DESCRIPTION OF CAPITAL PROPOSAL

A. Background

1. Description of original capital proposal

In March, 2000, the Board in connection with publishing an interim rule implementing provisions of the Gramm-Leach-Bliley Act (GLB Act) that allow financial holding companies to engage in merchant banking activities, invited public comment on a proposal to establish capital requirements governing investments by bank holding companies in nonfinancial companies. The capital proposal would assess, at the holding company level, a 50 percent capital charge on the carrying value of each investment.

The capital proposal applied to investments, including equity and debt instruments under some circumstances, made by a bank holding company under any of its equity investment authorities, including its merchant banking authority, investment authority under Regulation K, authority to make investments through small business investment companies, authority to hold indirectly investments under section 24 of the Federal Deposit Insurance Act, and authority to make investments in less than 5 percent of the shares of any company under sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act (BHC Act). This capital proposal did not apply, however, to shares that a bank holding company acquires in a company engaged only in financial activities, acquires in connection with its securities underwriting, dealing or market making activities and held in trading accounts, or acquires through an insurance underwriting company.

2. Brief summary of comments

The Board and the Secretary of the Treasury together received more than 130 comments on the capital proposal. Commenters included members of Congress, other federal agencies, state banking departments, banking organizations, securities firms, trade associations for the banking and securities industries, law firms and individuals. Many commenters acknowledged that equity investment activities involve greater risks than traditional banking activities. For example, a trade association for the banking industry fully supported the proposed capital charge as appropriate to protect banking organizations and the financial system from the risks associated with merchant banking investment activities.

Most commenters, however, opposed the capital proposal or one or more aspects of the proposal. Some commenters contended that the proposal, by applying a uniform 50-percent charge to all equity investments, failed adequately to take into account risk variances between different types of equity investments (e.g., private equity investments vs. investments in publicly traded stocks) or between different investment portfolios. A number of commenters argued that the proposal would frustrate Congress' desire to permit a "two-way street" between securities firms and banking organizations or would place bank holding companies, and particularly those with large equity investment portfolios, at a disadvantage in competing with nonbanking organizations and foreign banking organizations in the market for making equity investments. Some commenters also contended that the Board lacked the authority to establish special capital requirements for merchant banking and similar equity investments.

Many commenters acknowledged that the internal capital models developed by banking organizations and securities firms frequently require equity investment activities to be supported by significant amounts of capital. Some commenters argued that banking organizations should be permitted to use their internal capital models to determine the appropriate amount of regulatory capital needed to support their investment activities. Others argued that, because banking organizations use internal models for a variety of purposes, it is not appropriate for the agencies to rely on selected data from those models as a principal basis for establishing a minimum regulatory capital requirement for equity investments. Commenters also argued that the banking agencies should not use data derived from internal models to support establishing a high regulatory capital requirement for equity investments without also using the data from these models to reduce the amount of regulatory capital needed to support more traditional banking assets, such as consumer and commercial loans.

Many commenters suggested specific amendments or alternatives to the proposed capital charge. For example, some commenters suggested that the Board rely solely on the examination and supervisory process, as well as market discipline, to ensure that a bank holding company maintains adequate capital to support its equity investment activities. Other commenters argued that the proposal should be replaced with a rule that prohibits bank holding companies from including any unrealized gains on equity investments in their regulatory capital. Some commenters argued that the proposal should be amended to impose a lower capital charge on equity investments such as, for instance, by assigning equity investments a 200 percent risk-weight or by applying a capital charge higher than the current minimums only to equity investments that exceed some threshold amount of the banking organization's Tier 1 capital (e.g., 30 percent).

Some commenters argued that a higher capital charge should be limited only to merchant banking investments made by financial holding companies under the new merchant banking authority in the GLB Act, and should not be applied to past or future investments made by banking organizations under other statutory authorities. Other commenters requested that specific investment authorities be excluded from the proposal. For example, a number of commenters argued that the proposal should not apply to investments made by small business investment company (SBIC) subsidiaries of a banking organization because SBICs are an important source of capital for small businesses, are subject to oversight by the Small Business Administration, and have not historically caused significant losses at banking organizations. Many state banking institutions also argued that the proposal should not apply to the equity investments made by state banks under the special grandfather provisions of section 24(f)(2) of the Federal Deposit Insurance Act (FDI Act). Others asserted that the capital charge should not be applied to investments approved on a case-by-case basis by the FDIC under section 24 of the FDI Act, to investments made under section 4(c)(6) or 4(c)(7) of the BHC Act, or to debt instruments.

A number of commenters asserted that a capital charge higher than the current minimums should not be applied to equity investments actually made prior to issuance of the capital proposal. Commenters argued that the business decisions concerning these investments were made based on the capital rules then in effect, and that applying a new, higher capital charge to these pre-existing investments would be unfair.

B. Revised Capital Adequacy Proposal

The Board has carefully reviewed the comments regarding its initial capital proposal. In addition, the Board has consulted with the Treasury Department and has worked with the other Federal banking agencies to improve the proposal and to develop capital standards that would apply uniformly to equity investments held by bank holding companies and those held by depository institutions.

The new proposal attempts to balance the concerns of commenters with the belief of the Federal banking agencies that banking organizations must maintain sufficient capital to offset the risk of an activity that generally involves risks that are higher than the risks associated with many traditional banking activities. In striking this balance, the new proposal focuses on establishing a regulatory capital requirement that the Federal banking agencies believe represents the minimum capital levels consistent with the safe and sound conduct of equity investment activities. The agencies fully expect that individual banking organizations in most cases will allocate higher economic capital levels, as appropriate, commensurate with the risk in the individual investment portfolios of the company.

The banking agencies have been guided by several principles in considering the appropriate levels of capital that should be required as a regulatory minimum to support equity investment activities. First, equity investment activities in nonfinancial companies generally involve greater risks than traditional bank and financial activities. Analysis of the annual returns for a diversified portfolio of publicly-traded small cap stocks over the past seventy-five years indicates that capital levels well in excess of the current regulatory minimum capital levels for banking organizations may be needed to support equity investment activities with the level of financial soundness expected of organizations that control insured depository institutions. Over the past twenty-five years, a study of venture capital investment firms indicates that, while some of these firms did very well, nearly 20 percent of these firms failed and a substantial number of others achieved only modest returns. Two national rating agencies have indicated that the private equity business is largely funded with equity capital and that equity portfolios, including mature and well diversified equity portfolios, require substantially more capital than loans.

Firms and institutional investors that engage to a significant degree in equity investment activities typically support their equity investment activities with high levels of capital–often dollar for dollar–due to the greater risk and illiquidity of these types of investments and the higher leverage that often is employed by portfolio companies. In fact, the vast majority of commenters did not disagree that equity investment activities are riskier than traditional banking activities or that it is prudent to fund these types of investment activities with higher levels of capital.

For these reasons, the agencies believe that capital in excess of the current regulatory minimum capital levels for more traditional banking activities should be required to allow a banking organization to conduct equity investment activities in a safe and sound manner.

A second and related principle that guided the agencies in considering this new proposal is that the financial risks to an organization engaged in equity investment activities increase as the level of their investments accounts for a larger portion of the organization’s capital, earnings and activities. Banking organizations have for some time engaged in equity investment activities using various authorities, including primarily SBICs and authority to make limited passive investments under sections 4(c)(6) and (7) of the BHC Act. When the current capital treatment, which requires a minimum of 4% Tier 1 capital (6% in the case of depository institutions that must meet the regulatory well-capitalized definition) was developed, these equity investment activities by bank holding companies and banks were small in relation to the more traditional lending and other activities of these organizations.

The level of these investment activities has grown significantly in recent years, however. For example, investments made through SBICs owned by banking organizations have alone more than doubled in the past 5 years. In addition, the merchant banking authority granted to financial holding companies by the GLB Act provides significant new authority to make equity investments without many of the restrictions that apply to other authorities currently used by banking organizations to make these investments. The agencies believe that it is appropriate to revisit the regulatory capital requirements applicable to equity investment activities in light of the dramatic growth in banking organizations’ equity investment activities through existing authorities and the grant of this new and expanded merchant banking authority.

A third principle guiding the agencies’ efforts is that the risk of loss associated with a particular equity investment is likely to be the same regardless of the legal authority used to make the investment or whether the investment is held in the bank holding company or in the bank. In fact, the agencies’ supervisory experience is that banking organizations are increasingly making investment decisions and managing equity investment risks across legal entities as a single business line within the organization. These organizations use different legal authorities available to different legal entities within the organization to conduct a unified equity investment business.

In light of these principles, the agencies propose to amend their respective capital regulations and guidelines to establish special minimum regulatory capital requirements for equity investments in nonfinancial companies as described herein. This capital treatment would apply symmetrically to equity investment activities of bank holding companies and banks. Importantly, this new proposal applies a series of marginal capital charges that increase with the level of a banking organization’s overall exposure to equity investment activities relative to the institution’s Tier 1 capital.

The Board and the OCC each propose to amend their respective capital regulations and guidelines applicable to banks to incorporate the capital treatment described below. In addition, the Board proposes to amend its capital guidelines and regulations that apply on a consolidated basis to bank holding companies as described below.

The agencies invite comment on all aspects of the proposal.

1. Scope of coverage

The proposed capital treatment discussed below would apply only to equity investments in nonfinancial companies. Specifically, the proposed capital treatment would apply to equity investments made in nonfinancial companies:

- by financial holding companies under the merchant banking authority of section 4(k)(4)(H) of the BHC Act;

- by bank holding companies (including financial holding companies) in less than 5 percent of the shares of a nonfinancial company under the authority of section 4(c)(6) or 4(c)(7) of the BHC Act;

- by bank holding companies (including financial holding companies) or banks in nonfinancial companies through SBICs;

- by bank holding companies (including financial holding companies) or banks under Regulation K; and

- by banking organizations under section 24 of the Federal Deposit Insurance Act.

Many commenters, including a number of members of Congress, argued that investments in SBICs should not be subject to higher capital requirements. These commenters contended that SBICs serve the important public purpose of encouraging the development and funding of small businesses and that SBICs owned by banking organizations have generally been profitable to date.

Congress has, through the Small Business Investment Act, expressed its desire to facilitate the funding of small businesses through SBICs and has by statute imposed limits on the formation, operation, funding and investments of SBICs.

Congress has also imposed special limitations on the amount of capital that a banking organization may invest in an SBIC. In light of this congressional intent and these statutory limits, the revised proposal would not apply any special capital charge to investments in nonfinancial companies held by SBICs owned by banks or bank holding companies so long as these investments remain within traditional limits.

The agencies note, however, that SBICs have grown significantly in the past few years, in part because of the appreciation of the value of SBIC investments on their books. Reflecting both the specific congressional preference for SBICs and the appreciation in the value of SBIC investments, the proposal would apply special capital charges to equity investments made through SBICs only when the carrying value of those investments exceeds certain high thresholds relative to Tier 1 capital. The agencies note that nearly all SBICs owned by banking organizations currently are below the thresholds proposed.

Commenters requested clarification regarding whether the capital charge would apply to certain other types of equity investments, including in particular investments in companies that engage solely in banking and financial activities that the investing company could conduct directly. Banking organizations have special expertise in managing the risks associated with financial activities. As a result, neither the original proposal made by the Board nor the new proposal by the banking agencies would apply to equity investments made in companies that engage in banking or financial activities that are permissible for the investing bank holding company or bank, as relevant, to conduct directly. The proposal also would not apply to an equity investment made under Regulation K in any company that is engaged solely in activities that have been determined to be financial in nature or incidental to financial services.

A number of commenters, requested that the agencies clarify whether the capital proposal would apply to equity securities held in a trading account. The new proposal does not apply to securities that are held in a trading account in accordance with applicable accounting principles and as part of an underwriting, market making or dealing activity. Several commenters also requested clarification regarding whether the proposal would apply to investments that the primary supervisor of the bank or bank holding company has determined to be designed primarily to promote the public welfare and are held in community development corporations. The proposal would not apply to these investments.

Many commenters argued that the proposed capital treatment should not be applied to investments in nonfinancial companies held by state banks in accordance with section 24 of the FDI Act. Commenters argued that state banks, especially state banks located in New England, have been authorized to make limited amounts of equity investments for more than 50 years and that these investments have provided diversification to their earnings when loans have been unprofitable.

Section 24 of the FDI Act allows state banks to retain equity investments in nonfinancial companies made pursuant to state law under certain circumstances. In particular, section 24(f) permits certain state banks to retain shares of publicly traded companies and registered investment companies if the investment was permitted under a state law enacted as of a certain date, the state bank engaged in the investment activity as of a certain date and the total amount of equity investments made by the bank does not exceed the capital of the bank. Commenters argued that Congress specifically considered the risks to state banks from these investments when deciding to grandfather these equity investment activities.

In addition to this grandfathered investment authority, a state bank may hold equity in other nonfinancial companies if the FDIC determines that the investment does not pose a material risk to the deposit insurance fund. The FDIC is empowered to establish and has established higher capital requirements and other limitations on equity investments of state banks held under this authority, such as investments in companies engaged in real estate investment and development activities. The FDIC has to date in most cases required state banks that make these investments to limit the amount of the investment and to deduct these investments from the bank's capital, effectively imposing a 100 percent capital charge on these investments.

For these reasons, the agencies propose to exclude from the special capital charge any investment in a nonfinancial company held by a state bank in accordance with the grandfather provisions of section 24(f) of the FDI Act. The proposal would apply to other equity investments in nonfinancial companies held by state banks in accordance with other provision of section 24.[1]

[1] Under the proposal, the Board of Directors of the FDIC, acting directly, may, in exceptional cases and after a review of the proposed activity, permit a lower capital deduction for investments approved by the Board of Directors under section 24 of the

(continued...)

A few commenters argued that the capital proposal should not be applied to any equity investment made by a bank or bank holding company prior to March 13 2000. These investments were made at a time when the agencies had not proposed a higher regulatory capital charge, are modest in amount at most banking organizations, and will be liquidated over time. As explained below, the new capital proposal establishes a marginal capital structure that is different and, on average, lower than the original proposal. The new proposal also provides that no special capital charge would be imposed on investments made through an SBIC within certain thresholds. SBICs hold a very large portion of the investments made prior to March 13, 2000, by banking organizations. In light of these changes, the agencies request comment on whether it is necessary or appropriate to grandfather the individual investments made prior to March 13, 2000. The agencies also request comment on the alternative of allowing banking organizations to phase in over a period of time (such as 3 years) the proposed capital standards with regard to investments made prior to March 13, 2000.

Commenters also argued that capital charges should not apply to debt that is extended to companies in which an organization has made an equity investment. The original proposal would have applied the proposed capital charge to any debt instrument with equity features (such as conversion rights, warrants or call options). In addition, the proposal would have applied a higher capital charge to any other type of debt extended to a company if the debt instrument is held by a banking organization that also owns at least 15 percent of the equity of the company. The original proposal included exceptions for short-term, secured credit provided for working capital purposes, any extension of credit that meets the collateral requirements of section 23A of the Federal Reserve Act, any extension of credit that is guaranteed by the U.S. Government, and any extension of credit at least 50 percent of which is sold or participated out to unaffiliated parties.

Commenters noted that the legal doctrine of equitable subordination affects the ability of investors to make loans to portfolio companies that serve as the functional equivalent of equity. Under this doctrine, courts in bankruptcy proceedings

[1] (...continued)
FDI Act so long as the bank's investments under section 24 and SBIC investments represent, in the aggregate, less than 15 percent of the Tier 1 capital of the bank. The FDIC and the other banking agencies reserve the authority to impose higher capital charges where appropriate.

have, under certain circumstances, subordinated the claims of creditors that are also investors in a company to the claims of other creditors, effectively treating the debt held by the investor as if the debt were equity.

After considering the comments on this matter, the agencies have revised the approach to debt instruments with equity features. The new proposal applies the proposed capital treatment to equity features of debt (such as warrants and options to purchase equities in nonfinancial companies) and to debt instruments convertible into equity investments in nonfinancial companies where the equity feature or instrument is held under one of the authorities listed above. The primary supervisor will monitor the use of debt held under any authority as a method for providing the equivalent of equity funding to portfolio companies, and may, on a case-by-case basis in the supervisory process, require banking organizations to maintain higher capital against debt where circumstances indicate that the debt serves as the functional equivalent of equity.

The original capital proposal made by the Board did not apply to equity investments made under section 4(k)(4)(I) of the BHC Act by an insurance underwriting affiliate of a financial holding company, and the revised proposal continues that approach. These investments generally are already subject to higher capital charges under state insurance laws. The Board requests comment regarding whether special capital requirements or other supervisory restrictions should be applied to assure that financial holding companies do not use insurance underwriting companies to arbitrage any differences in the capital requirements on equity investment activities that apply to insurance companies and other financial holding company affiliates. To the extent appropriate, the Board will address these matters in a separate proposal regarding the appropriate method for accounting for insurance companies under the Board's consolidated capital adequacy guidelines applicable to financial holding companies.

The agencies believe that the authorities discussed above cover the principal authorities available to banking organizations to make equity investments in companies that engage in nonfinancial activities. The agencies request comment on whether there are other investment activities that should be covered by this capital proposal.

As noted above, the new proposal would apply the special capital charge to investments in nonfinancial companies made in accordance with the portfolio investment provisions of Regulation K. This includes investments made through socalled Edge Act and Agreement corporations. This special capital treatment would not apply, for example, to the ownership of equity securities held by an Edge Act or Agreement corporation to hedge equity derivative transactions for foreign customers. The agencies request comment on whether it is appropriate to apply the capital charge to investments made through Edge Act corporations and Agreement corporations in nonfinancial companies overseas.

2. Capital charges

As noted above, the agencies propose to amend their respective capital guidelines and rules to apply a different charge to equity investments in nonfinancial companies than is currently applied to traditional banking investments and activities. This proposal would apply symmetrically to banks and bank holding companies. This proposal would not have a significant effect on the capital levels of any major banking organization based on current investment levels.

The proposal involves a progression of capital charges that increases with the size of the aggregate equity investment portfolio of the banking organization relative to its Tier 1 capital. This approach takes account of the greater impact that losses in a larger portfolio of equity investments relative to capital may have on the financial condition of a banking organization.

As explained in the attached proposed amendment to the capital rules, the proposed capital charge would be applied by making a deduction from the organization's Tier 1 capital. This deduction would be based on the adjusted carrying value of equity investments in nonfinancial companies. The adjusted carrying value is the value at which the relevant investment is recorded on the balance sheet, reduced by net unrealized gains that are included in carrying value but that have not been included in Tier 1 capital and associated deferred tax liabilities.

For the reasons explained above, no additional capital charge would be applied to SBIC investments made by a bank or bank holding company, so long as the adjusted carrying value of the investments does not exceed 15 percent of the Tier 1 capital of the depository institution that holds the investment or, in the case of an SBIC held directly by the bank holding company, 15 percent of the pro rata Tier 1 capital of all depository institutions controlled by the bank holding company. These investments would be included, however, in determining the aggregate size of the organization's investment portfolio for purposes of applying the marginal capital charges discussed below.

For all investments other than SBIC investments, an 8 percent Tier 1 capital charge would be applied so long as the adjusted carrying value of all such investments (plus all SBIC investments and other covered investments) represent less than 15 percent of Tier 1 capital. This difference in treatment for investments made outside of an SBIC recognizes the special limits that have been imposed on the operations of SBICs and preferences that Congress has granted to SBICs.

In the case of a portfolio of covered investments that, in the aggregate (including SBIC investments and other covered investments), exceeds 15 percent of the organization's Tier 1 capital, a 12 percent Tier 1 capital charge would apply to the portion of the portfolio above the 15 percent threshold. The 12 percent marginal charge would apply to the adjusted carrying value of equity investments up to 25 percent of Tier 1 capital. In the case of a portfolio of covered investments that, in the aggregate, exceeds 25 percent of the organization's Tier 1 capital, a 25 percent marginal Tier 1 capital charge would apply to the portion of the portfolio above the 25 percent threshold. The following table, which is included in the proposed regulation, reflects these capital charges.

Table 1
Deduction for
Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held by the bank or bank holding company (as a percentage of the Tier 1 capital of the bank or bank holding company)[2]	Deduction from Tier 1 Capital (as a percentage of the adjusted carrying value of the investment)
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent

[2] For purposes of calculating the percentage of equity investments relative to Tier 1 capital, Tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, but prior to the deduction for deferred tax assets and nonfinancial equity investments.

25 percent and above	25 percent

The agencies propose to apply heightened supervision to the equity investment activities of banking organizations as appropriate, including in the event that the adjusted carrying value of all nonfinancial equity investments represents more than 50 percent of the organization's Tier 1 capital. The agencies may in any case impose a higher minimum capital charge on an organization as appropriate in light of the risk management systems; risk, nature, size and composition of the organization's investments; market conditions; and other relevant information and circumstances.

In the event that the agencies determine not to apply this special capital charge to equity investments made by a banking organization prior to March 13, 2000, the agencies propose to include the adjusted carrying value of an organization's investment portfolio made in grandfathered investments for purposes of determining the appropriate marginal capital charge on investments that are not grandfathered.

Commenters questioned how the original capital proposal would apply to investments held through equity investment funds, in particular, through investment partnerships where the holding company may control the fund, usually through its role as general partner, but is not the sole participant in the fund. As noted in the original proposal, the capital charge in such instances would apply only to the holding company's proportionate share of the fund's investments. Such treatment would apply even if the partnership is consolidated in the holding company's financial reporting statements. Similarly, the new proposal provides that minority interest resulting from any such consolidation would not be included in the Tier 1 capital of the holding company. Such minority interest is not available to support the overall financial business of the holding company.

Similar treatment is proposed for minority interest with respect to investments in nonfinancial companies under the authorities covered by the proposal. Generally, it would not be expected that any nonfinancial company whose shares are acquired pursuant to these authorities would be consolidated, either because the investment is temporary as in the case of merchant banking investments, or limited to a minority interest. However, if consolidation does occur, any resulting minority interest must be excluded from Tier 1 capital because the minority interest is not available to support the general financial business of the banking organization.

The agencies invite comment on all aspects of the proposal, including in particular on the proposed marginal capital charges and the methods for calculating and applying the deduction to capital. The agencies recognize that the proposed capital deduction may have an effect on the calculation of the leverage ratio for the banking organization. Accordingly, the agencies also request comment on whether this effect is likely to be significant, whether an adjustment should be permitted to account for this effect, and, if so, what type of adjustment is appropriate.

3. Alternatives suggested by commenters

Commenters offered a variety of alternatives to the original capital proposal. Among these suggestions were to rely on internal capital models, to rely on the supervisory process for determining appropriate capital charges on a case-by-case basis, to require banking organizations to adopt the regulatory equivalent of available-for-sale accounting, and to adopt a reduced capital charge.

Many commenters suggested that the agencies rely fully on internal capital models developed by each banking organization to measure the capital needs of the organization across all of its activities. A number of commenters argued that the original capital proposal was flawed because it adopted a higher capital charge on equity investments in a manner similar to the internal capital models used by many banking organizations without at the same time allowing banking organizations to adopt features of these models that allocate less capital than the regulatory minimum capital requirements against other, less risky, activities.

The agencies believe that internal capital models that take account of the different risks and capital needs of each of the activities of a particular banking organization ultimately represent an effective method for determining the capital adequacy of an organization. The agencies have encouraged the development of comprehensive internal capital models, and many banking organizations have begun to develop their own internal capital models. As yet, however, these models are largely untested and unable to capture the risks of many activities conducted by banking organizations. Moreover, the stage of development and sophistication of models varies greatly across organizations. In addition, as noted by many commenters, assessing the adequacy of capital by reference to risk models is most effective when applied across the entire organizational risk structure, rather than piece meal for selected assets or portfolios. As a result, the agencies do not believe that it is appropriate at this time to rely on internal modeling of equity portfolios as a replacement for regulatory minimum capital requirements. The agencies believe, however, that robust internal modeling can be an effective method for addressing capital adequacy. Accordingly, the agencies will review a banking organization’s internal models in assessing the adequacy of the organization’s capital levels in relation to its equity investment activities and expect to revisit the need for regulatory minimum capital requirements for equity investment activities as internal models become more sophisticated and reliable.

Another alternative suggested by many commenters was that the agencies assess the appropriate regulatory capital levels for equity investment activities on a case-by-case basis through the supervisory process. These commenters argued that it was inappropriate for the agencies to adopt a single regulatory minimum capital requirement that would apply in the same way to all banking organizations engaged in equity investment activities, regardless of the differences in portfolio risks at different organizations. These commenters believed that the capital needs of individual organizations could be best assessed through the individual examination of each organization, with the agencies assessing higher capital requirements on a case-by-case basis to address particular risks at individual organizations.

The agencies agree that examination and supervision are important methods for assuring that individual organizations are conducting equity investment activities in a safe and sound manner and have adequate capital to support those activities. The agencies expect to pay particular attention to the investment activities of banking organizations and to heighten that supervision as the level of concentration in these activities increases at an organization. The supervisory process will consider, among other things, the institution’s internal allocation of capital to equity investment activities as an important element in assessing capital adequacy.

However, the agencies believe that supervisory experience and analysis of equity investment activities over a long period of time indicate that it is prudent to establish minimum capital requirements for equity investment activities in addition to effective supervision and examination. Establishing minimum capital requirements by rule also reduces the potential that capital requirements at an organization will be arbitrarily set during the examination process. A uniform regulatory minimum capital rule also indicates to organizations that are entering this business line for the first time the agencies’ expectations for additional capital to support these activities.

Some commenters suggested that the agencies require that banking organizations adopt the regulatory equivalent of available-for-sale (AFS) accounting.

Commenters argued that this approach improves the capital strength of an organization by eliminating from Tier 1 capital, at least for regulatory reporting purposes, any reliance on unrealized gains on equity investments. This arguably reduces the volatility in capital that results from changes in the value of equity investments, which often occur unpredictably and quickly during the life of the investment, by preventing banking organizations from taking unrealized gains into income, and thus capital, for regulatory purposes.

AFS accounting has been adopted by many organizations and represents a prudent and appropriate approach to accounting for equity investments in many situations. Nonetheless, the agencies have determined not to require the regulatory equivalent of this accounting treatment for regulatory capital calculations for several reasons. First, this approach does not address the risk associated with the initial cost of the investment. Instead, it effectively applies a 100 percent capital charge on unrealized gains while maintaining the normal capital charge on the initial investment cost. For investments that are very profitable, this charge may be too high, while for investments that are not performing well, this capital charge is likely to be too low.

In addition, an AFS approach creates differences in capital treatment for companies that acquired the same equity investment, with the same risk, on different dates. Under the AFS approach, an investor that has acquired an investment in the initial offering of stock of the portfolio company would be effectively required to hold more capital against the investment than a second investor that acquires the same amount of shares of the same company for a higher price at a later date.

Moreover, a capital charge based on the AFS approach is easily manipulated through the sale and repurchase of equity of the same company. This manipulation would be difficult to monitor and prevent.

While the agencies have not proposed adopting the regulatory equivalent of the AFS accounting approach, the agencies recognize that a regulatory minimum capital charge must take account of situations in which an investor determines to adopt this approach for GAAP reporting purposes. Accordingly, the capital charge proposed by the agencies is based on the "adjusted carrying value" of the relevant investment and the proposal would require deduction of the adjusted carrying value from risk-weighted assets for purposes of calculating the risk-based capital ratio. This treatment retains the flexibility of an investor to adopt AFS accounting or other accounting treatments permitted under GAAP.

PROPOSED AMENDMENTS TO THE BOARD'S CAPITAL RULES

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), 1843(k), 1844(b), 1972(l), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. In Appendix A to part 225, the following revisions are made:

a. In section II.A., one sentence is added at the end of paragraph 1.c., Minority interest in equity accounts of consolidated subsidiaries;

b. In section II.B., a new paragraph (v) is added at the end of the introductory paragraph and a new paragraph 5 is added at the end of section II.B; and

c. In sections III. and IV., footnotes 24 through 57 are redesignated as footnotes 29 through 62, respectively.

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

* * * * *

II. * * *

A. * * *

1. * * *

c. * * * Minority interests in small business investment companies and investment funds that hold nonfinancial equity investments (as defined in section II.B.5.b.) and minority interests in subsidiaries that are engaged in nonfinancial activities and held under one of the legal authorities listed in section II.B.5.b are not included in a banking organization's Tier 1 or total capital base.

* * * * *

B. * * *

(v) Nonfinancial equity investments–portions are deducted from the sum of core capital elements in accordance with section II.B.5 of this Appendix.

* * * * *

5. Nonfinancial equity investments. a. General. A bank holding company must deduct from its Tier 1 capital the appropriate percentage (as determined below) of the adjusted carrying value of all nonfinancial equity investments made by the parent bank holding company or by its direct or indirect subsidiaries.

b. Scope of nonfinancial equity investments. A nonfinancial equity investment means any equity investment made by the bank holding company (i) pursuant to the merchant banking authority of section 4(k)(4)(H) of the BHC Act and subpart J of the Board's Regulation Y, (ii) under section 4(c)(6) or 4(c)(7) of BHC Act in a nonfinancial company or in a company that makes investments in nonfinancial companies, (iii) in a nonfinancial company through a small business investment company (SBIC) under section 302(b) of the Small Business Investment Act of 1958,[24] (iv) in a nonfinancial company under the portfolio investment provisions of the Board's Regulation K (12 CFR 211.5(b)(1)(iii)) or (v) in a nonfinancial company under section 24 of the Federal Deposit Insurance Act (other than section 24(f)).[25] A nonfinancial company is an entity that engages in any activity that has not been determined to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act.

[24] An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in a SBIC that is not consolidated with the parent banking organization is treated as a nonfinancial equity investment.

[25] See 12 U.S.C. 1843(c)(6), (c)(7) and (k)(4)(H); 15 U.S.C. 682(b); 12 CFR 211.5(b)(1)(iii); and 12 U.S.C. 1831a(f). In a case in which the Board of the FDIC, acting directly in exceptional cases and after a review of the proposed activity, has permitted a lesser capital deduction for an investment approved by the Board of Directors under section 24 of the Federal Deposit Insurance Act, such deduction shall also apply to the consolidated bank holding company capital calculation so long as the bank's investments under section 24 and SBIC investments represent, in the aggregate, less than 15 percent of the Tier 1 capital of the bank.

This section II.B.5. does not apply to, and no deduction is required for, any nonfinancial equity investment that is held in the trading account in accordance with applicable accounting principles and as part of an underwriting, market making or dealing activity.

c. Amount of deduction from core capital. The bank holding company must deduct from its Tier 1 capital the appropriate percentage, as set forth in Table 1, of the adjusted carrying value of all nonfinancial equity investments held by the bank holding company and its subsidiaries. The amount of the deduction increases as the aggregate amount of nonfinancial equity investments held by the bank holding company and its subsidiaries increases as a percentage of the bank holding company's Tier 1 capital.

Table 1
Deduction for
Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank holding company (as a percentage of the Tier 1 capital of the parent banking organization)[26]	**Deduction from Tier 1 Capital (as a percentage of the adjusted carrying value of the investment)**
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

[26] For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of Tier 1 capital, Tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, but prior to the deduction for deferred tax assets and nonfinancial equity investments.

These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent holding company's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank holding company equals 20 percent of the Tier 1 capital of the bank holding company, then the amount of the deduction would be (i) 8 percent of the adjusted carrying value of all investments up to 15 percent of the company's Tier 1 capital, and (ii) 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the company's Tier 1 capital.

The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under this paragraph is excluded from the bank holding company's risk-weighted assets for purposes of computing the denominator of the company's risk-based capital ratio.[27]

As noted in section I, this Appendix establishes *minimum* risk-based capital ratios and banking organizations are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a banking organization from nonfinancial equity investments increases with its concentration in such investments and strong capital levels above the minimum requirements are particularly important when a banking organization has a high degree of concentration in nonfinancial equity investments (e.g., in excess of 50 percent of Tier 1 capital). The Federal Reserve intends to monitor banking organizations and apply heightened supervision to equity investment activities as appropriate, including where the banking organization has a high degree of concentration in nonfinancial equity investments, to ensure that organizations maintain capital levels that are appropriate in light of their equity investment activities. The Federal Reserve also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the banking organization, or other information, indicate that a higher minimum capital requirement is appropriate.

d. SBIC investments. No deduction is required for nonfinancial equity investments that are made by a bank holding company or a subsidiary through an

[27] For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from Tier 1 capital, the entire adjusted carrying value of the investment will be excluded from risk-weighted assets in calculating the denominator for the risk-based capital ratio.

SBIC that is consolidated with the bank holding company or in a SBIC that is not consolidated with the bank holding company to the extent that such investments, in the aggregate, do not exceed 15 percent of the aggregate Tier 1 capital of the subsidiary banks of the bank holding company. Any nonfinancial equity investment that is held through or in an SBIC and not deducted from Tier 1 capital will be assigned a 100 percent risk-weight and included in the parent holding company's consolidated risk-weighted assets.[28]

To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holding company holds through a consolidated SBIC or in a non-consolidated SBIC exceeds, in the aggregate, 15 percent of the aggregate Tier 1 capital of the company's subsidiary banks, the appropriate percentage of such amounts (as set forth in Table 1) must be deducted from the bank holding company's Tier 1 capital. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held through a consolidated SBIC and in a non-consolidated SBIC (including any investments for which no deduction is required) must be included in determining for purposes of Table 1 the total amount of nonfinancial equity investments held by the bank holding company in relation to its Tier 1 capital.

e. Transition provisions. [Comment requested.]

f. Adjusted carrying value. For purposes of this section II.B.5., the "adjusted carrying value" of investments is the aggregate value at which the investments are carried on the balance sheet of the consolidated bank holding company reduced by any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank holding company's Tier 1 capital. For example, for investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank holding company) less (i) any unrealized

[28] If a bank holding company has an investment in a SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank holding company, the adjusted carrying value of the bank holding company's nonfinancial equity investments through the SBIC is equal to the holding company's proportionate share of the SBIC's adjusted carrying value of its nonfinancial equity investments. The remainder of the SBIC's adjusted carrying value (i.e. the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank holding company.

gains on those investments that are included in other comprehensive income and not reflected in Tier 1 capital, and (ii) associated deferred tax liabilities.[29]

As discussed above with respect to consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial company that is consolidated for accounting purposes under generally accepted accounting principles, the parent banking organization's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the consolidated bank holding company's core capital in accordance with section II.B.1 of this Appendix). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit equivalent amounts of the company's off-balance sheet items) should be excluded from the banking organization's risk-weighted assets for regulatory capital purposes.

g. Equity investments. For purposes of this section II.B.5, an equity investment means any equity instrument (including warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity where the instrument or feature is held under one of the legal authorities listed in section II.B.5.b. above. An investment in subordinated debt or other types of debt instruments may be treated as an equity investment if, in the judgment of the appropriate federal banking agency, the instrument is the functional equivalent of equity.

* * * * *

3. In Appendix D to part 225, in section II.b., footnote 3 is revised and the fourth sentence of section II.b. is revised to read as follows.

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

* * * * *

[29] Unrealized gains on AFS investments may be included in supplementary capital to the extent permitted under section II.A.2.e of this Appendix. In addition, the unrealized losses on AFS equity investments are deducted from Tier 1 capital in accordance with section II.A.1.a of this Appendix.

II. * * *

b. * * *[3] As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the organization's Consolidated Financial Statements (FR Y-9C Report), less goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, are in excess of 25 percent of Tier 1 capital; all other identifiable intangible assets; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitations set forth in section II.B.4 of Appendix A of this part; the total adjusted carrying value of nonfinancial equity investments that are subject to a deduction from capital; and other investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital.

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, 92a, 93a, 248(a), 248(c), 321-338a, 371d, 461, 481-486, 601, 611, 1814, 1816, 1818, 1820(d), 1823(j), 1828(o), 1831o, 1831p-1, 1831r-1, 1831w, 1835a, 1882, 2901-2907, 3105, 3310, 3331-3351, and 3906-3909; 15 U.S.C. 78b, 781(b), 781(g), 781(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.

[3] Tier 1 capital for banking organizations includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of Tier 1 capital.) In addition, as a general matter, Tier 1 capital excludes goodwill; amounts o mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, i the aggregate, exceed 100 percent of Tier 1 capital; nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 25 percent of Tier 1 capital; all other identifiable intangible assets; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations; and a percentage of the organization's nonfinanci equity investments. The Federal Reserve may exclude certain other investments in subsidiaries or associated companies as appropriate.

2. In Appendix A to part 208, the following revisions are made:

a. In section II.A., one sentence is added at the end of paragraph 1.c., Minority interest in equity accounts of consolidated subsidiaries;

b. In section II.B., a new paragraph (v) is added at the end of the introductory paragraph and a new paragraph 5 is added at the end of section II.B; and

c. In sections III. and IV., footnotes 24 through 57 are redesignated as footnotes 29 through 62, respectively.

b. In section II.B., a new paragraph (v) is added at the end of the introductory paragraph and a new paragraph 5 is added at the end of section II.B.

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

* * * * *

II. * * *

A. * * *

1. * * *

c. * * * Minority interests in small business investment companies and investment funds that hold nonfinancial equity investments (as defined in section II.B.5.b.) and minority interests in subsidiaries that are engaged in nonfinancial activities and held under one of the legal authorities listed in section II.B.5.b are not included in the bank's Tier 1 or total capital base.

B. * * *

(v) Nonfinancial equity investments–portions are deducted from the sum of core capital elements in accordance with section II.B.5 of this Appendix.

* * * * *

5. Nonfinancial equity investments. a. General. A bank must deduct from its Tier 1 capital the appropriate percentage (as determined below) of the adjusted carrying value of all nonfinancial equity investments made by the parent bank or by its direct or indirect subsidiaries.

b. Scope of nonfinancial equity investments. A nonfinancial equity investment means any equity investment made by the bank in a nonfinancial company through a small business investment company (SBIC) under section 302(b) of the Small Business Investment Act of 1958[24] or under the portfolio investment provisions of the Board's Regulation K (12 CFR 211.5(b)(1)(iii)).[25] A nonfinancial company is an entity that engages in any activity that has not been determined to be permissible for the bank to conduct directly, or to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act.

This section II.B.5. does not apply to, and no deduction is required for, any nonfinancial equity investment that is held in the trading account in accordance with applicable accounting principles and as part of an underwriting, market making or dealing activity.

c. Amount of deduction from core capital. The bank must deduct from its Tier 1 capital the appropriate percentage, as set forth in Table 1, of the adjusted carrying value of all nonfinancial equity investments held by the bank and its subsidiaries. The amount of the deduction increases as the aggregate amount of nonfinancial equity investments held by the bank and its subsidiaries increases as a percentage of the bank's Tier 1 capital.

Table 1
Deduction for
Nonfinancial Equity Investments

[24] An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in a SBIC that is not consolidated with the bank is treated as a nonfinancial equity investment.

[25] See 12 CFR 211.5(b)(1)(iii); and 15 U.S.C. 682(b).

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank (as a percentage of the Tier 1 capital of the bank)[26]	**Deduction from Tier 1 Capital (as a percentage of the adjusted carrying value of the investment)**
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent bank's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank equals 20 percent of the Tier 1 capital of the bank, then the amount of the deduction would be (i) 8 percent of the adjusted carrying value of all investments up to 15 percent of the bank's Tier 1 capital, and (ii) 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the bank's Tier 1 capital.

The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under this paragraph is excluded from the bank's risk-weighted assets for purposes of computing the denominator of the bank's risk-based capital ratio.[27]

[26] For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of Tier 1 capital, Tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, but prior to the deduction for deferred tax assets and nonfinancial equity investments.

[27] For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from Tier 1 capital, the entire adjusted carrying value of the investment will be excluded from risk-weighted assets in calculating the denominator for the risk-based capital ratio.

As noted in section I, this Appendix establishes *minimum* risk-based capital ratios and banks are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a bank from nonfinancial equity investments increases with its concentration in such investments and strong capital levels above the minimum requirements are particularly important when a bank has a high degree of concentration in nonfinancial equity investments (e.g., in excess of 50 percent of Tier 1 capital). The Federal Reserve intends to monitor banks and apply heightened supervision to equity investment activities as appropriate, including where the bank has a high degree of concentration in nonfinancial equity investments, to ensure that banks maintain capital levels that are appropriate in light of their equity investment activities. The Federal Reserve also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the bank, or other information, indicate that a higher minimum capital requirement is appropriate.

d. SBIC investments. No deduction is required for nonfinancial equity investments that are made by a bank through an SBIC that is consolidated with the bank or in an SBIC that is not consolidated with the bank to the extent that such investments, in the aggregate, do not exceed 15 percent of the bank's Tier 1 capital. Any nonfinancial equity investment that is held through or in an SBIC and not deducted from Tier 1 capital will be assigned a 100 percent risk-weight and included in the bank's consolidated risk-weighted assets.[28]

To the extent the adjusted carrying value of all nonfinancial equity investments that are held by a bank through a consolidated SBIC or in a non-consolidated SBIC exceed, in the aggregate, 15 percent of the bank's Tier 1 capital, the appropriate percentage of such amounts (as set forth in Table 1) must be deducted from the bank's Tier 1 capital. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held through a consolidated SBIC and in a non-consolidated SBIC (including any investments for which no deduction is required) must be included in determining for purposes of Table 1 the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital.

[28] If a bank has an investment in a SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank, the adjusted carrying value of the bank's nonfinancial equity investments through the SBIC is equal to the bank's proportionate share of the SBIC's adjusted carrying value of its nonfinancial equity investments. The remainder of the SBIC's adjusted carrying value (i.e. the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank.

e. Transition provisions. [Comment requested.]

f. Adjusted carrying value. For purposes of this section II.B.5., the "adjusted carrying value" of investments is the aggregate value at which the investments are carried on the balance sheet of the bank reduced by any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank's Tier 1 capital. For example, for investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank) less (i) any unrealized gains on those investments that are included in other comprehensive income and not reflected in Tier 1 capital, and (ii) associated deferred tax liabilities.[29]

As discussed above with respect to consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial company that is consolidated for accounting purposes under generally accepted accounting principles, the bank's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the bank's core capital in accordance with section II.B.1 of this Appendix). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit equivalent amounts of the company's off-balance sheet items) should be excluded from the bank's risk-weighted assets for regulatory capital purposes.

g. Equity investments. For purposes of this section II.B.5., an equity investment means any equity instrument (including warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity where the instrument or feature is held under one of the legal authorities listed in section II.B.5.b. above. An investment in subordinated debt or other types of debt instruments may be treated as an equity investment if, in the judgment of the Federal Reserve, the instrument is the functional equivalent of equity.

* * * * *

[29] Unrealized gains on AFS investments may be included in supplementary capital to the extent permitted under section II.A.2.e of this Appendix. In addition, the unrealized losses on AFS equity investments are deducted from Tier 1 capital in accordance with section II.A.1.a of this Appendix.

3. In Appendix B to part 208, in section II.b., footnote 3 is revised and the fourth sentence of section II.b. is revised to read as follows.

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

* * * * *

II. * * *

b. * * *[3] As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income (Call Reports), less goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, are in excess of 25 percent of Tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted Tier 1 capital; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitations set forth in section II.B.4 of Appendix A of this part; and the total adjusted carrying value of nonfinancial equity investments that are subject to a deduction from capital.

[3] Tier 1 capital for state member banks includes common equity, minority interest in the equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, as a general matter, Tier 1 capital excludes goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, exceed 100 percent of Tier 1 capital; nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 25 percent of Tier 1 capital; other identifiable intangible assets; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations; and a percentage of the bank's nonfinancial equity investments. The Federal Reserve may exclude certain other investments in subsidiaries or associated companies as appropriate.