

# RESCINDED

## Transmittal



October 28, 1997

Number: 184

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With the attached joint notice of proposed rule-making, the Office of Thrift Supervision (OTS), in concert with the OCC, FDIC and Fed, has taken an important step toward making minimum capital requirements the same for thrifts and banks. The agencies would modify their rules to give the same capital treatment to three areas of the risk-based capital standards:

- 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.

In addition, the proposal contains uniform and simplified Tier 1 capital standards. Key provisions are:

Construction loans on presold residential property:

Adopt the current practice of the FDIC and the Fed for qualifying residential construction loans. The agencies would assign a 50 percent risk weight to these loans once the property is sold and other criteria are satisfied, even if the sale occurs after the construction loan was made. OTS and the OCC currently permit an institution to use a 50 percent risk weight only if the property is sold before the construction loan is made.

Junior liens on one- to four-family residential properties:

Adopt the OCC's current approach that places qualifying first mortgages on one- to four-family residential properties in the 50 percent risk-weight category and nonqualifying first mortgages and all junior loans on such properties in the 100-percent risk weight category. The current OTS rule parallels the OCC's rule, but in certain circumstances OTS has interpreted such loans as a single extension of credit.

Mutual funds: Require an institution to assign its total investment in a mutual fund to the highest risk weight of any asset that the fund is authorized to hold, in accordance with its prospectus. An institution, however, could opt to assign the investment on a pro-rata basis to different risk-

weight categories according to the investment limits for different categories in the fund's prospectus. Current OTS rules are similar? but are based on the actual holdings of the fund, rather than limits in the prospectus.

The agencies also propose to require all institutions, other than those with a CAMELS rating of 1, to have a Tier 1 capital ratio of at least 4 percent. Institutions with a CAMELS 1 composite rating would continue to be subject to a lower 3 percent Tier 1 leverage ratio requirement. This change would align the agencies' Tier 1 capital rules with their Prompt Corrective Action rules.

The proposal is one of a series of steps the agencies are taking to implement a provision of the Riegle Community Development and Regulatory Improvement Act of 1994 requiring the federal banking agencies to work toward uniform regulations and policies.

The joint notice of proposed rulemaking was published in the October 27, 1997, edition of the *Federal Register*, Vol. 62, No. 207, pp. 55686-55692. Written comments must be received on or before December 26, 1997, and should be addressed to: Manager, Dissemination Branch, Records Management and Information Policy Division, Office of Thrift Supervision, 1700 G Street, N.W., Washington, DC 20552. Comments may be faxed to 202/906-7755, or e-mailed to: public.info@ots.treas.gov.

For further information contact:

John F. Connolly 202/906-6465  
Karen Osterloh 202/906-6639

Nicholas P. Retsinas  
Director  
Office of Thrift Supervision

Attachment

Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

**ACTION:** Joint notice of proposed rulemaking.

**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 proposing to amend their respective risk-based capital standards and leverage capital standards for banks and thrifts. The proposal would represent a significant step in implementing section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994, with regard to the Agencies' capital adequacy standards. (Section 303 requires the Agencies to work jointly to make uniform their regulations and guidelines implementing common statutory or supervisory policies.) The effect of the proposal would be that the Agencies would have uniform 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, as well as uniform and simplified minimum Tier 1 capital leverage standards.

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

**ADDRESSES:** Comments should be directed to:

**OCC:** Comments may be submitted to Docket No. 97-19, Communications Division, Third Floor, Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, D.C. 20219. Comments will be available for inspection and photocopying at that address. In addition, comments may be sent by facsimile transmission to FAX number (202) 874-5274, or by electronic mail to

**REGS.COMMENTS@OCC.TREAS.GOV.**

**Board:** Comments directed to the Board should refer to Docket No. R-0947 and may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington D.C., 20551. Comments may also be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or the guard station in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room MP-500 of the Martin Building

**DEPARTMENT OF THE TREASURY**

**Office of the Comptroller of the Currency**

**12 CFR Part 3**

[Docket No. 97-19]

**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-AB96**

**DEPARTMENT OF THE TREASURY**

**Office of Thrift Supervision**

**12 CFR Part 567**

[Docket No. 97-36]

**RIN 1550-AA98**

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

**AGENCIES:** Office of the Comptroller of the Currency, Treasury; Board of

between 9 a.m. and 5 p.m. weekdays, except as provided in 12 CFR 261.8 of the Federal Reserve's Rules Regarding Availability of Information.

**FDIC:** Written comments should be sent to Robert E. Feldman, Executive Secretary, Attention: **Comments/OES**, Federal Deposit Insurance Corporation, 550 17th Street N.W., Washington, D.C. 20429. Comments may be hand delivered to the guard station at the rear of the 17th Street building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m. (FAX number (202) 898-3838; Internet address: comments@fdic.gov). Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, N.W., Washington, D.C. 20429, between 9:00 a.m. and 4:30 p.m. on business days.

**OTS:** Send comments to Manager, Dissemination Branch, Records Management and Information Policy, Office of Thrift Supervision, 1700 G Street, N.W., Washington, D.C. 20552, Attention Docket No. 97-36. These submissions may be hand-delivered to 1700 G Street, N.W., from 9:00 a.m. to 5:00 p.m. on business days; they may be sent by facsimile transmission to FAX number (202) 9067755; or they may be sent by e-mail:

**public.info@ots.treas.gov.** Those commenting by e-mail should include their name and telephone number. Comments will be available for inspection at 1700 G Street, N.W., from 9:00 a.m. until 4:00 p.m. on business days.

**FOR FURTHER INFORMATION CONTACT:**

**OCC:** Roger Tufts, Senior Economic Advisor (202/874-5070), Tom Rollo, National Bank Examiner (202/874-5070), Capital Policy Division; or Ronald Shimabukuro, Senior Attorney (202/874-5090), Legislative and Regulatory Activities Division.

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

**FDIC:** For supervisory issues, Stephen G. Pfeifer, Examination Specialist, Accounting Section, Division of Supervision (202/898-8904); for legal issues, Jamey Basham, Counsel, Legal Division (202/898-7265).

**OTS:** John F. Connolly, Senior Program Manager for Capital Policy, (202/906-6465), Michael D. Solomon, Senior Policy Advisor (202/906-5654), Supervision Policy; or Karen Osterloh,

Assistant Chief Counsel, (202/906-6639). Regulations and Legislation Division, Office of the Chief Counsel.

**SUPPLEMENTARY INFORMATION:** Section 303(a)(2) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4803(a)) (Riegle Act) provides that the Agencies shall, consistent with the principles of safety and soundness, statutory law and policy, and the public interest, work jointly to make uniform all regulations and guidelines implementing common statutory or supervisory policies. Section 303(a)(1) of the Riegle Act requires the Agencies to review their own regulations and written policies and to streamline those regulations and policies where possible. To fulfill the section 303 mandate, the Agencies have been reviewing, on an interagency basis and internally, their capital standards to identify areas where they have substantively different capital treatments or where streamlining is appropriate. As a result of these reviews, the Agencies have identified inconsistencies in the risk-based capital treatment of certain types of transactions, in particular, construction loans on presold residential properties, loans secured by junior liens on 1-to 4-family residential properties, and investments in mutual funds.<sup>1</sup> The Agencies also believe that the minimum leverage capital standards could be streamlined and made uniform among the Agencies.

The Agencies are proposing various amendments to their risk-based capital and leverage standards to eliminate these differences and to streamline their rules.

**Proposed Amendments**

**Construction Loans on Presold Residential Property**

The Agencies' all assign a qualifying loan to a builder to finance the construction of a presold 1-to 4-family residential property to the 50 percent risk weight category, provided the borrower has a substantial equity interest 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. Under the OCC and OTS rules, the construction loan may not receive a 50 percent risk weight unless, prior to the extension of credit to the builder, the

property was sold to an individual who will occupy the residence upon completion of construction. Under the capital rules of the Board and the FDIC, however, such loans to builders for residential construction are eligible for a 50 percent risk weight once the property is sold, even if the sale occurs after the construction loan has been made.

The Agencies are proposing to eliminate this difference by permitting qualifying residential construction loans to become eligible for the 50 percent risk weight category at the time the property is sold, even if that sale occurs after the institution has made the loan to the builder. In this regard, the OCC and OTS are proposing revised regulatory language that would permit this treatment because construction loans for residences sold to individual purchasers are equally safe regardless of whether sold before or after the loan is made to the builder. The Board is proposing a revision to its regulatory language to conform its discussion of qualifying construction loans to builders to the language of the FDIC.

**Junior Liens on 1- to 4-Family Residential Properties**

The Agencies are not uniform in their risk-based capital treatment of real estate loans secured by junior liens on 1-to 4-family residential properties when the lending institution also holds the first lien and no other party holds an intervening lien. In such cases, the Board views both loans as a single extension of credit secured by a first lien held by the lending institution and, accordingly, assigns the combined loan amount to either the 50 percent or 100 percent risk weight category depending upon whether certain other criteria are met.

One criterion to qualify for a 50 percent risk weight is that the loan must be made in accordance with prudent underwriting standards, including an appropriate ratio of the current loan balance to the value of the property (the loan-to-value or LTV ratio).<sup>2</sup> When considering whether a loan is consistent with prudent underwriting standards, the Board evaluates the LTV ratio based on the combined loan amount. If the combined loan amount satisfies prudent underwriting standards, both the first and second lien are assigned to the 50 percent risk weight category. The FDIC

<sup>2</sup> Other criteria include that the loan may not be 90 days or more past due or carried in nonaccrual status. The OTS rule also specifies that the documented LTV ratio may not exceed 60 percent of the securing real estate, unless the loan amount over the 80 percent LTV threshold is insured by qualifying private mortgage insurance.

<sup>1</sup> The Agencies also identified inconsistencies in their treatment of transactions supported by qualifying collateral, which are addressed in a pending joint notice of proposed rulemaking. 61 FR 42565 (August 16, 1996).

also combines the first and second liens to determine the appropriateness of the LTV ratio, but it applies the risk weights differently than the Board. If the combined loan amount satisfies prudent underwriting standards, the FDIC risk weights the first lien at 50 percent and the **second** lien at 100 percent; otherwise, both liens are risk weighted at 100 percent. The **OCC** treats **all first** and junior liens separately, even if the lending institution holds both liens and **no** party holds an intervening lien. Qualifying first liens are risk weighted at 50 percent, and non-qualifying first liens and all junior liens are risk weighted at 100 percent. The OTS definition of qualifying mortgage in its capital rule 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 individual with no intervening liens as a single extension of credit.

The **Agencies** have decided to propose **adopting** the **OCC's** capital treatment of junior liens as the uniform interagency approach because it is simple to implement and monitor, and it treats all junior liens consistently. Under this approach, all junior liens would be assigned to the 100 percent risk weight category. The Board and the FDIC are proposing conforming revisions to their risk-based capital standards. The OTS would revisit its policy interpretation of its current rule, which parallels the **OCC's** text.

#### **Mutual Funds**

The Board and FDIC generally assign all of an institution's investment in a mutual fund to the risk weight category appropriate to the highest risk weighted asset that a particular mutual fund is permitted to invest in pursuant to its prospectus. As a general rule, the **OCC** applies the same treatment, but permits, on a case-by-case basis, an institution's investment to be allocated on a pro-rata basis among risk weight categories based on the percentages of a **portfolio** authorized to be invested in assets in a particular risk weight category as set forth in the fund's prospectus. The OTS generally assigns all of an institution's investment in a mutual fund to the risk weight category applicable to the highest risk weighted asset that the fund actually holds at a particular time. The OTS, however, on a case-by-case basis, permits pro-rata allocation among risk weight categories based on the fund's actual holdings. All of the **Agencies'** rules provide that the minimum risk weight for investments in mutual funds is 20 percent.

The **Agencies** are proposing to achieve uniformity in the capital

treatment of an institution's investments in mutual funds by generally assigning **the** institution's total investment to the risk category appropriate to the highest risk weighted asset the fund is permitted to hold in accordance with its stated investment limits set forth in the prospectus. The **Agencies**, however, are proposing to allow an institution, at its option, to assign the investment on a pro-rata basis to different risk weight categories according to the investment limits in the **fund's** prospectus, but in no case will indirect holdings through shares in a mutual fund be assigned to a risk weight less than 20 percent. For example, an institution's investment in a mutual fund that is authorized, in accordance with its prospectus, to invest up to 40 percent of its portfolio in corporate bonds and the remainder in U.S. government bonds, normally would be placed in the 100 percent risk-weight category. However, the institution could choose to place only 40 percent of its investment in the 100 percent risk weight category and the remainder in the 20 percent risk weight category. The proposed rules note that if a mutual fund is permitted to contain an insignificant quantity of highly liquid securities of superior quality that do not qualify for a preferential risk weight, such securities generally will be disregarded in determining the risk weight for the overall fund. The **Agencies** also emphasize that any activities which are speculative in nature or otherwise inconsistent with the preferential risk weighting assigned to the fund's assets could result in the mutual fund investment being assigned to the 100 percent risk category.

#### **Tier 1 Leverage Ratio**

The **Agencies'** Tier 1 leverage ratio (that is, the ratio of Tier 1 capital to total assets) is an indicator of an institution's capital adequacy and places a constraint on the degree to which an institution can leverage its equity capital base. The Board, FDIC, and **OCC** require the most highly-rated institutions—that is, those with, among other things, a composite 1 rating under the Uniform Financial Institutions Rating System (**UFIRS**)<sup>3</sup>—to meet a minimum leverage ratio of 3.0 percent. The minimum leverage ratio for other institutions is 3.0 percent “plus an additional cushion of at least 100 to 200 basis points.”

All four **Agencies'** prompt corrective action (**PCA**) rules require institutions to satisfy a 4.0 percent leverage ratio (3.0

percent for institutions with a composite 1 rating under the **UFIRS**) to be considered “adequately capitalized.” The OTS capital rule includes a 3.0 percent core (Tier 1) capital requirement,\* but the 4.0 percent standard to be adequately capitalized under the **Agencies'** **PCA** rules has been the controlling thrift leverage standard.

The **Agencies** are proposing revisions to their leverage capital standards so that the most highly-rated institutions would be subject to a minimum 3.0 percent leverage ratio and all other institutions would be subject to a minimum 4.0 percent leverage ratio (the same standard used to be adequately capitalized under their **PCA** rules). This proposed change would simplify and streamline the **Agencies'** leverage rules.

In addition, it would make the OTS Tier 1 leverage standard consistent with the current standard to be “adequately capitalized” under all four agencies' **PCA** rules and with the other agencies' Tier 1 leverage standards. The OTS is also proposing to be consistent with the other three agencies by explicitly clarifying that the prescribed leverage standard is a minimum standard for financially strong institutions, that higher capital may be required if warranted, and that institutions should maintain capital levels consistent with their risk exposure.

The **Agencies** request comment on all aspects of this proposal. Comment is specifically requested on the proposed treatment of first and second mortgages, which places qualifying first mortgages on **1- to 4-family** residential properties in the **50** percent risk-weight category and all second mortgages in the 100 percent risk-weight category. Please comment on whether the combined loan-to-value ratio of a first and second mortgage to the same borrower, or some other criteria, provides a sound basis for modifying the proposed capital treatment of such first and second mortgages. Comment is also specifically requested on the 20 percent minimum risk weight applied to banks' investments in mutual funds. In particular, commenters are encouraged to discuss whether 20 percent is too low or too high as a lower bound in light of mutual funds' various credit, operational, and legal risks, and where these risks lie.

\*The **OTS's** core capital ratio is the OTS equivalent to the other agencies' Tier 1 leverage ratio. OTS is proposing to add definitions of Tier 1 capital and Tier 2 capital to clarify that these are equivalent to **core** and supplementary capital, respectively.

<sup>3</sup>The **UFIRS** is used by supervisors to summarize their evaluations of the strength and soundness of financial institutions in a comprehensive and uniform manner.

**Regulatory Flexibility Act Analysis****OCC Regulatory Flexibility Act Analysis**

Pursuant to section 605(b) of the Regulatory Flexibility Act, the OCC certifies that this proposed rule would not have a significant economic impact on a substantial number of small entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). Accordingly, a regulatory flexibility analysis is not required. The proposed rule would reduce regulatory burden by unifying the Agencies' risk-based capital treatment for presold construction loans, junior liens, and investments in mutual funds, and simplifying the Tier 1 leverage standards. The economic impact of this proposed rule on banks, regardless of size, is expected to be minimal.

**Fedeml Reserve Board Regulatory Flexibility Act Analysis**

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board does not believe this proposal would have a significant impact on a substantial number of small business entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). Accordingly, a regulatory flexibility analysis is not required. The effect of the proposal would be to reduce regulatory burden on depository Institutions by unifying the Agencies' risk-based capital treatment for presold construction loans, junior liens, and investments in mutual funds, and simplifying the Tier 1 leverage standards. The economic impact of the proposed rule on institutions, regardless of size, is expected to be minimal.

**FDIC Regulatory Flexibility Act Analysis**

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96-354.5 U.S.C. 601 *et seq.*), it is certified that the proposal would not have a significant impact on a substantial number of small entities. The effect of the proposal would be to simplify depository institutions' capital calculations.

**OTS Regulatory Flexibility Act Analysis**

Pursuant to section 605(b) of the Regulatory Flexibility Act, the OTS certifies that this proposed rule will not have a significant economic impact on a substantial number of small entities. The effect of the proposal would be to reduce regulatory burden on depository institutions by simplifying the treatment of junior liens, permitting institutions to risk weight holdings in a mutual fund on a pro rata basis, and making OTS'

Tier 1 leverage ratio consistent with its current standard to be adequately capitalized under PCA. In addition, the proposal will eliminate various inconsistencies in the risk-based capital treatments applied by the Agencies.

**Paperwork Reduction Act**

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

**OCC and OTS Executive Order 12866 Determination**

The OCC and the OTS have determined that this proposed rule does not constitute a "significant regulatory action" for the purposes of Executive Order 12866.

**OCC and OTS Unfunded Mandates Reform Act of 1995 Determinations**

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 1044 (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 proposed rule is limited to changing the risk weighting of presold residential construction loans, second liens, and mutual fund investments 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 proposal clarifies and makes uniform existing regulatory requirements for national banks. The OCC and OTS have therefore determined that the proposed 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.

**Authority and Issuance****Office of the Comptroller of the Currency****12 CFR CHAPTER I**

For the reasons set out in the joint preamble, part 3 of chapter I of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

**PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES**

1. The authority citation for part 3 continues to read as follows:

Authority: 12 U.S.C. 93a, 161.1616, 1626(n), 1828 note, 1831n note, 1635.3907, and 3909.

2. In § 3.6, paragraph (c) is revised to read as follows:

**§ 3.6 Minimum capital ratios.**

(c) *Additional leverage ratio requirement.* An institution operating at or near the level in paragraph (b) of this section is expected to have well-diversified risks, including no undue interest rate risk exposure; excellent control systems; good earnings; high asset quality; high liquidity; and well managed on- and off-balance sheet activities; and in general be considered a strong banking organization, rated composite 1 under the Uniform Financial Institutions Rating System (CAMELS) rating system of banks. For all but the most highly-rated banks meeting the conditions set forth in this paragraph, the minimum Tier 1 leverage ratio is to be 4 percent. In all cases, banking institutions should hold capital commensurate with the level and nature of all risks.

3. In appendix A to part 3, section 3., the second undesignated paragraph and paragraph (a)(3)(iv) are revised to read as follows:

APPENDIX A TO PART 3—RISK BASED CAPITAL GUIDELINES

Section 3. Risk Categories/Weights for On-Balance Sheet Assets and Off-Balance Sheet Items

Some of the assets on a bank's balance sheet may represent an indirect holding of a pool of assets, e.g., mutual funds, that encompass more than one risk weight within the pool. In those situations, the bank may assign the asset to the risk category applicable to the highest risk-weighted asset that pool is permitted to hold pursuant to its stated investment objectives in the fund's prospectus. Alternatively, the bank may assign the asset on a pm rata basis to different risk categories according to the investment limits in the fund's prospectus. In either case, the minimum risk weight that the bank may assign to such a pool is 20 percent. If, in order to maintain a necessary degree of liquidity, the fund is permitted to hold an insignificant amount of its investments in short-term, highly-liquid securities of superior credit quality (that do not qualify for a preferential risk weight), such securities generally will not be taken into account in determining the risk category into which the bank's holding in the overall pool should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of that fund above the 20 percent category. More detail on the treatment of mortgage-backed securities is provided in section 3(a)(3)(vi) of this appendix A.

(a) \* \* \*

(3) \* \* \*

(iv) Loans to residential real estate builders for one-to-four family residential property construction, if the bank obtains sufficient documentation demonstrating that the buyer of the home intends to purchase the home (i.e., a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (i.e., a firm written commitment for permanent financing of the home upon completion), subject to the following additional criteria:

Dated: September 29, 1997. Eugene A. Ludwig, Comptroller of the Currency.

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 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, 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, 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

III. \* \* \* A. \* \* \* 21

3. In appendix A to part 208, section ZLLC.3 is amended by removing and reserving footnote 34 and by adding a new sentence to the end of the first paragraph of footnote 35 to read as follows:

III. \* \* \* C. \* \* \* 35

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

21 An investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the stated investment objectives set forth in the prospectus. The bank may, at its option, assign the investment on a pm rata basis to different risk categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in any mutual fund be assigned to a risk weight less than 20 percent. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities generally will be disregarded in determining the risk category into which the bank's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of that fund above the 20 percent category. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

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).

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

II. \* \* \* a. For a strong banking organization (rated composite 1 under the UFIRS rating system of banks) the minimum ratio of Tier 1 capital to total assets is 3.0 percent. Such institutions must not be anticipating or experiencing significant growth, and are expected to have welldiversified risk (including no undue interest rate risk exposure), excellent asset quality, high liquidity, good earnings, and in general to be considered a strong banking organization. For all other institutions, the minimum ratio is 4.0 percent. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banks. In all cases, banking institutions should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.

By order of the Board of Governors of the Federal Reserve System, October 21, 1997. William w. Wiles, Secretary of the Board.

Federal Deposit Insurance Corporation 12 CFR CHAPTER III

For the reasons set forth in the joint preamble, part 325 of chapter III of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 325—CAPITAL MAINTENANCE

1. The authority citation for part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1818, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 1835, 3907, 3909, 4808; Pub. L. 102-233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102-242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

2. Paragraph (b)(2) in § 325.3 is revised to read as follows:

§ 325.3 Minimum leverage capital requirement

(b) \* \* \* (2) For all but the most highly-rated institutions meeting the conditions set forth in paragraph (b)(1) of this section, the minimum leverage capital requirement for a bank (or for an insured depository institution making an application to the FDIC) shall consist of a ratio of Tier 1 capital to total assets of not less than 4 percent.

3. In appendix A to part 325, section II.B., paragraph 1 is revised to read as follows:

**APPENDIX A TO PART 325—  
STATEMENT OF POLICY ON RISK-  
BASED CAPITAL**

• • • • •  
II. • • •  
B. • • •

1. *Indirect Holdings of Assets.* Some of the assets on a bank's balance sheet may represent an indirect holding of a pool of assets: for example, mutual funds. An investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the stated investment objectives set forth in its prospectus. The bank may, at its option, assign the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in any mutual fund be assigned to a risk weight less than 20 percent. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities generally will be disregarded in determining the risk category into which the bank's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

4. In appendix A to part 325, section II.C. is amended by removing and reserving footnote 26.

By order of the Board of Directors.  
Dated at Washington, D.C. this 4th day of February 1997.

Federal Deposit Insurance Corporation.  
Jerry L. Langley,  
Executive Secretary

**Office of Thrift Supervision**  
12 CFR CHAPTER V

For the reasons set forth in the joint preamble, part 567 of chapter V of title 12 of the Code of Federal Regulations is proposed to be amended as set forth below:

**PART 567—CAPITAL**

1. The authority citation for part 567 continues to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a, 1626 (note).

2. In § 567.1, paragraph (jj)(1)(ii) is revised, and new paragraphs (mm) and (nn) are added to read as follows:

**§ 567.1 Definitions.**

(jj) *Qualifying residential construction loan.* (1) • • •

(ii) The residence being constructed must be a 1-4 family residence sold to a home purchaser;

(mm) Tier 1 capital. The term *Tier 1 capital* means core capital as computed in accordance with § 567.5(a) of this part.

(nn) Tier 2 capital. The term *Tier 2 capital* means supplementary capital as computed in accordance with § 567.5(b) of this part.

3. Section 567.2(a)(2)(ii) is revised to read as follows:

**§ 567.2 Minimum regulatory capital requirement.**

(2) *Leverage ratio requirement.* • • •  
(ii) A savings association must satisfy this requirement with core capital as defined in § 567.5(a) of this part.

4. Section 567.6(a)(1)(vi) is revised to read as follows:

**§ 567.6 Risk-based capital credit risk-weight categories.**

(vi) *Indirect ownership interests in pools of assets.* An asset representing an indirect holding of a pool of assets, e.g., mutual funds, generally is assigned to the risk-weight category under this section based upon the risk weight that would be assigned to the assets in the portfolio of the pool. An investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk-weight categories,

generally is assigned to the risk-weight category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the investment objectives set forth in its prospectus. The savings association may, at its option, assign the investment on a pro-rata basis to different risk-weight categories according to the investment limits in the fund's prospectus. In no case will an indirect holding through shares in a mutual fund be assigned to the zero percent risk-weight category. 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 in determining the risk-weight category into which the savings association's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk-weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk-weight category.

5. Section 567.6 is revised to read as follows:

**§ 567.8 Leverage ratio.**

(a) The minimum leverage capital requirement for a savings association assigned a composite rating of 1, as defined in § 516.3(c) of this chapter, shall consist of a ratio of core capital to adjusted total assets of 3 percent. These generally are strong associations that are not anticipating or experiencing significant growth and have well-diversified risks, including no undue interest rate risk exposure, excellent asset quality, high liquidity, and good earnings.

(b) For all savings associations not meeting the conditions set forth in paragraph (a) of this section, the minimum leverage capital requirement shall consist of a ratio of core capital to adjusted total assets of 4 percent. Higher capital ratios may be required if warranted by the particular circumstances or risk profiles of an

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

Dated: April 17, 1997.

The Office of Thrift Supervision.

**Nicolas P. Retsinas,**

*Director.*

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6720-01-P

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