FEDERAL RESERVE SYSTEM

12 CFR II

For the reasons set forth in the joint preamble, parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations are proposed to be amended as follows:

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

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

Authority: 12 U.S.C. 24, 36, 92(a), 93(a), 248(a), 248(c), 321-338a, 371d, 461, 481-486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831, 1831o, 1831p-1, 1831 r-1, 1835(a), 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:

A. The introductory paragraph to section II. is revised.

B. A new fifth paragraph is added to section III. A.

C. In section III.B., paragraph 3 is revised and footnote 23 is removed, and in paragraph 4, footnote 24 is removed.

D. In section III. C., paragraphs 1 through 3, footnotes 25-37 are redesignated as footnotes 23-35, and paragraph 4 is revised.

E. In section III.D., the introductory paragraph and paragraph 1 are revised.

F. In sections III.D. and III.E., footnote 46 is removed and footnotes 47-51 are redesignated as footnotes 44-48.

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

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II. * * *

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 liability 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 liability to liabilities explicitly treated in the guidelines, the ability of the liability to absorb losses while the bank operates as a going concern, the maturity and redemption features of the liability, 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]

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III. * * *

A. * * *

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

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[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.

III. * * *

B. * * *

3. Recourse obligations, direct credit substitutes, 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. Use of the term "asset securitizations" or "securitizations" in this rule includes structured financings, as well as asset securitization transactions.

a. Definitions -- (i) Credit derivatives are on- or off-balance sheet notes or contracts that allow one party (the "beneficiary") to transfer the credit risk of a "reference asset," which it often owns, to another party (the "guarantor"). The value of a credit derivative is dependent, at least in part, on the credit performance of the reference asset, which typically is a publicly traded loan or corporate bond.

(ii) Credit-enhancing representations and warranties means representations and warranties extended by a bank when it transfers assets (including loan servicing assets) or assumed by the bank when it purchases loan servicing assets that obligate the bank to absorb credit losses on transferred assets or serviced loans. These representations and warranties typically arise when the bank agrees to protect purchasers or some other party from losses due to the default or nonperformance of the obligor on the transferred assets or serviced loans, or insufficiency in the value of collateral supporting the transferred assets or serviced loans.

(iii) Direct credit substitute means an arrangement in which a bank assumes, in form or in substance, any risk of credit loss directly or indirectly associated with a third-party asset or other financial claim, that exceeds the bank's pro rata share of the asset or claim. If the bank has no claim on the asset, then the assumption of <u>any</u> risk of loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

<u>(1)</u> Financial guarantee-type standby letters of credit that support financial claims on the account party;

<u>(2)</u> Guarantees, surety arrangements, credit derivatives, and irrevocable guarantee-type instruments backing financial claims such as outstanding securities, loans, or other financial liabilities, or that back off-balance sheet items against which risk-based capital must be maintained;

<u>(3)</u> Purchased subordinated interests or securities that absorb more than their <u>pro</u> <u>rata</u> share of losses from the underlying assets;

<u>(4)</u> Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

<u>(5)</u> Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than mortgage servicer cash advances as defined in paragraph <u>III</u>.B.3.a.(vi) of this appendix A), or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the serviced loans.

(iv) <u>Externally rated</u> means, with respect to an instrument or obligation, that the instrument or obligation has received a credit rating from a nationally-recognized statistical rating organization.

(v) <u>Financial guarantee-type standby letter of credit</u> means any letter of credit or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer:

<u>(1)</u> To repay money borrowed by, advanced to, or for the account of, the account party, or

(2) To make payment on account of any indebtedness undertaken by the account party in the event that the account party fails to fulfill its obligation to the beneficiary.

(vi) Mortgage servicer cash advance means funds that a residential mortgage loan servicer advances to ensure an uninterrupted flow of payments or the timely collection of residential mortgage loans, including disbursements made to cover foreclosure costs or other expenses arising from a mortgage loan to facilitate its timely collection. A mortgage servicer cash advance is not a recourse obligation or a direct credit substitute if the mortgage servicer is entitled to full reimbursement or, for any one residential mortgage loan, nonreimbursable advances are contractually limited to an insignificant amount of the outstanding principal on that loan.

(vii) Nationally recognized statistical rating organization means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers (17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H)).

(viii) Recourse means an arrangement in which a bank retains, in form or in substance, any risk of credit loss directly or indirectly associated with a transferred asset 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 loss is recourse. A recourse obligation typically arises when an institution transfers assets and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to:

(1) Credit-enhancing representations and warranties on the transferred assets that obligate the servicer to absorb credit losses, including early-default clauses;

(2) Retained loan servicing assets if the servicer is responsible for losses associated with the loans being serviced other than mortgage servicer cash advances as defined in paragraph III.B.3.a.(vi) of this appendix A.

(3) Retained subordinated interests or securities or credit derivatives 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; and

(5) Loan strips sold without direct recourse where the maturity of the transferred loan that is drawn is shorter than the maturity of the commitment.

(ix) Securitization means the pooling and repackaging of loans or other credit exposures into securities that can be sold to investors. For purposes of this appendix A, securitization also includes structured finance transactions or programs that generally create stratified credit risk positions whether in the form of a security or not whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

(x) Traded position means a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that is rated with a reasonable expectation that, in the near future:

(1) The position would be sold to investors relying on the rating; or

(2) A third party would, in reliance on the rating, enter into a transaction such as a purchase, loan, or repurchase agreement involving the position.

b. Amount of position to be included in risk-weighted assets -- (i) General rule for determining the credit equivalent amount and risk weight of recourse obligations and direct credit substitutes. Except as otherwise provided in this section III of this appendix A, the risk weighted asset amount or the credit equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed. This credit equivalent amount is assigned to the risk weight category appropriate to the obligor or, if relevant, the guarantor or nature of any collateral. Thus, a bank that extends a partial direct credit substitute, e.g., a financial standby letter of credit, that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported. Furthermore, for direct credit substitutes that are on-balance sheet assets, e.g., purchased subordinated securities, banks must maintain capital against the amount of the direct credit substitutes and the full amount of the assets being supported, i.e., all more senior positions. This treatment is subject to the low-level capital rule discussed in section III.B.3.c.(i) of this appendix A. For purposes of this appendix A, the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed means for:

(1). A financial guarantee-type standby letter of credit, surety arrangement, credit derivative, guarantee, or irrevocable guarantee-type instruments, the full amount of the assets that the direct credit substitute fully or partially supports;

(2). A subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(3). Mortgage servicing assets that are recourse obligations or direct credit substitutes, the outstanding amount of the loans serviced;

(4) Credit-enhancing representations and warranties, the amount of the assets subject to the representations or warranties;

(5) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party, the full amount of the enhanced financial obligations;

(6) Loans strips, the amount of the loans; and

(7) For assets sold with recourse, the amount of assets for which risk of loss is directly or indirectly retained, less any applicable recourse liability account established in accordance with generally accepted accounting principles. (Other types of recourse obligations or direct credit substitutes should be treated in accordance with the principles contained in section III.B.3. of this appendix A. 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 A.)

(ii) Determining the credit risk weight of recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities that are rated within one of the five highest rating categories. (1) A traded position is eligible for the risk-based capital treatment described in this paragraph if its external rating is within one of the five highest rating categories, e.g., AAA through BB, used by a nationally-recognized statistical rating organization. A recourse obligation, direct credit substitute, or asset- or mortgage-backed security which is not externally rated but is senior in all respects to a traded position that is externally rated, including access to any collateral, is also eligible for the risk-based capital treatment described in this paragraph III.B.3.b.(ii) as if it had the same rating as the traded position. This treatment for the unrated senior position is subject to current and prospective supervisory guidance on a case-by-case basis.

(A) Two highest investment grades. Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in either of the two highest investment grade categories, e.g., AAA or AA, is assigned to the 20 percent risk category.

(B) Third highest investment grade. Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the third highest investment grade category, e.g., A, is assigned to the 50 percent risk category.

(C) Lowest investment grade. Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the lowest investment grade category, e.g., BBB, is assigned to the 100 percent risk category.

(D) One category below investment grade. Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the next lower category below the lowest investment grade category, e.g., BB, is assigned a 200 percent risk weight.

(2) Nontraded recourse obligations, direct credit substitutes, or asset- or mortgage-backed securities that are retained, assumed or issued in connection with an asset securitization also are eligible for the treatment described in this paragraph III.B.3.b.(ii) if they are externally rated within one of the five highest rating categories by two nationally-recognized statistical rating organizations, the ratings are publicly available, and the ratings are based on the same criteria used to rate securities sold to the public.

(3) A direct credit substitute extended in connection with an asset securitization that is

not a traded position and is not externally rated by a nationally-recognized statistical rating organization (such as a letter of credit) may be eligible for the treatment described in paragraphs III.B.3.b.(ii)(C) and (D), i.e., a minimum risk weight of 100 percent, if it satisfies the criteria of one of the following approaches deemed appropriate for the institution by the Federal Reserve:

(A) A bank, under its qualifying internal risk rating system, assigns an internal rating to a direct credit substitute extended to an asset-backed commercial paper program that is equivalent to an external credit rating one category below investment grade or higher provided by a nationally recognized statistical rating organization. A qualifying internal risk rating system must be reviewed and deemed appropriate by the Federal Reserve and must satisfy the following criteria and any other prudential standards that the Federal Reserve determines are necessary. Qualifying internal risk rating systems at a minimum must:

(i) Be an integral part of an effective risk management system that explicitly incorporates the full range of risks arising from a bank's participation in securitization activities;

(ii) Link the internal ratings 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;

(iii) Separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of a particular securitization transaction;

(iv) Identify gradations of risk among "pass" assets and other risk positions;

(v) Have clear, explicit criteria that are used to classify assets into each internal risk grade, including subjective factors;

(vi) Have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

(vi) Have an internal audit procedure that periodically verifies that the internal credit risk ratings are assigned in accordance with the established criteria;

(viii) Monitor the performance of the internal ratings assigned to nonrated nontraded direct credit substitutes over time to determine the appropriateness of the initial rating assignment and adjust individual ratings accordingly; and,

(ix) Be consistent with, or more conservative than, the rating assumptions and methodologies of nationally recognized statistical rating organizations.

(B) A bank's direct credit substitute extended to a securitization or structured finance program is reviewed by a nationally recognized statistical rating organization, in conjunction with a review of the overall program, and is assigned a rating or its equivalent. If the program has options for different combinations of assets, standards, internal credit enhancements, and other relevant factors, the rating organization may specify ranges of rating categories that may apply premised on which options are utilized by the bank's risk position. The bank must demonstrate to the Federal Reserve that the nationally recognized statistical rating organization's programmatic rating for its risk position generally meets the same standards used by the rating organization for rating traded positions, and that the rating organization's underlying premises are satisfied for particular direct credit substitutes issued by the bank. If a bank participates in a securitization or structured finance program 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.

(C) A bank may rate its credit risk exposure to direct credit substitutes by relying on a qualifying credit assessment computer program. A nationally recognized statistical rating agency or other acceptable third party must have developed such a credit assessment system for determining the credit risk of direct credit substitutes and other stratified credit positions. Banks must demonstrate to the Federal Reserve that ratings under such a credit assessment computer program correspond credibly and reliably with the ratings assigned by the rating agencies to publicly traded securities.

(iii) Determining the credit risk weight for off-balance sheet securitized assets that are subject to early amortization provisions. If a bank securitizes revolving assets, such as credit cards, home equity lines, or commercial loans issued under lines of credit, in a securitization transaction that it has sponsored and which includes early amortization provisions, then the sponsoring bank must maintain risk-based capital against the off-balance sheet securitized assets from the inception of the transaction. An early amortization feature is a provision that, under specified conditions, returns principal to investors prior to the expected payment dates and generally is a result of a deteriorating portfolio. The securitized, off-balance sheet assets are to be converted to an on-balance sheet credit equivalent amount using the 100 percent conversion factor and assigned to the 20 percent risk category. However, this capital requirement when combined with the capital requirements for any retained recourse or direct credit substitutes associated with the securitized assets is limited to a total of eight percent of the off-balance sheet securitized assets.

c. Limitations on risk-based capital requirements. (i) Low-level exposure. If the maximum contractual liability or 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 liability or exposure to loss, less any liability account established in accordance with generally accepted accounting principles. This limitation does not apply to assets sold with implicit recourse.

(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 an on-balance sheet asset.

(iii) Related on-balance sheet assets. If a recourse obligation or direct credit substitute subject to section III.B.3. of this appendix A 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 the latter cases, both the on-balance sheet assets and the related recourse obligations and direct credit substitutes are incorporated into the risk-based capital calculation.

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III. * * *

C. * * *

4. Category 4: 100 percent. a. All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

b. This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[36] 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;[37] 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).

c. Also included in this category are industrial-development bonds and similar obligations issued under the auspices of state 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

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

[37] 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.

government entity, is obligated to pay the principal and interest, and all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

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

D. * * *

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 A. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral.[38] Attachment IV to this appendix A sets forth the conversion factors for various types of off-balance sheet items.

1. Items with a 100 percent conversion factor. a. Except as otherwise provided in section III.B.3. of this appendix A, 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 A.

b. Sale and repurchase agreements and forward agreements. Forward agreements are

[38] 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.

legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[39] 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 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[40] has been conveyed, the full amount of the assets that are supported, in whole or in part, by the credit enhancement

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

[40] 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.

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.[41] 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.[42]

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.[43]

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[41] 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.

[42] 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.

[43] 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.

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

1. The authority citation for part 225 continues 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:

A. The introductory paragraph to section II is revised.

B. A new fifth paragraph is added to section III.A.

C. In section III.B., paragraph 3 is revised and footnote 26 is removed, and in paragraph 4. footnote 27 is removed .

D. In section III.C., paragraphs 1 through 3, footnotes 28-40 are redesignated as footnotes 26-38, and paragraph 4 is revised.

E. In section III.D,. the introductory paragraph and paragraph 1 are revised.

G. In section III.D. and III.E., footnote 50 is removed and footnotes 51-57 are redesignated as 46-52.

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

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II. * * *

An institution'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 liability 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 liability to liabilities explicitly treated in the guidelines, the ability of the liability to absorb losses while the institution operates as a going concern, the maturity and redemption features of the liability, 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 organization's overall capital structure. Consequently, an organization 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 organization's capital base.[5]

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[5] 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. In the case of limited-life Tier 2 instruments, consultation would generally be obviated if the new security is of equal or greater maturity than the one it replaces.

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III. * * *

A. * * *

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

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III. * * *

B. * * *

3. Recourse obligations, direct credit substitutes, 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. Use of the

term “asset securitizations” or “securitizations” in this rule includes structured financings, as well as asset securitization transactions.

a.. Definitions -- (i) Credit derivatives are on- or off-balance sheet notes or contracts that allow one party (the “beneficiary”) to transfer the credit risk of a “reference asset,” which it often owns, to another party (the “guarantor”). The value of a credit derivative is dependent, at least in part, on the credit performance of the reference asset, which typically is a publicly traded loan or corporate bond.

(ii) Credit-enhancing representations and warranties means representations and warranties extended by a bank when it transfers assets (including loan servicing assets) or assumed by the bank when it purchases loan servicing assets that obligate the bank to absorb credit losses on transferred assets or serviced loans. These representations and warranties typically arise when the bank agrees to protect purchasers or some other party from losses due to the default or nonperformance of the obligor on the transferred assets or serviced loans, or insufficiency in the value of collateral supporting the transferred assets or serviced loans.

(iii) Direct credit substitute means an arrangement in which a banking organization assumes, in form or in substance, any risk of credit loss directly or indirectly associated with a third-party asset or other financial claim, that exceeds the banking organization's pro rata share of the asset or claim. If the banking organization has no claim on the asset, then the assumption of any risk of loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(1) Financial guarantee-type standby letters of credit that support financial claims on the account party;

(2) Guarantees, surety arrangements, credit derivatives, and irrevocable guarantee-type instruments backing financial claims such as outstanding securities, loans, or other financial

liabilities, or that back off-balance sheet items against which risk-based capital must be maintained;

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

(4) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

(5) Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than mortgage servicer cash advances as defined in paragraph III.B.3.a.(vi) of this appendix A), or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the serviced loans.

(iv) Externally rated means, with respect to an instrument or obligation, that the instrument or obligation has received a credit rating from a nationally-recognized statistical rating organization.

(v) Financial guarantee-type standby letter of credit means any letter of credit or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer:

(1) To repay money borrowed by, advanced to, or for the account of, the account party; or

(2) To make payment on account of any indebtedness undertaken by the account party in the event that the account party fails to fulfill its obligation to the beneficiary.

(vi) Mortgage servicer cash advance means funds that a residential mortgage loan servicer advances to ensure an uninterrupted flow of payments or the timely collection of residential mortgage loans, including disbursements made to cover foreclosure costs or other expenses arising from a mortgage loan to facilitate its timely collection. A mortgage servicer cash advance is not a recourse obligation or a direct credit substitute if the mortgage servicer is entitled to full reimbursement or, for any one residential mortgage loan, nonreimbursable advances are contractually limited to an insignificant amount of the outstanding principal on that loan.

(vii) Nationally recognized statistical rating organization means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers (17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H)).

(viii) Recourse means an arrangement in which a banking organization retains, in form or in substance, any risk of credit loss directly or indirectly associated with a transferred asset that exceeds a pro rata share of the banking organization's claim on the asset. If a banking organization has no claim on a transferred asset, then the retention of any risk of loss is recourse. A recourse obligation typically arises when an institution transfers assets and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a banking organization provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to:

(1) Credit-enhancing representations and warranties on the transferred assets that obligate the servicer to absorb credit losses, including early-default clauses;

(2) Retained loan servicing assets if the servicer is responsible for losses associated with the loans being serviced other than mortgage servicer cash advances as defined in paragraph III.B.3.a.(v) of this appendix A.

(3) Retained subordinated interests or securities or credit derivatives 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; and

(5) Loan strips sold without direct recourse where the maturity of the transferred loan that is drawn is shorter than the maturity of the commitment.

(ix) Securitization means the pooling and repackaging of loans or other credit exposures into securities that can be sold to investors. For purposes of this appendix A, securitization also includes structured finance transactions or programs that generally create stratified credit risk positions whether in the form of a security or not whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

(x) Traded position means a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that is rated with a reasonable expectation that, in the near future:

(1) The position would be sold to investors relying on the rating; or

(2) A third party would, in reliance on the rating, enter into a transaction such as a purchase, loan, or repurchase agreement involving the position.

b. Amount of position to be included in risk-weighted assets. i. General rule for determining the credit equivalent amount and risk weight of recourse obligations and direct credit substitutes. Except as otherwise provided in section III of this appendix A, the risk weighted asset amount or the credit equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed. This credit equivalent amount is assigned to the risk weight category appropriate to the obligor or, if relevant, the guarantor or nature of any collateral. Thus, a banking organization that extends a partial direct credit substitute, e.g., a financial standby letter of credit, that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported. Furthermore, for direct credit substitutes that are on-balance sheet assets, e.g., purchased subordinated securities, banking organizations must maintain capital against the amount of the direct credit substitutes and the full amount of the assets being supported, i.e., all more senior positions. This treatment is subject to the low-level capital rule discussed in section III.B.3.c.i. of this appendix A. For purposes of this appendix A, the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed means for:

(1) A financial guarantee-type standby letter of credit, surety arrangement, credit derivative, guarantee, or irrevocable guarantee-type instruments, the full amount of the assets that the direct credit substitute fully or partially supports;

(2) A subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(3) Mortgage servicing assets that are recourse obligations or direct credit substitutes, the outstanding amount of the loans serviced;

(4) Credit-enhancing representations and warranties, the amount of the assets subject to the representations or warranties;

(5) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party, the full amount of the enhanced financial obligations;

(6) Loans strips, the amount of the loans; and

(7) For assets sold with recourse, the amount of assets for which risk of loss is directly or indirectly retained, less any applicable recourse liability account established in accordance with generally accepted accounting principles.

Other types of recourse obligations or direct credit substitutes should be treated in accordance with the principles contained in section III.B.3 of this appendix A. 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 A.

(ii) Determining the credit risk weight of recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities that are rated within one of the five highest rating categories. (1) A traded position is eligible for the risk-based capital treatment described in this paragraph if its external rating is within one of the five highest rating categories, e.g. AAA through BB, used by a nationally-recognized statistical rating organization . A recourse obligation, direct credit substitute, or asset- or mortgage-backed security which is not externally rated but is senior in all respects to a traded position that is externally rated, including access to any collateral, is also eligible for the risk-based capital treatment described in this paragraph III.B.3.b.ii. as if it had the same rating as the traded position. This treatment for the unrated senior position is subject to current and prospective supervisory guidance on a case-by-case basis.

(A) Two highest investment grades. Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in either of two highest investment grade categories, e.g., AAA or AA, is assigned to the 20 percent risk category.

(B) Third highest investment grade. Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the third highest investment grade category, e.g., A, is assigned to the 50 percent risk category.

(C) Lowest investment grade. Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the lowest investment grade category, e.g., BBB, is assigned to the 100 percent risk category.

(D) One category below investment grade. Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the next lower category below the lowest investment grade category, e.g., BB, is assigned to the 200 percent risk category.

(2) Nontraded recourse obligations, direct credit substitutes, or asset- or mortgage-backed securities that are retained, assumed, or issued in connection with an asset securitization are also eligible for the treatment described in this paragraph III.B.3.b.ii. if they are externally rated within one of the five highest rating categories by two nationally-recognized statistical rating organizations, the ratings are publicly available, and the ratings are based on the same criteria used to rate securities sold to the public.

(3) A direct credit substitute extended in connection with an asset securitization that is not a traded position and is not externally rated by a nationally-recognized statistical rating organization (such as a letter of credit) may be eligible for the treatment described in paragraph III.B.3.b.(ii)(C) and (D), i.e., a minimum risk weight of 100 percent, if it satisfies the criteria of one of the following approaches deemed appropriate for the organization by the Federal Reserve. A banking organization, under its qualifying internal risk rating system, assigns

an internal rating to a direct credit substitute extended to an asset-backed commercial paper program that is equivalent to an external credit rating one category below investment grade or higher provided by a nationally recognized statistical rating organization. A qualifying internal risk rating system must be reviewed and deemed appropriate by the Federal Reserve and must satisfy the following criteria and any other prudential standards that the Federal Reserve determines are necessary. Qualifying internal risk rating systems at a minimum must:

(i) Be an integral part of an effective risk management system that explicitly incorporates the full range of risks arising from a banking organization's participation in securitization activities;

(ii) Link the internal ratings 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;

(iii) Separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of a particular securitization transaction;

(iv) Identify gradations of risk among "pass" assets and other risk positions;

(v) Have clear, explicit criteria that are used to classify assets into each internal risk grade, including subjective factors;

(vi) Have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

(vii) Have an internal audit procedure that periodically verifies that the internal credit risk ratings are assigned in accordance with the established criteria;

(viii) Monitor the performance of the internal ratings assigned to nonrated nontraded direct credit substitutes over time to determine the appropriateness of the initial rating assignment and adjust individual ratings accordingly; and,

(ix) Be consistent with, or more conservative than, the rating assumptions and methodologies of nationally recognized statistical rating organizations.

(B) A banking organization's direct credit substitute extended to a securitization or structured finance program is reviewed by a nationally recognized statistical rating organization, in conjunction with a review of the overall program, and is assigned a rating or its equivalent. If the program has options for different combinations of assets, standards, internal credit enhancements, and other relevant factors, the rating organization may specify ranges of rating categories that may apply premised on which options are utilized by the bank's risk position. The banking organization must demonstrate to the Federal Reserve that the nationally recognized statistical rating organization's programmatic rating for its risk position generally meets the same standards used by the rating organization for rating traded positions, and that the rating organization's underlying premises are satisfied for particular direct credit substitutes issued by the institution. If a banking organization participates in a securitization or structured finance program sponsored by another party, the Federal Reserve may authorize the institution to use this approach based on a programmatic rating obtained by the sponsor of the program. An institution may rate its credit risk exposure to direct credit substitutes by relying on a qualifying credit assessment computer program. A nationally recognized statistical rating agency or other acceptable third party must have developed such a credit assessment system for determining the credit risk of direct credit substitutes and other stratified credit positions. Institutions must demonstrate to the Federal Reserve that ratings under such a credit assessment computer program correspond credibly and reliably with the ratings assigned by the rating agencies to publicly traded securities.

(iii) Determining the credit risk weight for off-balance sheet securitized assets that are subject to early amortization provisions. If a bank securitizes revolving assets, such as credit cards, home equity lines, or commercial loans issued under lines of credit, in a securitization transaction that it has sponsored and which includes early amortization provisions, then the sponsoring bank must maintain risk-based capital against the off-balance sheet securitized assets from the inception of the transaction. An early amortization feature is a provision that, under specified conditions, returns principal to investors prior to the expected payment dates and generally is a result of a deteriorating portfolio. The securitized, off-balance sheet assets are to be converted to an on-balance sheet credit equivalent amount using the 100 percent conversion factor and assigned to the 20 percent risk category. However, this capital requirement when combined with the capital requirements for any retained recourse or direct credit substitutes associated with the securitized assets is limited to a total of eight percent of the off-balance sheet securitized assets.

c. Limitations on risk-based capital requirements -- (i) Low-level exposure. If the maximum contractual liability or exposure to loss retained or assumed by a banking organization 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 liability or exposure to loss, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply to assets sold with implicit recourse.

(ii) Mortgage-related securities or participation certificates retained in a mortgage loan swap. If a banking organization 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 banking organization continued to hold these loans as an on-balance sheet asset.

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

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III. * * *

C. * * *

4. Category 4: 100 percent. a. All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

b. This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[39] 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;[40] 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).

c. Also included in this category are industrial-development bonds and similar obligations issued under the auspices of state 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.

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

[40] 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.

D. * * *

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 A. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral.[41] Attachment IV to this appendix A sets forth the conversion factors for various types of off-balance sheet items.

1. Items with a 100 percent conversion factor. a. Except as otherwise provided in section III.B.3. of this appendix A, 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 A.

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

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

[41] The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral of 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.

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

organization lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor, or if applicable to any collateral delivered to the lending bank, or, the independent custodian acting on the lending banking organization's behalf. Where a banking organization is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the banking organization, the transaction is deemed to be collateralized by cash on deposit in the banking organization 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[43] 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.[44] 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

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

[44] 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.

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.[45]

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

f. In the case of direct credit substitutes that take the form of a syndication where each banking organization is obligated only for its pro rata share of the risk and there is no recourse to the originating banking organization, each banking organization will only include its pro rata share of the assets supported, in whole or in part, by the direct credit substitute in its risk-based capital calculation.[46]

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[45] 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.

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

[THIS SIGNATURE PAGE PERTAINS TO THE BOARD'S PORTION OF THE JOINT PROPOSED RULE ENTITLED "RISK-BASED CAPITAL STANDARDS; RECOURSE AND DIRECT CREDIT SUBSTITUTES"]

By order of the Board of Governors of the Federal Reserve System,

___________________, 2000.

Jennifer J. Johnson,
Secretary of the Board.