where streamlining is appropriate.

As a result of this review, the agencies identified inconsistencies in their respective risk-based capital treatments for certain types of transactions and determined that their minimum Tier 1 leverage capital standards could be streamlined and made uniform. Accordingly, on

October 27, 1997, the agencies issued a joint proposal (62 FR 55686) to amend their respective risk-based and leverage capital standards to address the following: (1) construction loans on presold residential properties; (2) junior liens on 1- to 4-family residential properties; (3) investments in mutual funds; and (4) the Tier 1 leverage ratio.

The agencies received 15 public comments on the proposal (six from industry trade groups, two each from thrifts, bank holding companies, and national banks, and one each from a savings bank, a state nonmember bank, and a concerned individual). These comments are discussed in greater detail in the material that follows.

After consideration of these comments and further deliberation of the issues involved, the agencies are adopting this final rule to make their risk-based and leverage capital standards uniform with respect to the aforementioned items. The capital treatments for construction loans on presold residential properties, investments in mutual funds, and the Tier 1 leverage ratio are adopted essentially as proposed. The capital treatment for junior liens on 1- to 4-family residential properties, however, differs from the proposed treatment.

II. Proposal, Comments Received, and Final Rule

A. Construction Loans on Presold Residential Properties

<u>Proposal</u>

Certain qualifying construction loans on presold residential properties currently are eligible for the 50 percent risk weight.[2] Under OCC and OTS rules, a qualifying construction loan on presold residential property is eligible for a 50 percent risk weight if, prior to the extension of credit to the builder, the property is sold to an individual who will occupy the residence upon completion of construction. In contrast, the Board and FDIC consider such a loan to be eligible for a 50 percent risk weight once the property is sold, regardless of whether the institution made the loan to the builder before or after the individual purchased the residence from the builder. Consistent with the capital treatment accorded such loans by the Board and FDIC, the agencies proposed that qualifying construction loans on presold residential property would be eligible for a

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[2] Qualifying construction loans on presold residential property generally are those in which the borrower has substantial equity in the project, the property has been presold under a binding contract, the purchaser has a firm commitment for a permanent qualifying mortgage loan, and the purchaser has made a substantial earnest money deposit.

50 percent risk weight at the time the property was sold, regardless of when the institution made the loan to the builder.

Comments Received

The nine commenters who addressed this issue expressed unanimous support for the proposal. Four commenters noted that presold residential loans were equally safe whether the property was sold before or after the initial extension of credit to the builder. One of these commenters added that the quality of the loan was of greater importance than the timing of the property sale. Five commenters did not provide reasons for supporting the proposal.[3]

Final Rule

The agencies concur with commenters and believe that qualifying construction loans on presold residential property have the same credit risk regardless of the timing of the property sale. Consequently, as proposed, the agencies will permit a qualifying residential construction loan to be eligible for the 50 percent risk category at the time the property is sold, regardless of when the institution made the loan to the builder. The OCC and OTS are revising their risk-based capital standards to permit this treatment. The Board is revising its regulatory language to conform its discussion of qualifying construction loans to that of the FDIC.

B. Junior Liens on 1- to 4-Family Residential Properties

Proposal

[3] One commenter noted that the OTS, through guidance in the Thrift Financial Report, interprets the earnest money deposit requirement more stringently than guidance in the Call Report. On an ongoing basis, the agencies review their reporting instructions to move toward greater consistency among the agencies.

The current agency rules are not uniform with respect to the risk based capital treatment for junior liens on 1- to 4-family residential properties. Under Board and FDIC rules, first and junior liens on 1- to 4-family residential properties are combined to determine loan-to-value (LTV) ratios.[4] The Board treats these liens as a single extension of credit and assigns the combined loan to either the 50 percent or 100 percent risk category, depending on whether or not the loan is Aqualifying@ under other criteria in the capital standards.[5] The FDIC risk-weights the first lien at 50 percent, unless the combined loan amount is not qualifying, in which case the first lien is risk-weighted at 100 percent. All junior liens are risk-weighted at 100 percent. The OCC also risk-weights all junior liens at 100 percent, qualifying first liens at 50 percent, and nonqualifying first liens at 100 percent, but does not combine liens when calculating LTV ratios. The OTS definition of qualifying loans parallels that of the OCC, but in response to specific inquiries, the OTS has interpreted this provision to treat first and second mortgage loans to a single borrower with no intervening liens as a single extension of credit secured by a first lien.

Under the proposal, when an institution holds a first lien and junior lien(s) on a 1- to 4-family residential property, and no other party holds an intervening lien, the liens would be treated separately for LTV and risk-weighting purposes. Liens would not be combined for LTV purposes. Qualifying first liens would be risk-weighted at 50 percent and nonqualifying first liens and all junior liens would be risk-weighted at 100 percent. This is the capital treatment currently accorded by the OCC. The agencies note that this rulemaking does not affect the risk-based capital treatment of junior liens where an institution does not hold the first lien, or where there are intervening liens; such junior liens remain subject to the 100 percent risk weight.

Comments Received

The agencies received ten comments on the junior lien component of the proposal. Three commenters supported the proposed capital treatment for junior liens, six commenters were opposed, and one commenter expressed neither support nor opposition.

Of the three commenters that supported the proposal, one offered support without explanation. The other two agreed with the proposal=s simplicity and ease of understanding and implementation, but disagreed about whether first and junior liens should be combined for LTV

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[4] As the LTV ratio increases, the risk profile of a loan is generally considered to increase as well. In the event of a loan default, a high LTV may indicate that the value of the underlying collateral will not be sufficient to cover the amount of the loan. In addition, borrowers who have a greater equity stake in their property are generally less willing to default on their loans. Since high-LTV loans are considered to carry greater risk, institutions are expected to hold more capital against these loans.

[5] Generally, a loan is qualifying when it meets prudent underwriting criteria, including appropriate LTV ratios, and is considered to be performing adequately. A loan that is 90 days or more past due, or is in nonaccrual status, is not considered to be performing adequately.

purposes. One supported the separate treatment for first and junior liens for the purposes of calculating LTV ratios, while the other suggested that the liens should be combined.

Of the six commenters opposing the junior lien proposal, two opposed the separate treatment of loans for LTV purposes, stating that all liens should be combined when calculating the LTV ratio for a single borrower. According to these commenters, failure to combine liens when calculating LTV ratios would increase the incentive for lenders to utilize creative lending arrangements to reduce capital charges without a corresponding reduction of risk. One further suggested that the presence of any form of junior financing should result in the entire loan receiving a 100 percent risk weight.

The other four commenters opposing the junior lien proposal indicated that the degree of risk associated with junior liens varies widely and that a 100 percent risk weight for all junior liens could be too high in some instances. Two of these commenters essentially endorsed the current approach taken by the Board, suggesting that first and junior liens held by the same lender should be treated as a single extension of credit that would be risk-weighted in its entirety at either 50 percent or 100 percent, depending on LTV ratios and loan performance. Another commenter suggested that the definition of Aqualifying mortgage loans@ should include junior liens that meet the same performance criteria as first liens, and that qualifying junior liens with a combined LTV of 80 percent or lessBregardless of who holds the first lienBshould receive a 50 percent risk weight. A fourth commenter suggested that first and junior liens by the same lender be combined and placed in the 50 percent risk category if the combined LTV ratio at loan inception is below 75 percent.

Finally, one commenter neither supported nor opposed the proposal, but indicated that it was inappropriate because a 100 percent risk weight was too high for a single-family first mortgage loan. This commenter suggested that limitations, such as a $200 thousand maximum, could be placed on certain nonqualifying first liens that would allow them to be risk-weighted at 50 percent.

Final Rule

The agencies are adopting a capital treatment for junior liens on 1- to 4-family residential properties that differs from the proposal. Although the proposed treatment is the simplest of the agencies= current approaches to apply, the agencies believe that the goal of simplicity is outweighed by other concerns. The agencies believe that, when an institution holds first and junior liens to a single borrower with no intervening liens, placing all of these junior liens in the 100 percent risk categoryBregardless of the quality of the individual loansBplaces an unfair capital burden on institutions. Where junior liens held by the first lienholder (with no intervening liens) do not pose an undue risk, the agencies agree with the commenters that the 100 percent risk weight may be excessive.

The agencies also agree with the commenters who believe that it is appropriate to combine first and junior liens when calculating the LTV ratio. The agencies are concerned that institutions could use creative lending arrangements to reduce capital charges without reducing risk. Moreover, where an institution holds first and junior liens to a single borrower with no intervening liens, it is the economic equivalent of a single extension of credit that is secured by the same collateral and should be treated accordingly. The agencies believe that it is therefore appropriate that first and junior liens be combined when calculating the LTV ratio.

Consequently, the agencies are adopting the current Board treatment for such loans. When a lending institution holds the first lien and junior liens on a 1- to 4-family residential property and no other party holds an intervening lien, the loans will be viewed as a single extension of credit secured by a first lien on the underlying property for the purpose of determining the LTV ratio, as well as for risk weighting. The institution's combined loan amount will be assigned to either the 50 percent or 100 percent risk category, depending on whether the credit satisfies the criteria for a 50 percent risk weighting.

To qualify for the 50 percent risk category, the combined loan must be made in accordance with prudent underwriting standards, including an appropriate LTV ratio.[6] In addition, none of the combined loans may be 90 days or more past due, or be in nonaccrual status. Loans that do not meet all of these criteria must be assigned in their entirety to the 100 percent risk category. The OCC, FDIC, and OTS are revising their respective risk-based capital standards to conform with this capital treatment.

C. Investments in Mutual Funds

Proposal

The current agency rules are not uniform with respect to the risk-based capital treatment for investments in mutual funds. The Board, FDIC, and OCC generally assign a risk weight to an institution's mutual fund investment according to the highest risk-weighted asset allowable under the fund's prospectus. The OCC also permits institutions, on a case-by-case basis, to allocate mutual fund investments among the various risk weight categories based on a pro rata distribution of allowable investments under the fund's prospectus. The OTS assigns a risk weight to a mutual

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[6] Prudent underwriting standards include an appropriate ratio of the loan balance to the value of the property. A loan secured by a 1- to 4-family residential property has such a ratio if the loan complies with the Interagency Guidelines for Real Estate Lending (guidelines). See 12 CFR part 34, subpart D (OCC); 12 CFR part 208, subpart C (Board); 12 CFR part 365 (FDIC); and 12 CFR 560.100-101 (OTS). A loan may comply with these guidelines despite having a ratio above the supervisory limit if, for example, the loan is supported by other credit factors, is an excluded transaction, or is a prudently underwritten exception to the lender's policies. The aggregate amount of (1) all loans in excess of the supervisory loan-to-value limits, and (2) all loans made via exceptions to the general lending policy is limited to 100 percent of total capital.

fund investment based on the highest risk-weighted asset actually held by the fund, but also allows, on a case-by-case basis, an institution's investment in a mutual fund to be allocated among risk weight categories based on a pro rata distribution of actual fund holdings. All four agencies apply a 20 percent minimum risk weight to such investments.

Mirroring the OCC's treatment for investments in mutual funds, the agencies proposed that an institution's investment in a mutual fund generally would be assigned a risk weight according to the highest risk-weighted asset allowable in the fund's prospectus. The proposal also would permit institutions the option of assigning mutual fund investments on a pro rata basis to different risk weight categories according to the limits set forth in the fund's prospectus. In no case could the risk weight of a mutual fund investment be less than 20 percent. If, for purposes of liquidity, a fund holds an insignificant amount of its assets in short-term, highly liquid securities, the institution could disregard these securities in determining the proper risk weight.

<u>Comments Received</u>

The agencies received eight comments on this component of the proposal. Six commenters supported the proposal—with two suggesting further modifications—while two commenters opposed the proposal.

Commenters supporting the proposal noted that it would provide flexibility and would encourage investment in lower-risk mutual funds. One of these commenters suggested that, to reflect the volatility of mutual fund values, the minimum risk weight on mutual fund investments should be raised from 20 percent to 50 percent. Another commenter stated that the 20 percent risk weight floor was too high, and that up to half of a mutual fund's authorized investment in U.S. Government securities should be accorded a zero percent risk weight. One commenter requested that the risk-based capital standards clarify precisely what constitutes an "insignificant quantity of highly liquid securities of superior quality," suggesting a cap of 5 percent on such investments.

The two commenters that opposed the proposal stated that instead of assigning risk weights based on the maximum investment limits permitted under the fund's prospectus, institutions should have the option of assigning risk weights based on pro rata calculations of actual fund holdings. Both commenters asserted that this approach would assign risk weights based on the actual risk of the underlying fund assets instead of their potential risk. One commenter added that the proposal would disproportionately affect smaller institutions, which are more likely to invest in mutual funds than are large institutions.

<u>Final Rule</u>

After consideration of these comments, the agencies are adopting the final rule as proposed. The final rule assigns an institution's total investment in a mutual fund to the risk category appropriate to the highest risk-weighted asset the fund may hold in accordance with its stated investment limits set forth in the prospectus. The agencies concur with commenters that permitting the option of assigning risk weights for mutual fund investments on a pro rata basis provides greater flexibility. Consequently, under the final rule, institutions also have the option of assigning the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus. Because actual fund holdings can change significantly from day-to-day, the agencies believe that it is more prudent to base risk weight distributions on investment limits than on a fund's actual underlying assets. The agencies note that this should not impose an additional burden on small institutions because all institutions will have a choice between the two risk weight calculation methods for investments in mutual funds.

Regardless of the risk-weighting method used, the total risk weight of a mutual fund must be no less than 20 percent. While the agencies are sensitive to the concern that the 20 percent minimum risk weight may be higher than the standard risk weight of some of the assets held by a mutual fund, the agencies nevertheless believe that a mutual fund has certain credit, operational, and legal risks that necessitate a risk weight greater than zero percent. The agencies are also aware that the sum of investment limits in a mutual fund prospectus may exceed 100 percent. If this is the case, then institutions may not reduce their capital requirements by assigning the highest proportion of the total fund investment to the lowest risk weight categories. Instead, institutions must assign risk weights in descending order, beginning with the highest risk-weighted assets.[7]

In addition, if a mutual fund can hold an immaterial amount of highly liquid, high quality securities that do not qualify for a preferential risk weight, then those securities may be disregarded in determining the fund's risk weight. The agencies are not designating a specific level below which an amount of such securities is immaterial, as this may vary on a case-by-base basis depending on the particular mutual fund. As a general matter, however, this amount is immaterial if it is reasonably necessary to ensure the short-term liquidity of the fund, and the securities do not materially affect the risk profile of the fund.

The prudent use of hedging instruments by a mutual fund to reduce its risk exposure will not increase the mutual fund's risk weighting. Mutual fund investments are assigned to the 100 percent risk category if they are speculative in nature or otherwise inconsistent with the preferential risk weighting assigned to the fund's assets.

The Board, FDIC, and OTS are revising their risk-based capital standards to reflect the capital treatment accorded investments in mutual funds by the OCC.

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[7] For example, assume that a fund's prospectus permits 100 percent risk-weighted assets up to 30 percent of the fund, 50 percent risk-weighted assets up to 40 percent of the fund, and 20 percent risk-weighted assets up to 60 percent of the fund. In such a case, the institution must assign 30 percent of the total investment to the 100 percent risk category, 40 percent to the 50 percent risk category, and 30 percent to the 20 percent risk category. The institution may not minimize its capital requirement by assigning 60 percent of the total investment to the 20 percent risk category and 40 percent to the 50 percent risk category.

D. Tier 1 Leverage Ratio

Proposal

The Tier 1 leverage ratioBthat is, the ratio of Tier 1 capital to total assetsBis an indicator of an institution=s capital adequacy and places a constraint on the degree to which an institution can leverage its capital base. The Board, FDIC, and OCC currently require institutions with a composite rating of A1@ under the Uniform Financial Institutions Rating System to have a minimum leverage ratio of 3.0 percent. Institutions that are not A1@-rated must have a minimum leverage ratio of 3.0 percent, plus an additional cushion of at least 100 to 200 basis points. The OTS currently requires all institutions to maintain core capital in an amount equal to 3.0 percent of adjusted total assets.[8]

In order to streamline and clarify the leverage ratio requirement, the agencies proposed to revise the leverage ratio requirement to make clear that A1@-rated institutions would be required to maintain a minimum Tier 1 leverage ratio of 3.0 percent, while all other institutions would be required to maintain a minimum leverage ratio of 4.0 percent. These thresholds are the same as required to be Aadequately capitalized@ under the agencies= prompt corrective action (PCA) guidelines.

Comments Received

The agencies received nine comments with regard to this component of the proposal, seven of which supported the more consistent leverage capital treatment among the agencies. Two commenters neither supported nor opposed the proposal. One of these commenters stated that the proposal was essentially meaningless because an institution with a leverage ratio of 3.0 percent would be unlikely to receive a composite rating of A1@, while the other commenter encouraged the agencies to continue working together to make the capital standards more simple and consistent.

Four of the commenters that supported the proposal nevertheless expressed concerns about the use of the leverage ratio as a supervisory tool. All four questioned the appropriateness of leverage requirements in light of comprehensive risk-based capital requirements, noting that banks were at a competitive disadvantage relative to securities firms, foreign banking organizations, and secondary market agencies. One of these commenters proposed that PCA guidelines be modified so that institutions that have either adopted a risk-based capital market risk measure or are A1@-rated be subject to a 3.0 percent minimum leverage ratio to be considered Aadequately capitalized,@ and a 4.0 percent minimum leverage ratio to be considered Awell

[8] The OTS core capital ratio is the equivalent of the other agencies= Tier 1 leverage ratio. This final rule will add definitions of Tier 1 and Tier 2 capital to the OTS capital rule to clarify that these are the equivalents of core and supplemental capital, respectively.

capitalized.@ Three commenters recommended that the agencies consider discontinuing entirely the use of the leverage ratio, noting that risk-based capital requirements now incorporate credit and market risks.

Final Rule

The agencies are adopting the final rule as proposed. Consequently, under this final rule the most highly-rated institutions must maintain a minimum Tier 1 leverage ratio of 3.0 percent, with all other institutions required to maintain a minimum leverage ratio of 4.0 percent. In addition, as proposed, the OTS is amending its leverage capital standard to be consistent with the other three agencies by stating that higher-than-minimum capital levels may be required if warranted, and that institutions should maintain capital levels consistent with their risk exposures.

The agencies acknowledge commenter concerns about the usefulness of the leverage ratio as a supervisory tool for those institutions that have adopted market risk capital measures. Nevertheless, the agencies note that a leverage requirement for PCA purposes is mandated under the provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991. Moreover, the agencies believe that the Tier 1 leverage ratio, when used in conjunction with risk-based capital ratios, is a useful supervisory tool in assessing an institution=s capital adequacy. While a change to the PCA leverage ratio guidelines is beyond the scope of this final rule, the agencies may consider whether the leverage requirements under PCA should be further modified in the future.

III. Regulatory Flexibility Act Analysis

OCC: Pursuant to section 605(b) of the Regulatory Flexibility Act, the OCC certifies that this final rule will not have a significant impact on a substantial number of small entities. This final rule makes no changes with respect to the capital treatment of mutual funds or with respect to the minimum leverage ratio for national banks. However, with respect to the capital treatment of construction loans the final rule eases the regulatory burden on national banks by providing a more favorable risk-based capital treatment. As to the capital treatment of junior liens on 1- to 4-family residences, the OCC believes that while certain loans may be subject to an increased capital requirement, other loans may be subject to a lower capital charge. However, the OCC does not believe that the impact of this provision will be significant. Therefore, the OCC believes that the net economic impact of these changes on national banks, regardless of size, is expected to be minimal and a regulatory flexibility analysis is not required.

Board: Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board has determined that this final rule will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). The treatment of construction loans, junior liens, and the leverage ratio does not differ from the Board's current treatment. The treatment of mutual fund risk weights differs from current treatment, but affected institutions are not required to adopt the new treatment. Accordingly, a regulatory flexibility analysis is not required, because the economic impact of the final rule on institutions, regardless of size, is expected to be minimal.

FDIC: Pursuant to section 605(b) of the Regulatory Flexibility Act, the FDIC has determined that this final rule will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). The treatment of construction loans and the leverage ratio does not differ from the FDIC's current treatment. The treatment of junior liens under the final rule is the same as current treatment to the extent affected institutions must combine the loans in evaluating the prudence of the loan-to-value ratio, and the change in treatment (lower risk weighting of the junior lien) is optional. The treatment of mutual fund risk weights differs from current treatment, but this change is also optional. Accordingly, a regulatory flexibility analysis is not required, because the economic impact of the final rule on institutions, regardless of size, is expected to be minimal.

OTS: Pursuant to section 605(b) of the Regulatory Flexibility Act, the OTS certifies that this final rule will not have a significant impact on a substantial number of small entities. The final rule relaxes regulatory burdens on all savings associations by providing a more favorable risk-based capital treatment for construction loans. The changed treatment of mutual funds should have minimal impact on small savings associations, as the new treatment is consistent with most thrifts= current actual practice. The increased monitoring and recordkeeping necessary to use OTS= current regulatory treatment was not cost-effective for small thrifts. While the rule also increases the leverage ratio requirement, this change should have little impact since it is consistent with requirements for an Aadequately capitalized@ institution under the prompt corrective action rules. The current treatment of junior liens on 1- to 4-family residences is unchanged. Accordingly, the economic impact of these changes on savings associations, regardless of size, is expected to be minimal and a regulatory flexibility analysis is not required.

IV. Paperwork Reduction Act

The agencies have determined that the final rule will not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 et seq.).

V. Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA) (Title II, Pub. L. 104-121) provides generally for agencies to report rules to Congress for review. The reporting requirement is triggered when a federal agency issues a final rule. Accordingly, the agencies filed the appropriate reports with Congress as required by SBREFA.

The Office of Management and Budget has determined that this final rule does not constitute a Amajor rule@ as defined by SBREFA.

VI. OCC and OTS Executive Order 12866 Determination

The OCC and the OTS have determined that this final rule does not constitute a Asignificant regulatory action@ for the purposes of Executive Order 12866.

VII. OCC and OTS Unfunded Mandates Reform Act of 1995 Determinations

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, this final rule is limited to making the risk weighting of presold residential construction loans, second liens, and mutual fund investments consistent under the agencies= risk-based capital rules. It also establishes a uniform, simplified leverage requirement for all institutions. In addition, with respect to the OCC, this final rule clarifies and makes uniform existing regulatory requirements for national banks. The OCC and OTS, therefore, have determined that the final rule will not result in expenditures by State, local, or tribal governments or by the private sector of $100 million or more. Accordingly, the OCC and OTS have not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

List of Subjects

12 CFR Part 3

Administrative practice and procedure, Capital, National banks, Reporting and recordkeeping requirements, Risk.

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities.

12 CFR Part 325

Bank deposit insurance, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

Federal Reserve System

12 CFR Chapter II

For the reasons set forth in the joint preamble, part 208 of chapter II of title 12 of the Code of Federal Regulations is amended as set forth below:

PART 208 -- MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for part 208 is revised to read as follows:

Authority: 12 U.S.C. 24, 36, 92a, 93a, 248(a), 248(c), 321-338a, 371d, 461, 481-486, 601, 611, 1814, 1816, 1818, 1820(d), 1823(j), 1828(o), 1831o, 1831p-1, 1831r-1, 1835a, 1882, 2901-2907, 3105, 3310, 3331-3351, and 3906-3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o-4(c)(5), 78q, 78q-1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

2. In appendix A to part 208, section III. A., footnote 21 is revised to read as follows:

APPENDIX A TO PART 208 -- CAPITAL ADEQUACY GUIDELINES FOR STATE MEMBER BANKS: RISK-BASED MEASURE

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III. * * *

A. * * * [21]

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[21] 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.

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3. In appendix A to part 208, section III.C.3., footnote 34 is revised to read as follows:

* * * * *

III. * * *

C. * * *

3. * * * [34]

* * * * *

4. In appendix A to part 208, section III.C.3. is amended by adding a new sentence to the end of the first paragraph of footnote 35 to read as follows:

* * * * *

III. * * *

C. * * *

3. * * * [35]

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[34]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.

[35] * * * 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). * * *

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4. In appendix B to part 208, section II.a. is revised to read as follows:

APPENDIX B to PART 208 -- CAPITAL ADEQUACY GUIDELINES FOR STATE MEMBER BANKS: TIER 1 LEVERAGE MEASURE

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II. * * *

a. The minimum ratio of Tier 1 capital to total assets for strong banking institutions (rated composite A1@ 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.

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By order of the Board of Governors of the Federal Reserve System, February 24, 1999.

(Signed) Jennifer J. Johnson

Jennifer J. Johnson,
Secretary of the Board