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Part II

Department of the Treasury
Office of the Comptroller of the Currency

12 CFR Parts 3 and 6

Federal Reserve System

12 CFR Parts 208 and 225

Federal Deposit Insurance Corporation

12 CFR Part 325

Department of the Treasury
Office of Thrift Supervision

12 CFR Parts 565 and 567

Risk-Based Capital Guidelines; Capital Adequacy Guidelines, and Capital Maintenance: Servicing Assets; Final Rule

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DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Parts 3 and 6

[Docket No. 98-10]

RIN 1557-AB14

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R-0976]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064-AC07

DEPARTMENT OF THE TREASURY

Office Of Thrift Supervision

12 CFR Parts 565 and 567

[Docket No. 98-68]

RIN 1550-AB11

Capital; Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Servicing Assets

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

ACTION: Final rule.

SUMMARY: The Office of the Comptroller of the Currency (OCC); the Board of Governors of the Federal Reserve System (Board); the Federal Deposit Insurance Corporation (FDIC); and the Office of Thrift Supervision (OTS) (collectively, the Agencies) are amending their capital adequacy standards for banks, bank holding companies, and savings associations (collectively, institutions or banking organizations) to address the regulatory capital treatment of servicing assets on both mortgage assets and financial assets other than mortgages (nonmortgages). This rule increases the maximum amount of servicing assets (when combined

with purchased credit card relationships (PCCRs)) that are includable in regulatory capital from 50 percent to 100 percent of Tier 1 capital. Servicing assets include the aggregate amount of mortgage servicing assets (MSAs) and nonmortgage servicing assets (NMSAs). It also applies a further sublimit of 25 percent of Tier 1 capital to the aggregate amount of NMSAs and PCCRs. The rule also subjects the valuation of MSAs, NMSAs, and PCCRs to a 10 percent discount. The final rule also modifies certain terms used in the Agencies' capital rules to be more consistent with the terminology found in accounting standards recently prescribed by the Financial Accounting Standards Board (FASB) for the reporting of these assets.

DATES: This final rule is effective October 1, 1998. The Agencies will not object if an institution wishes to apply the provisions of this final rule beginning on August 10, 1998.

FOR FURTHER INFORMATION CONTACT:

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Board: Arleen Lustig, Supervisory Financial Analyst (202/452-2987), Arthur W. Lindo, Supervisory Financial Analyst, (202/452-2695) or Thomas R. Boemio, Senior Supervisory Financial Analyst, (202/452-2982), Division of Banking Supervision and Regulation. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202) 452-3544, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551.

FDIC: For supervisory issues, Stephen G. Pfeifer, Examination Specialist, (202/898-8904), Accounting Section, Division of Supervision; for legal issues, Marc J. Goldstom, Counsel, (202/898-8807), Legal Division.

OTS: Michael D. Solomon, Senior Program Manager for Capital Policy, (202/906-5654), Christine Smith, Capital and Accounting Policy Analyst, (202/906-5740), or Timothy J. Stier, Chief Accountant, (202/906-5699), Vern McKinley, Senior Attorney, Regulations and Legislation Division (202/906-6241), Office of Thrift Supervision, 1700 G Street, N.W., Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION:

I. Background

This section describes the changes in accounting guidance that have prompted the Agencies to amend their risk-based and leverage capital rules with respect to servicing assets.

FAS 122

In May 1995, FASB issued Statement of Financial Accounting Standards No. 122, ``Accounting for Mortgage Servicing Rights'' (FAS 122), which eliminated the distinction in generally accepted accounting principles (GAAP) between originated mortgage servicing rights (OMSRs)

and purchased mortgage servicing rights (PMSRs). FAS 122 required that these assets, together known as mortgage servicing rights (MSRs), be treated as a single class of assets for financial statement purposes, regardless of how the servicing rights were acquired.¹ This change allowed OMSRs to be reported as balance sheet assets for the first time. Under FAS 122, OMSRs and PMSRs were treated the same for reporting, valuation, and disclosure purposes. Among other things, FAS 122 imposed valuation and impairment criteria based on the stratification of MSRs by their predominant risk characteristics. In addition, prior to FAS 122, GAAP treated MSRs as intangible assets. FAS 122 eliminated this characterization as unnecessary because similar characterizations as tangible or intangible are not applied to most other assets.

\1\ Mortgage servicing rights represent the contractual obligations undertaken by an institution to provide the servicing for mortgage loans owned by others, typically for a fee. Mortgage servicing rights generally have value to the servicing institution due to the present value of the expected net future cash flows for servicing mortgage assets. PMSRs are mortgage servicing rights that are purchased from other parties. The purchaser is not the originator of the mortgages. OMSRs, on the other hand, generally represent the servicing rights created when an institution originates mortgage loans and subsequently sells the loans but retains the servicing rights.

The Agencies adopted FAS 122 for regulatory reporting purposes and then issued a joint interim rule on the regulatory capital treatment of MSRs with a request for public comment on August 1, 1995 (60 FR 39226). The interim rule, which became effective upon publication, amended the Agencies' capital adequacy standards for mortgage servicing rights and intangible assets. It treated OMSRs in the same manner as PMSRs for regulatory capital purposes. The interim rule permitted banking organizations to include MSRs plus PCCRs in regulatory capital up to a limit of 50 percent of Tier 1 capital.² In addition, the interim rule applied a 10 percent valuation discount (or ``haircut'') to all MSRs and PCCRs. This haircut is statutorily required for PMSRs.³ The interim rule did not

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amend any other elements of the Agencies' capital rules.

\2\ For OTS purposes, Tier 1 capital is the same as core capital.

\3\ This 10 percent haircut is required by section 475 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) (12 U.S.C. 1828 note). Also see the Financial Institutions Recovery, Reform, and Enforcement Act (FIRREA) (12 U.S.C. 1464(t))

for the statute applicable to thrifts. It applies to the fair value of the MSRs so that the amount of MSRs recognized for regulatory capital purposes does not exceed 90 percent of the fair value.

FAS 125

In June 1996, FASB issued Statement of Financial Accounting Standards No. 125, 'Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities' (FAS 125), the servicing related provisions of which became effective on January 1, 1997. FAS 125, which superseded FAS 122, requires organizations to recognize separate servicing assets (or liabilities) for the contractual obligation to service financial assets (e.g., mortgage loans, credit card receivables) that the entities have either sold or securitized with servicing retained. Furthermore, servicing assets (or liabilities) that are purchased (or assumed) as part of a separate transaction must also be recognized under FAS 125.

FAS 125 also eliminates the previous distinction in GAAP between normal servicing fees and excess servicing fees.⁴ FAS 125 reclassifies these cash flows into two assets: (a) servicing assets, which are measured based on contractually specified servicing fees; and (b) interest-only (I/O) strips receivable, which reflect rights to future interest income from the serviced assets in excess of the contractually specified servicing fees. In addition, FAS 125 generally requires I/O strips and other financial assets (including loans, other receivables, and retained interests in securitizations) to be measured at fair value if they can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.⁵ However, under FAS 125, no servicing asset (or liability) need be recognized when a banking organization securitizes assets, retains all of the resulting securities, and classifies the securities as held-to-maturity in accordance with FAS 115.

\4\ Prior to FAS 125, excess servicing fees arose only when an organization sold loans but retained the servicing and received a servicing fee that was in excess of a normal servicing fee. Excess servicing fees receivable (ESFRs) represented the present value of the excess servicing fees and were reported as a separate asset on an institution's balance sheet.

\5\ These assets are to be measured at fair value like debt securities that are classified as available-for-sale or trading securities under FASB Statement No. 115, 'Accounting for Certain Investments in Debt and Equity Securities' (FAS 115).

FAS 125 also adopts the valuation approach established in FAS 122 for determining the impairment of mortgage servicing assets (MSAs) and extends this approach to all other servicing assets (i.e., servicing assets on financial assets other than mortgages). Thus, impairment

should be assessed based on the stratification of servicing assets by their predominant risk characteristics.

The Agencies issued interim guidance to banking organizations on December 18, 1996, to ensure banking organizations' compliance with FAS 125 for reporting purposes when the servicing-related provisions became effective on January 1, 1997. Under the interim guidance, the Agencies also clarified that their existing rules on mortgage servicing applied to all MSAs. Furthermore, consistent with their existing rules, the OCC, FDIC, and the Board did not allow the inclusion of NMSAs for regulatory capital purposes. The OTS included NMSAs in regulatory capital, subject to the same 50 percent of Tier 1 capital aggregate limit, 25 percent sublimit, and 10 percent haircut applicable to PCCRs.

II. Description of the Proposal

The Agencies issued a joint proposed rule on August 4, 1997 (62 FR 42006). The proposal raised three main questions: (1) Should the Agencies continue to retain a limitation on the amount of mortgage servicing assets that may be included in regulatory capital; (2) should the Agencies continue to deduct NMSAs for regulatory capital purposes; and, (3) should the Agencies impose regulatory capital limits on I/O strips receivable not in the form of a security or on certain other nonsecurity financial instruments subject to prepayment risk (collectively, I/O strips receivable)?

Specifically, with respect to the first issue, the Agencies proposed to increase the aggregate amount of MSAs and PCCRs that banking organizations could include in regulatory capital from 50 to 100 percent of Tier 1 capital. In addition, they proposed to apply the 10 percent haircut to all MSAs. The proposal also continued to subject PCCRs to a 10 percent haircut and a 25 percent of Tier 1 capital sublimit.

With respect to the second issue, the Agencies proposed to exclude from regulatory capital the amount of banking organizations' NMSAs. Prior to the adoption of FAS 125, NMSAs generally were not recognized as balance sheet assets for GAAP or regulatory reporting purposes.

With respect to the third issue, the Agencies requested comment on two options for the capital treatment of I/O strips receivable. Under Alternative A, I/O strips receivable, whether or not in the form of a security, would be included in Tier 1 capital on an unlimited basis; that is, they would not be subject to any Tier 1 capital deduction. Under Alternative B, I/O strips receivable not in the form of a security would be combined with the corresponding type of servicing assets and subject to the same capital limitation and 10 percent haircut (or capital deduction) that are applied to the related servicing assets.

In addition, the Agencies specifically requested public comment on a number of topics related to the proposal. The topics included the reliability of the fair values of servicing assets, the appropriate Tier 1 capital limitation for mortgage and NMSAs, and whether servicing assets that are disallowed for regulatory capital purposes should be deducted on a basis that is net of any associated deferred tax liability.

III. Summary of Comments and Description of the Final Rule

Final Rule

After considering the public comments received and discussed below, the Agencies have decided to amend their respective risk-based and leverage capital rules as follows:

(a) All servicing assets and PCCRs that are includable in capital are each subject to a 90 percent of fair value limitation (also known as a ``10 percent haircut``).

\6\ The Agencies have chosen to use FAS 125 terminology when referring to servicing assets and financial assets. The Agencies' regulatory reports (Reports of Condition and Income for commercial banks and FDIC-supervised savings banks, Thrift Financial Report (TFR) for savings associations, and Consolidated Financial Statements (FR Y-9C) for bank holding companies) also reflect FAS 125 definitions for the reporting of servicing assets. Consistent with the foregoing, the FDIC has made an additional technical clarification to its definition of ``mortgage servicing assets`` in 12 CFR 325.2(n) that conforms this definition more closely to the definitions used in the Agencies' regulatory reports.

(b) The aggregate amount of all servicing assets and PCCRs included in capital cannot exceed 100% of Tier 1 capital.

(c) The aggregate amount of NMSAs and PCCRs included in capital cannot exceed 25% of Tier 1 capital.

(d) All other intangible assets (other than qualifying PCCRs) must be deducted from Tier 1 capital.

Amounts of servicing assets and PCCRs in excess of the amounts allowable must be deducted in determining Tier 1 capital. Furthermore, I/O strips receivable, whether or not in security form, are not subject to any regulatory capital limitations under this rule.

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Summary of Comments

The Agencies collectively received 35 comment letters on the proposal during the comment period, which ended on October 3, 1997. The commenters represented a diverse group of organizations that included: Six banks, seven bank holding companies, seven Federal Reserve Banks, seven thrifts, seven trade associations, and one government sponsored enterprise. This final rule is similar in most respects to the Agencies' proposal, but incorporates several changes in response to comments received. The following analysis identifies and discusses the major issues raised in the comments and the Agencies' responses to these issues.

Capital Limitation for Mortgage Servicing Assets

The Agencies solicited comment on a proposal to increase the 50 percent of Tier 1 capital limit for MSAs and PCCRs to 100 percent of Tier 1 capital and to retain a 25 percent sublimit for PCCRs. The Agencies also requested comment on what the aggregate limit, if any, should be for the inclusion of MSAs and PCCRs in regulatory capital. The Agencies received 29 comments on this issue. Twenty-five of the 29

commenters supported increasing the 50 percent limit. Some of these commenters supported the proposal's increase to 100 percent of Tier 1 capital. Others recommended a higher Tier 1 capital limitation (e.g., 200 percent of capital), while still others recommended the complete elimination of any limitation on the amount of MSAs included in Tier 1 capital.

Those commenters supporting an increase in, or elimination of, the Tier 1 capital limit argued that the GAAP valuation and impairment requirements for MSAs under FAS 125, which are based on the lower of cost or market (LOCOM), are conservative. Therefore, they argued that these standards provide safeguards against the risks associated with these assets and preclude the need for regulatory capital limitations. They further reasoned that the fair value of MSAs is readily available in the active, mature market for MSAs. This information, in turn, allows market participants to use market-based data on prepayment speeds and discount rates to model the present values of MSAs using discounted cash flow valuation techniques. Furthermore, they argued that the use of the market-based data on prepayments, loan balances, delinquencies, and servicing costs helps reduce the volatility of reported values of servicing assets. Some of these commenters also noted that software packages used to determine fair values of MSAs enable servicers to more accurately value MSAs.

Several commenters who were in favor of eliminating the regulatory capital limit on MSAs believed that the Agencies' capital guidelines should focus on institutions' overall risk profiles rather than on limitations for specific types of assets, such as MSAs which are often hedged.

Furthermore, most commenters believed that the requirement to deduct from Tier 1 capital all amounts of MSAs exceeding the percent of Tier 1 capital limitation would continue to put insured institutions at a competitive disadvantage vis-a-vis non-regulated/nonbank entities. Such uninsured entities are not subject to the cost of this capital limitation, which increases insured institutions' costs for performing servicing and, in turn, limits the growth of their portion of the servicing and securitization markets.

Other commenters noted that the Tier 1 capital limit should be increased because the limit is considerably more constraining now than it was prior to the issuance of FAS 122 and FAS 125 because FAS 122 required the capitalization of OMSRs and FAS 125 redefined MSAs to include the bulk of ESFRs. The 50 percent limit was originally intended only for PMSRs, but is now applied to OMSRs and the large majority of what were formerly classified as ESFRs.

Four commenters opposed the increase of MSAs to 100 percent of Tier 1 capital noting problems in estimating their value, including difficulty in making assumptions regarding future loan repayments, credit quality, and interest rates. In addition, these commenters pointed out that a weak economy or significant changes in interest rates could exacerbate problems of uncertainty in valuing MSAs, due, in part, to changes in mortgage prepayment rates. One commenter noted that despite continued growth in the market, it is concerned that community banks holding relatively small amounts of these assets still face significant difficulties in obtaining accurate valuations. These commenters do not believe that, for their banking organizations, adequate information is available overall to make appropriate assumptions in calculating valuations and impairment.

The Agencies believe that increasing the limit of MSAs allowable in Tier 1 capital from 50 to 100 percent is appropriate and that the

application of more rigorous valuation and impairment standards for servicing assets pursuant to FAS 125 has improved the valuation of these assets.⁷ FAS 125 has significantly changed the

treatment of mortgage servicing from when Congress through FIRREA imposed PMSR limits on thrifts in 1989 and FDICIA imposed valuation criteria on all banks' and thrifts' PMSRs in 1991.⁸

Furthermore, the volume of servicing assets that is traded regularly in the market has greatly increased, making market-based data more readily available and information on prepayment rates, delinquency rates, and other servicing costs more accessible. However, the Agencies also believe that more experience with institutions' application of the valuation standard under FAS 125, as well as with the volatility of these assets, is needed before considering the removal, or further easing, of the Tier 1 capital limits. Therefore, as a result of development of the mortgage servicing markets and the improved valuation and impairment standards under FAS 122 and 125, the Agencies are increasing the Tier 1 capital limit for MSAs from 50 to 100 percent of Tier 1 capital.

\7\ Among other things, FAS 125 requires banking organizations to stratify their servicing assets based on one or more of their predominant risk characteristics. Thus, declines in fair market value of a particular stratum of servicing assets below cost must be recognized under GAAP, while gains in the value of another stratum of servicing assets may not offset losses experienced in other strata. This methodology discourages banking organizations from overvaluing their servicing portfolios because they will be required to recognize larger declines if prepayments occur.

\8\ The current 50 percent of Tier 1 capital limit applies to the aggregate amount of MSAs and PCCRs only. The final rule will apply the 100 percent of Tier 1 capital limit to the aggregate amount of MSAs, NMSAs, and PCCRs.

Purchased Credit Card Relationships

The Agencies proposed no changes to the current regulatory capital treatment of PCCRs, which are subject to the 100 percent of Tier 1 limit, to a 25 percent of Tier 1 capital sublimit, and to a 10 percent haircut. Although the Agencies did not specifically request comment on the capital treatment of PCCRs, except in the context of an aggregate limit when combined with servicing assets, the Agencies received six comments on the regulatory capital limitation of PCCRs. Generally, these commenters supported removing all regulatory capital limits on PCCRs, although a few supported some type of limitation. Since the Agencies did not solicit comments, they are not taking any action at this time.⁹

\9\ Under the existing rules, only PCCRs are subject to the sublimit of 25 percent of Tier 1 capital. Under the final rule, the

sublimit will apply to the aggregate amount of PCCRs and NMSAs.

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Nonmortgage Servicing Assets

The Agencies requested comment on whether servicing assets on nonmortgage financial assets should be recognized in Tier 1 capital. The Agencies received 18 comments addressing this issue. Five commenters supported the proposal's full deduction of NMSAs from regulatory capital because of valuation and market liquidity concerns. The other commenters recommended that the Agencies place either no limit on NMSAs or apply the proposed treatment for MSAs (i.e., 100 percent of Tier 1 capital).

The commenters opposing the proposal acknowledged that the market for NMSAs is less developed than for MSAs, but believed that the Agencies should not prevent the development of markets for NMSAs by excluding these assets from regulatory capital. These commenters argued that: (1) The rigorous valuation and impairment criteria of FAS 125 are conservative and provide sufficient protection against overvaluation of NMSAs; (2) NMSAs have less potential for volatility than MSAs because they typically have shorter lives than MSAs and are not as sensitive to changes in market interest rates; (3) fair values are obtainable for NMSAs using discounted cash flow models or market surveys of similar pricing arrangements; (4) excluding NMSAs from regulatory capital would put financial institutions at a serious competitive disadvantage with non-regulated entities; and (5) there is sufficient experience with contractual servicing fees related to securitizations to enable examiners to evaluate the appropriateness of such fees. Finally, these commenters argued that, under FAS 125, the majority of banks with substantial amounts of servicing assets and other nonsecurity financial instruments related to securitizations generally have sophisticated cost accounting systems and can clearly track their cost associated with servicing the securitized receivables. Therefore, these commenters contended that a fully developed public market in trading these servicing portfolios is not necessary in determining their fair value.10</sup>/sup>

\10\ One commenter noted that OTS-regulated institutions are currently allowed to include NMSAs in Tier 1 capital, subject to the same haircut and 25 percent sublimit as PCCRs. Therefore, they recommended a grandfathering provision for transactions that occurred prior to any change in the regulatory capital treatment of NMSAs. Under today's final rule, these grandfathering provisions are unnecessary.

The proposal also requested comment on what types of nonmortgage financial assets (other than loans secured by first liens on 1- to 4-family residential properties) banking organizations currently book as servicing assets or I/O strips receivable. Seven commenters responded

to this question. These commenters noted the following types of servicing assets: Commercial loans, automobile loans, credit card receivables, unsecured installment loans, student loans, Small Business Administration loans, home equity loans, commercial mortgages, recreational vehicle loans, and marine loans.

After careful consideration of these comments, the Agencies have decided to allow banking organizations to include NMSAs in Tier 1 capital, but subject the aggregate of NMSAs and PCCRs to the 25 percent of Tier 1 sublimit and to the 10 percent haircut. The Agencies believe that a conservative regulatory capital limit is appropriate until the depth and maturity of this market develops further. This approach allows banking organizations to include some prudently valued NMSAs in Tier 1 capital calculations, while retaining the supervisory safeguards that the Agencies believe are warranted in light of their concerns about the potential valuation, liquidity, and volatility of these assets.

\11\ While savings associations may include NMSAs in core (Tier 1) capital, they may not include such assets in tangible capital under 12 U.S.C. 1464(t)(9)(C). See OTS final rule at 12 CFR 567.12(b)(2). In addition, OTS has revised its definition of tangible equity under the prompt corrective action rule at 12 CFR 565.2(f). The revised rule reflects the fact that NMSAs are deducted from tangible equity and other minor technical changes.

Discounted Valuation ('`Haircut`')

The final rule retains the interim rule's application of the required 10 percent discount in valuing MSAs and PCCRs. Although the Agencies did not specifically request comment on this issue, nine commenters recommended elimination of the haircut. These commenters acknowledged that the valuation discount is required by statute for PMSRs, but advocated its elimination by legislative change. At a minimum, some commenters recommended that the haircut apply only to PMSRs, even though the application of the haircut to PMSRs could be difficult because PMSRs are not reported as separate assets under GAAP. These commenters argued that the haircut is an arbitrary and ineffective way to protect against prepayment and other risks. Instead, they believed that it is preferable to measure risks associated with MSAs and PCCRs as part of banking organizations' overall interest rate risk analyses. One commenter, however, supported retaining the ten percent haircut because it injects an element of conservatism into the regulatory capital measure. The final rule retains the 10 percent haircut for MSAs and PCCRs and extends it to NMSAs. The Agencies, however, may revisit this issue if Congress revises the current statutory requirement.

\12\ Section 115 of S. 1405, the Financial Regulatory Relief and Economic Efficiency Act, currently pending, could, among other things, provide discretion for the Agencies to reduce or eliminate

the ten percent haircut for PMSRs.

Interest-Only Strips Receivable

The Agencies proposed, and requested public comment on, two options for the capital treatment of I/O strips receivable. Under Alternative A, I/O strips receivable, whether or not in the form of a security, would be included in Tier 1 capital on an unlimited basis, that is, they would not be deducted from Tier 1 capital regardless of the amount of such holdings. Under Alternative B, I/O strips receivable not in the form of a security would be subject to the same capital limitations and 10 percent haircut that are applied to the related type of servicing assets. The Agencies also asked for comment on whether the definition of I/O strips receivable that could be subject to such capital limitations under Alternative B should be expanded to include certain other financial assets not in security form that have substantial prepayment risks (as defined in FAS 125).

The Agencies received 19 comments on the treatment of I/O strips receivable. Fourteen commenters supported Alternative A, contending that I/O strips receivable should not be subject to a Tier 1 capital limit. They asserted that I/O strips receivable associated with servicing assets are indistinguishable from I/O strip securities and should be treated consistently with other I/O strip securities, which are not subject to Tier 1 capital limitations. In addition, these commenters believed that, because the income stream of I/O strips receivable is not dependent on a banking organization servicing the underlying loans, I/O strips receivable should not necessarily be subject to the same capital requirement applied to the servicing assets on the same type of loans. Some commenters noted that banking organizations' interest rate risk models currently measure and assess the risk of I/O strips, which provide a better analytical foundation for establishing capital requirements than imposing rigid percentage-of-capital limitations. Other commenters stated

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that I/O strips receivable often serve as a credit enhancement to securities holders and therefore already are subject to the capital treatment for recourse obligations and direct credit substitutes.

Five commenters supported Alternative B. The reasons cited by these commenters included the difficulty of valuing I/O strips receivable because they are not securities, not rated, and not registered. These commenters also cited the lack of an active, liquid market because these assets are relatively new financial assets. One commenter argued that if I/O strips receivable are not subject to the same capital limitation as their related servicing assets, banking organizations may be inclined to avoid capital limitations by negotiating contracts that classify more of the cash flows as I/O strips receivable instead of servicing assets.

Based on the comments received and a further analysis of the issues, the Agencies have decided to adopt Alternative A. The Agencies agree that I/O strips receivable associated with servicing assets are sufficiently similar to I/O strip securities, which are not subject to a capital deduction requirement under current rules, to warrant consistent treatment. Furthermore, the agencies also recognize the

prudential effects of banking organizations' relying on their own risk assessment and valuation tools, particularly their interest-rate risk, market risk, and other analytical models. Accordingly, the Agencies will not apply a regulatory capital limitation to I/O strips receivable or non-security financial instruments under the final rule. Nevertheless, the Agencies will continue to review banking organizations' valuation of I/O strips receivable, evaluate concentrations of these assets relative to the organizations' regulatory capital levels, and determine whether cash flows are being correctly classified as either I/O strips receivable or servicing assets. As with other assets, the Agencies may, on a case-by-case basis, require banking organizations that the Agencies determine have high concentrations of these assets relative to their capital, or are otherwise at risk from these assets, to hold additional capital commensurate with their risk exposure.

In addition, the Agencies will continue to apply the capital treatment for assets sold with recourse to those arrangements where I/O strips receivable are used as a credit enhancement to absorb credit risk on the underlying loans that have been sold.

Other Issues

Excess Servicing Fees Receivables

The proposal requested comment on the appropriate capital treatment for amounts previously designated as ESFRs if a banking organization still maintains this breakdown for income tax or other purposes. The Agencies requested comment on ESFRs because, for tax purposes, banking organizations may continue to report ESFRs separately from servicing assets. The agencies were exploring whether any banking organizations that report ESFRs for tax purposes would similarly want to report ESFRs separately for regulatory capital purposes.

The Agencies received nine comments on this question. The commenters generally supported according ESFRs the same capital treatment as I/O strips receivable, because both ESFRs and I/O strips receivable can be sold separately from the servicing asset, or treating ESFRs like other servicing assets. If ESFRs are treated like I/O strips receivable, the commenters thought that they should not be subject to any regulatory capital limitations or valuation discounts. Other commenters noted that the Agencies' proposed increase of servicing assets to 100 percent is a meaningful liberalization because more assets, including many ESFRs, may fall within the scope of the limit. One commenter, however, recommended a 200 percent capital limit.

Under this final capital rule, banking organizations should follow FAS 125 in reporting cash flows as either servicing assets or I/O strips receivable. Some cash flows that were previously categorized as ESFRs, particularly ESFRs not related to residential mortgage loans, will be classified as I/O strips receivable. On the other hand, some excess servicing fees may become part of the contractually specified servicing fees under FAS 125. The Agencies' decision to increase the Tier 1 capital limitation from 50 to 100 percent should mitigate the capital effects of including such ESFRs in servicing assets.

Hedging the Servicing Assets Portfolio

The proposal requested comment on what effect efforts to hedge the MSA portfolio should have on the application of capital limitations to various types of servicing assets. Thirteen commenters addressed this question. Two commenters believed that efforts to hedge the mortgage servicing asset portfolio should not impact the capital limitations for

these assets. Alternatively, six commenters supported the incorporation of hedging into banking organizations' capital computations. Two of these commenters recommended a method of incorporating hedging into the capital calculation by allowing institutions to include directly hedged servicing assets in Tier 1 capital without any regulatory capital limitation. One commenter noted that the Agencies should defer a decision on this issue until FASB completes its guidance on hedging.

The Agencies recognize the important function of hedging servicing assets due to the inherent volatility of these assets. Banking organizations with substantial portfolios of servicing assets generally should hedge these portfolios. However, because the Agencies have not had sufficient experience with institutions' hedging of servicing and other assets covered by FAS 125, the Agencies are not adjusting the capital limitations in this final rule to adjust for hedging. The Agencies may revisit this issue when they evaluate any changes that FASB may make to hedge accounting under GAAP.

Net of Tax

The proposal asked for comment on whether servicing assets that are disallowed for regulatory capital purposes should be deducted on a basis that is net of any associated deferred tax liability. Several commenters addressed this issue. Those commenters unanimously agreed that servicing assets and PCCRs deducted from Tier 1 capital under this rule should be deducted on a basis that is net of any associated deferred tax liability. Thus, this final rule gives banking organizations the option to deduct otherwise disallowed servicing assets on a basis that is net of any associated deferred tax liability. Any deferred tax liability used in this manner would not be available for the organization to use in determining the amount of net deferred tax assets that may be included for the purposes of Tier 1 capital calculations.

\13\ The OTS' current rule addresses the net of tax issue and the OTS has made minor technical changes to its final rule text. The OTS is also reviewing its TFR instructions implementing this provision to better accord with this rulemaking.

Tangible Equity

No comments were received on conforming the terminology in the definition of tangible equity found in each Agency's regulation for Prompt Corrective Action to reflect the FAS 125 conceptual changes for measuring servicing assets. Therefore, the term ``mortgage servicing assets'' will replace ``mortgage servicing rights'' in the

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definition of tangible equity in each Agency's Prompt Corrective Action regulation.

\14\ See OTS changes to tangible equity at footnote number 11.

III. Regulatory Flexibility Act Analysis

OCC Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Comptroller of the Currency certifies that this final 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 adoption of this final rule would reduce the regulatory burden of small businesses by aligning the terminology in the capital adequacy standards more closely to newly-issued generally accepted accounting principles and by relaxing the capital limitation on servicing assets. The economic impact of this final rule on banks, regardless of size, is expected to be minimal.

Board Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board certifies that this final 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 effect of this final rule would be to reduce the regulatory burden of banks and bank holding companies by aligning the terminology in the capital adequacy guidelines more closely to newly-issued generally accepted accounting principles and by relaxing the capital limitation on servicing assets. In addition, because the risk-based and leverage capital guidelines generally do not apply to bank holding companies with consolidated assets of less than \$150 million, this final rule will not affect such companies.

FDIC Regulatory Flexibility Act

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 this final rule would not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. The amendment concerns capital requirements for servicing assets held by depository institutions of any size. More specifically, it changes the current capital treatment of servicing assets by allowing depository institutions to include more of their servicing assets in Tier 1 capital. It would also reduce regulatory burden on the depository institutions (including small businesses) by aligning the terminology used in the capital adequacy guidelines more closely to newly-issued generally accepted accounting principles. The economic impact of this final rule on banks, regardless of size, is expected to be minimal.

OTS Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the OTS certifies that this final rule would not have a significant economic impact on a substantial number of small entities. The

amendment concerns capital requirements for servicing assets which may be entered into by depository institutions of any size. The effect of the final rule would be to reduce regulatory burden on depository institutions by aligning the terminology used in the capital adequacy standards more closely to newly-issued generally accepted accounting principles and by relaxing the capital limitation on servicing assets. The economic impact of this final rule on savings associations, regardless of size, is expected to be minimal.

IV. Early Compliance

Subject to certain exceptions, 12 U.S.C. 4802(b) provides that new regulations and amendments to regulations prescribed by a Federal banking agency which impose additional reporting, disclosures, or other new requirements on an insured depository institution shall take effect on the first day of a calendar quarter which begins on or after the date on which the regulations are published in final form. However, section 4802(b) also permits persons who are subject to such regulations to comply with the regulation before its effective date. Accordingly, the Agencies will not object if an institution wishes to apply the provisions of this final rule beginning with the date it is published in the Federal Register.

V. Paperwork Reduction Act

The Agencies have determined that this final rule would not create or change any collection of information pursuant to the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 et seq.).

VI. OCC and OTS Executive Order 12866 Statement

The Comptroller of the Currency and the Director of the OTS have determined that this final rule is not a significant regulatory action under Executive Order 12866. Accordingly, a regulatory impact analysis is not required.

VII. OCC and OTS Unfunded Mandates Act Statement

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, this amendment to the capital adequacy standards would relax the capital limitation on servicing assets and PCCRs. Further, the amendment moves toward greater consistency with FAS 125 in an effort to reduce the burden of complying with two different standards. Thus, no additional cost of \$100 million or more, to State, local, or tribal governments or to the private sector will result from this final rule. Accordingly, the OCC and the OTS have not prepared a budgetary impact statement nor specifically addressed any regulatory alternatives.

List of Subjects

12 CFR Part 3

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

12 CFR Part 6

National banks, Prompt corrective action.

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 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 325

Administrative practice and procedure, Banks, banking, Capital

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adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

12 CFR Part 565

Administrative practice and procedure, Capital, Savings associations.

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, parts 3 and 6 of chapter I of title 12 of the Code of Federal Regulations are amended as set forth below:

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, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907, and 3909.

2. Section 3.100 is amended by revising paragraph (c)(2) and by removing the words ``mortgage servicing rights'' in paragraphs (e)(7) and (g)(2) and adding ``mortgage servicing assets'' in their place to read as follows:

Sec. 3.100 Capital and surplus.

* * * * *

(c) * * *

(2) Mortgage servicing assets;

* * * * *

3. In appendix A to part 3, paragraph (c)(14) of section 1. is revised to read as follows:

Appendix A to Part 3--Risk-Based Capital Guidelines

Section 1. Purpose, Applicability of Guidelines, and Definitions

* * * * *

(c) * * *

(14) Intangible assets include mortgage and non-mortgage servicing assets (but exclude any interest only (IO) strips receivable related to these mortgage and nonmortgage servicing assets), purchased credit card relationships, goodwill, favorable leaseholds, and core deposit value.

* * * * *

4. In appendix A to part 3, paragraphs (c) introductory text, (c)(1), and (c)(2) of section 2 are revised to read as follows:

* * * * *

Section 2. Components of Capital.

* * * * *

(c) Deductions from Capital. The following items are deducted from the appropriate portion of a national bank's capital base when calculating its risk-based capital ratio:

(1) Deductions from Tier 1 Capital. The following items are deducted from Tier 1 capital before the Tier 2 portion of the calculation is made:

(i) Goodwill;

(ii) Other intangible assets, except as provided in section 2(c)(2) of this appendix A; and

(iii) Deferred tax assets, except as provided in section 2(c)(3) of this appendix A, that are dependent upon future taxable income, which exceed the lesser of either:

(A) The amount of deferred tax assets that the bank could reasonably expect to realize within one year of the quarter-end Call Report, based on its estimate of future taxable income for that year; or

(B) 10% of Tier 1 capital, net of goodwill and all intangible assets other than mortgage servicing assets, non-mortgage servicing assets, and purchased credit card relationships, and before any disallowed deferred tax assets are deducted.

(2) Qualifying intangible assets. Subject to the following conditions, mortgage servicing assets, nonmortgage servicing assets

⁶ and purchased credit card relationships need not be deducted from Tier 1 capital:

6\ Intangible assets are defined to exclude any IO strips receivable related to these mortgage and non-mortgage servicing assets. See section 1(c)(14) of this appendix A. Consequently, IO strips receivable related to mortgage and non-mortgage servicing assets are not required to be deducted under section 2(c)(2) of this appendix A. However, these IO strips receivable are subject to a 100 percent risk weight under section 3(a)(4) of this appendix A.

(i) The total of all intangible assets that are included in Tier 1 capital is limited to 100 percent of Tier 1 capital, of which no more than 25 percent of Tier 1 capital can consist of purchased credit card relationships and non-mortgage servicing assets in the aggregate. Calculation of these limitations must be based on Tier 1 capital net of goodwill and all identifiable intangible assets, other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships.

(ii) Banks must value each intangible asset included in Tier 1 capital at least quarterly at the lesser of:

(A) 90 percent of the fair value of each intangible asset, determined in accordance with section 2(c)(2)(iii) of this appendix A; or

(B) 100 percent of the remaining unamortized book value.

(iii) The quarterly determination of the current fair value of the intangible asset must include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates.

(iv) Banks may elect to deduct disallowed servicing assets on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income.

* * * * *

PART 6--PROMPT CORRECTIVE ACTION

1. The authority citation for part 6 continues to read as follows:

Authority: 12 U.S.C. 93a, 1831o.

2. Section 6.2 is amended by revising paragraph (g) to read as follows:

Sec. 6.2 Definitions.

* * * * *

(g) Tangible equity means the amount of Tier 1 capital elements in the OCC's Risk-Based Capital Guidelines (appendix A to part 3 of this chapter) plus the amount of outstanding cumulative perpetual preferred

stock (including related surplus) minus all intangible assets except mortgage servicing assets to the extent permitted in Tier 1 capital under section 2(c)(2) in appendix A to part 3 of this chapter.

* * * * *

Dated: July 17, 1998.
Julie L. Williams,
Acting Comptroller of the Currency.

Federal Reserve System

12 CFR Chapter II

For the reasons set forth in the joint preamble, the Board of Governors of the Federal Reserve System amends parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations 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, 92a, 93a, 248(a), 248(c), 321-338a, 371d, 461, 481-486, 601, 611, 1814, 1816, 1818, 1823(j), 1828(o), 1831o, 1831p-1, 1831r-1, 1835a, 1882, 2901-2907, 3105, 3310, 3331-3351 and 3906-3909; 15 U.S.C. 78b, 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.

2. Section 208.41, as revised at 63 FR 37652 effective October 1, 1998, is amended by revising paragraph (f) to read as follows:

Sec. 208.41 Definitions for purposes of this subpart.

* * * * *

(f) Tangible equity means the amount of core capital elements as defined in the Board's Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure (Appendix A to this part), plus the amount of outstanding cumulative perpetual preferred stock (including related surplus), minus all intangible assets except mortgage

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servicing assets to the extent that the Board determines that mortgage servicing assets may be included in calculating the bank's Tier 1 capital.

* * * * *

3. In Appendix A to part 208, sections II.B.1.b.i. through II.B.1.b.v. are revised to read as follows:

Appendix A to Part 208--Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure

* * * * *

II. * * *
B. * * *

1. Goodwill and other intangible assets * * *

b. Other intangible assets. i. All servicing assets, including servicing assets on assets other than mortgages (i.e., nonmortgage servicing assets) are included in this Appendix A as identifiable intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, a bank's capital are readily marketable mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships. The total amount of these assets included in capital, in the aggregate, can not exceed 100 percent of Tier 1 capital. Nonmortgage servicing assets and purchased credit card relationships are subject to a separate sublimit of 25 percent of Tier 1 capital.

\14\ Amounts of servicing assets and purchased credit card relationships in excess of these limitations, as well as identifiable intangible assets, including core deposit intangibles, including favorable leaseholds, are to be deducted from a bank's core capital elements in determining Tier 1 capital. However, identifiable intangible assets (other than mortgage servicing assets and purchased credit card relationships) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, 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, regardless of the date acquired, but prior to the deduction of deferred tax assets.

iii. The amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that a bank may include in capital shall be the lesser of 90 percent of their fair value, as determined in accordance with this section, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions in the commercial bank Consolidated Reports of Condition and Income (Call Reports). If both the application of the limits on mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships and the adjustment of the balance sheet amount for these assets would result in an amount being deducted from capital, the bank would deduct only the greater of the two amounts from its core capital elements in determining Tier 1 capital.

iv. Banks may elect to deduct disallowed servicing assets on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income.

v. Banks must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary.

The fair value of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships also must be determined at least quarterly. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates. Examiners will review both the book value and the fair value assigned to these assets, together with supporting documentation, during the examination process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of a bank's intangible assets.

* * * * *

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

* * * * *

II. * * *

B. * * *

4. Deferred tax assets. The amount of deferred tax assets that is dependent upon future taxable income, net of the valuation allowance for deferred tax assets, that may be included in, that is, not deducted from, a bank's capital may not exceed the lesser of (i) the amount of these deferred tax assets that the bank is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year,^{²⁰}

or (ii) 10 percent of Tier 1 capital. The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of the lesser of these two amounts is to be deducted from a bank's core capital elements in determining Tier 1 capital. For purposes of calculating the 10 percent limitation, Tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all other identifiable intangible assets other than mortgage and nonmortgage servicing assets and purchased credit card relationships, before any disallowed deferred tax assets are deducted. There generally is no limit in Tier 1 capital on the amount of deferred tax assets that can be realized from taxes paid in prior carry-back years or from future reversals of existing taxable temporary differences, but, for banks that have a parent, this may not exceed the amount the bank could reasonably expect its parent to refund.

\ 20\ To determine the amount of expected deferred-tax assets realizable in the next 12 months, an institution should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating-loss carry-forwards to be used during that year or the amount of existing temporary differences a bank expects to reverse within the year. Such projections should include the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating losses or tax-credit carry-forwards that would otherwise expire during the year. Institutions do not have to prepare a new 12-month projection each quarter. Rather, on interim report dates, institutions may use the future-taxable-income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

* * * * *

5. In Appendix B to part 208, 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. A bank's Tier 1 leverage ratio is calculated by dividing its Tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of Tier 1 capital as set forth in the risk-based capital guidelines contained in Appendix A of this part will be used.² 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 from Tier 1 capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of Appendix A of this part.³

\2\ 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; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

\3\ Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. in Appendix A of this part.

* * * * *

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

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. In Appendix A to part 225, sections II.B.1.b.i. through II.B.1.B.v. are revised to read as follows:

Appendix A to Part 225--Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure

* * * * *

II. * * *

B. * * *

1. Goodwill and other intangible assets * * *

b. Other intangible assets. i. All servicing assets, including servicing assets on assets other than mortgages (i.e., nonmortgage servicing assets) are included in this Appendix A as identifiable intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, an organization's capital are readily marketable mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships. The total amount of these assets included in capital, in the aggregate, cannot exceed 100 percent of Tier 1 capital. Nonmortgage servicing assets and purchased credit card relationships are subject, in the aggregate, to a sublimit of 25 percent of Tier 1 capital.¹⁵

\15\ Amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from an organization's core capital elements in determining Tier 1 capital. However, identifiable intangible assets (other than mortgage servicing assets, and purchased credit card relationships) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, Tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable

intangible assets and similar assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, regardless of the date acquired, but prior to the deduction of deferred tax assets.

iii. The amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that a bank holding company may include in capital shall be the lesser of 90 percent of their fair value, as determined in accordance with this section, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C Report). If both the application of the limits on mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships and the adjustment of the balance sheet amount for these intangibles would result in an amount being deducted from capital, the bank holding company would deduct only the greater of the two amounts from its core capital elements in determining Tier 1 capital.

iv. Bank holding companies may elect to deduct disallowed servicing assets on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income.

v. Bank holding companies must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair value of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships also must be determined at least quarterly. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates. Examiners will review both the book value and the fair value assigned to these assets, together with supporting documentation, during the inspection process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of an organization's intangible assets or similar assets.

* * * * *

3. In Appendix A to part 225, section II.B.4. is revised to read as follows:

* * * * *

II. * * *

B. * * *

4. Deferred tax assets. The amount of deferred tax assets that is dependent upon future taxable income, net of the valuation allowance for deferred tax assets, that may be included in, that is, not deducted from, a banking organization's capital may not exceed the lesser of (i) the amount of these deferred tax assets that the banking organization is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year, <SUP>23</SUP> or (ii) 10 percent of

Tier 1 capital. The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of the lesser of these two amounts is to be deducted from a banking organization's core capital elements in determining Tier 1 capital. For purposes of calculating the 10 percent limitation, 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, before any disallowed deferred tax assets are deducted. There generally is no limit in Tier 1 capital on the amount of deferred tax assets that can be realized from taxes paid in prior carryback years or from future reversals of existing taxable temporary differences.

\23\ To determine the amount of expected deferred tax assets realizable in the next 12 months, an institution should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating loss carryforwards to be used during that year or the amount of existing temporary differences a bank holding company expects to reverse within the year. Such projections should include the estimated effect of tax planning strategies that the organization expects to implement to realize net operating losses or tax credit carryforwards that would otherwise expire during the year. Institutions do not have to prepare a new 12 month projection each quarter. Rather, on interim report dates, institutions may use the future taxable income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

* * * * *

4. In Appendix D to part 225, 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

* * * * *

II. * * *

b. A banking organization's Tier 1 leverage ratio is calculated by dividing its Tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of Tier 1 capital as set forth in the risk-based capital guidelines contained in Appendix A of this part will be used.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; any investments in subsidiaries or associated companies that the Federal

Reserve determines should be deducted from Tier 1

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capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of Appendix A of this part.⁴

\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 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; all other identifiable intangible assets; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

\4\ Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. in Appendix A of this part.

* * * * *

By order of the Board of Governors of the Federal Reserve System, August 3, 1998.
Jennifer J. Johnson,
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 amended as follows:

PART 325--CAPITAL MAINTENANCE

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

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 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, as amended by Pub. L. 103-325, 108 Stat. 2160, 2233 (12 U.S.C. 1828 note); Pub. L. 102-242, 105 Stat. 2236, 2386, as amended

by Pub. L. 102-550, 106 Stat. 3672, 4089 (12 U.S.C. 1828 note).

2. In Sec. 325.2, paragraph (n) is revised to read as follows:

Sec. 325.2 Definitions.

* * * * *

(n) Mortgage servicing assets means those assets (net of any related valuation allowances) that result from contracts to service loans secured by real estate (that have been securitized or are owned by others) for which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing. For purposes of determining regulatory capital under this part, mortgage servicing assets will be recognized only to the extent that the assets meet the conditions, limitations, and restrictions described in Sec. 325.5 (f).

* * * * *

Sec. 325.2 [Amended]

3. In Sec. 325.2, paragraph (s) is amended by removing the words ``mortgage servicing rights'' and adding in their place the words ``mortgage servicing assets'' each time they appear.

4. In Sec. 325.2, paragraphs (t) and (v) are amended by removing the words ``mortgage servicing rights'' and adding in their place the words ``mortgage servicing assets, nonmortgage servicing assets,'' each time they appear.

5. In Sec. 325.5, paragraph (f) is revised to read as follows:

Sec. 325.5 Miscellaneous.

* * * * *

(f) Treatment of mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets. For purposes of determining Tier 1 capital under this part, mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets will be deducted from assets and from common stockholders' equity to the extent that these items do not meet the conditions, limitations, and restrictions described in this section. Banks may elect to deduct disallowed servicing assets on a basis that is net of any associated deferred tax liability. Any deferred tax liability netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income and calculating the maximum allowable amount of these assets under paragraph (g) of this section.

(1) Valuation. The fair value of mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets shall be estimated at least quarterly. The quarterly fair value estimate shall include adjustments for any significant changes in the original valuation assumptions, including changes in prepayment estimates or attrition rates. The FDIC in its discretion may require independent fair value estimates on a case-by-case basis where it is deemed appropriate for safety and soundness purposes.

(2) Fair value limitation. For purposes of calculating Tier 1

capital under this part (but not for financial statement purposes), the balance sheet assets for mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets will each be reduced to an amount equal to the lesser of:

(i) 90 percent of the fair value of these assets, determined in accordance with paragraph (f)(1) of this section; or

(ii) 100 percent of the remaining unamortized book value of these assets (net of any related valuation allowances), determined in accordance with the instructions for the preparation of the Consolidated Reports of Income and Condition (Call Reports).

(3) Tier 1 capital limitation. The maximum allowable amount of mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets, in the aggregate, will be limited to the lesser of:

(i) 100 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed nonmortgage servicing assets, and any disallowed deferred tax assets; or

(ii) The sum of the amounts of mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets determined in accordance with paragraph (f)(2) of this section.

(4) Tier 1 capital sublimit. In addition to the aggregate limitation on mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets set forth in paragraph (f)(3) of this section, a sublimit will apply to purchased credit card relationships and nonmortgage servicing assets. The maximum allowable amount of purchased credit card relationships and nonmortgage servicing assets, in the aggregate, will be limited to the lesser of:

(i) Twenty-five percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed nonmortgage servicing assets, and any disallowed deferred tax assets; or

(ii) The sum of the amounts of purchased credit card relationships and nonmortgage servicing assets, determined in accordance with paragraph (f)(2) of this section.

* * * * *

Sec. 325.5 [Amended]

6. In Sec. 325.5, paragraph (g)(2)(i)(B) is amended by removing the words ``any disallowed mortgage servicing rights'' and adding in their place the words ``any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets''.

7. In Sec. 325.5, paragraph (g)(5) is amended by removing the words ``mortgage servicing rights'' and adding in their place the words ``mortgage servicing assets, nonmortgage servicing assets''.

Appendix A to Part 325--[Amended]

8. In appendix A to part 325, the words ``mortgage servicing rights'' are removed and the words ``mortgage servicing assets, nonmortgage servicing assets'' are added each time they appear in section I.A.1., section I.B.(1) and footnote 8 to section I.B.(1), section II.C., and Table I--Definition of Qualifying Capital and

footnote 2 to Table I.

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Appendix B to Part 325--[Amended]

9. In appendix B to part 325, section IV.A. and footnote 1 to section IV.A. are amended by removing the words ``mortgage servicing rights'' and adding in their place the word ``mortgage servicing assets, nonmortgage servicing assets'' each time they appear.

Dated at Washington, D.C., this 7th day of July, 1998.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.
Robert E. Feldman,
Executive Secretary.

Office of Thrift Supervision

12 CFR Chapter V

For the reasons set forth in the joint preamble, the Office of Thrift Supervision amends parts 565 and 567 of chapter V of title 12 of the Code of Federal Regulations as follows:

PART 565--PROMPT CORRECTIVE ACTION

1. The authority citation for part 565 continues to read as follows:

Authority: 12 U.S.C. 1831o.

2. Section 565.2 is amended by revising paragraph (f) to read as follows:

Sec. 565.2 Definitions.

* * * * *

(f) Tangible equity means the amount of a savings association's core capital as computed in part 567 of this chapter plus the amount of its outstanding cumulative perpetual preferred stock (including related surplus), minus intangible assets as defined in Sec. 567.1 of this chapter and nonmortgage servicing assets that have not been previously deducted in calculating core capital.

* * * * *

PART 567--CAPITAL

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

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a, 1828 (note).

4. Section 567.1 is amended by revising the definition for Intangible assets to read as follows:

Sec. 567.1 Definitions.

* * * * *

Intangible assets. The term intangible assets means assets considered to be intangible assets under generally accepted accounting principles. These assets include, but are not limited to, goodwill, core deposit premiums, purchased credit card relationships, and favorable leaseholds. Servicing assets are not intangible assets, and interest-only strips receivable and other nonsecurity financial instruments are not intangible assets under this definition.

* * * * *

5. Section 567.5 is amended by revising paragraph (a)(2)(ii) to read as follows:

Sec. 567.5 Components of capital.

(a) * * *

(2) * * *

(ii) Servicing assets that are not includable in core capital pursuant to Sec. 567.12 of this part are deducted from assets and capital in computing core capital.

* * * * *

6. Section 567.6 is amended by revising paragraphs (a)(1)(iv)(L) and (a)(1)(iv)(M) to read as follows:

Sec. 567.6 Risk-based capital credit risk-weight categories.

(a) * * *

(1) * * *

(iv) * * *

(L) Certain nonsecurity financial instruments including servicing assets and intangible assets includable in core capital under Sec. 567.12 of this part;

(M) Interest-only strips receivable;

* * * * *

7. Section 567.9 is amended by revising paragraph (c)(1) to read as follows:

Sec. 567.9 Tangible capital requirement.

* * * * *

(c) * * *

(1) Intangible assets, as defined in Sec. 567.1 of this part, and servicing assets not includable in tangible capital pursuant to Sec. 567.12 of this part.

* * * * *

6. Section 567.12 is amended by revising the section heading and paragraphs (a) through (f) to read as follows:

Sec. 567.12 Intangible assets and servicing assets.

(a) Scope. This section prescribes the maximum amount of intangible assets and servicing assets that savings associations may include in calculating tangible and core capital.

(b) Computation of core and tangible capital. (1) Purchased credit card relationships may be included (that is, not deducted) in computing core capital in accordance with the restrictions in this section, but must be deducted in computing tangible capital.

(2) In accordance with the restrictions in this section, mortgage servicing assets may be included in computing core and tangible capital and nonmortgage servicing assets may be included in core capital.

(3) Intangible assets, as defined in Sec. 567.1 of this part, other than purchased credit card relationships described in paragraph (b)(1) of this section and core deposit intangibles described in paragraph (g)(3) of this section, are deducted in computing tangible and core capital.

(c) Market valuations. The OTS reserves the authority to require any savings association to perform an independent market valuation of assets subject to this section on a case-by-case basis or through the issuance of policy guidance. An independent market valuation, if required, shall be conducted in accordance with any policy guidance issued by the OTS. A required valuation shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or attrition rates. The valuation shall determine the current fair value of assets subject to this section. This independent market valuation may be conducted by an independent valuation expert evaluating the reasonableness of the internal calculations and assumptions used by the association in conducting its internal analysis. The association shall calculate an estimated fair value for assets subject to this section at least quarterly regardless of whether an independent valuation expert is required to perform an independent market valuation

(d) Value limitation. For purposes of calculating core capital under this part (but not for financial statement purposes), purchased credit card relationships and servicing assets must be valued at the lesser of:

(1) 90 percent of their fair value determined in accordance with paragraph (c) of this section; or

(2) 100 percent of their remaining unamortized book value determined in accordance with the instructions for the Thrift Financial Report.

(e) Core capital limitation--(1) Aggregate limit. The maximum aggregate amount of servicing assets and purchased credit card relationships that may be included in core capital shall be limited to the lesser of:

(i) 100 percent of the amount of core capital computed before the deduction of any disallowed servicing assets and disallowed purchased credit card relationships; or

(ii) The amount of servicing assets and purchased credit card relationships determined in accordance with paragraph (d) of this section.

(2) Reduction by deferred tax liability. Associations may elect to deduct disallowed servicing assets on a basis

that is net of any associated deferred tax liability.

(3) Sublimit for purchased credit card relationships and non mortgage-related servicing assets. In addition to the aggregate limitation in paragraph (e)(1) of this section, a sublimit shall apply to purchased credit card relationships and non mortgage-related servicing assets. The maximum allowable amount of these two types of assets combined shall be limited to the lesser of:

(i) 25 percent of the amount of core capital computed before the deduction of any disallowed servicing assets and purchased credit card relationships; or

(ii) The amount of purchased credit card relationships and non mortgage-related servicing assets determined in accordance with paragraph (d) of this section.

(f) Tangible capital limitation. The maximum amount of mortgage servicing assets that may be included in tangible capital shall be the same amount includable in core capital in accordance with the limitations set by paragraph (e) of this section. All nonmortgage servicing assets are deducted in computing tangible capital.

* * * * *

Dated: July 6, 1998.

By the Office of Thrift Supervision.
Ellen Seidman,
Director.

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