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2/4

Department
of the Treasury

to: Mr. Porter

Review Officer

room: date: 2/3/92

Richard -- The material on top is specifically related to your request for information on the real estate proposals and our most recent efforts on the credit crunch.

The remainder is more general background information that you may find useful -- may be even interesting.

Let me know if you need anything additional.



David A. Lebryk

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PASSIVE LOSS RULES FOR ACTIVE REAL ESTATE DEVELOPERS

The passive loss rules would be amended so that a person's active real estate development operations are treated the same as other businesses', that is, gains and losses can be netted for tax purposes. The proposed amendment would be effective for taxable years ending on or after December 31, 1992.

Passive Loss Loopholes Were Closed in the 1986 Tax Reform

- The 1986 Tax Reform Act intended to close a tax loophole whereby real estate syndicators were forming limited partnerships of money-losing rental properties. These properties were syndicated to non-real estate investors, so-called "passive" investors, for the tax write off.
- However, the reform, as enacted, denied reasonable netting of gains and losses for income tax purposes by full time professional, or "active" developers of real properties.

Help Stop the Slide in Real Estate Values

- With the increase in the tax rate on capital gains, also contained in the 1986 Act, returns on investment of all kinds were lowered, but especially for real estate.
- Lower net returns on investment meant that values of apartments, shopping centers and office buildings began to fall.
- A prudent change in the passive loss rules only for active investors, along with the President's proposal to lower the tax rate on capital gains, will help stabilize real estate prices.

Conform Treatment to Other Businesses

- Because this measure is limited to "active" developers, it will not lead to tax loopholes or encouragement of non-economic construction of unneeded offices or apartments.
- Instead, this proposal will conform the passive loss rules for active real estate investors to the way other businesses operate under the tax rules. For example, corporations net the income and losses from their various subsidiary operations when filing their consolidated income taxes.

Accelerate Real Estate Sales from the RTC

- Along with the reduction in the capital gains tax, this change will help expedite sales of properties from the Resolution Trust Corporation (RTC), increasing the repayment of taxpayer funds in the savings and loan cleanup.
- Likewise, it will help the FDIC and banks market properties that are held in their portfolios. This will reduce the pressure on the FDIC deposit insurance fund.

Improve Bank and Savings & Loan Balance Sheets

- By boosting asset values of their real estate holdings, banks, savings and loans, and insurance companies will benefit through higher values for the properties they own.
- Higher asset values and enhanced sales of assets will boost capital levels of financial institutions.
- Higher capital levels will facilitate greater lending and will help banker and borrower confidence in fighting the "credit crunch."

FACILITATE GREATER PENSION FUND INVESTMENT IN REAL ESTATE

The President proposes four principal changes to tax rules governing the extent to which tax exempt organizations, such as pension funds, are subject to the Unrelated Business Income Tax (UBIT) including: (1) modifying the prohibition on seller-financing to include sales that are made on terms that are commercially reasonable; (2) modifying the sale-leaseback prohibition to permit certain leasebacks to the seller of debt-financed property; (3) permitting investments in certain qualifying partnerships, including repealing the rule which automatically subjects investments in partnerships to UBIT; and, (4) relaxing the prohibition on participating loans in the case of sales of property foreclosed on by financial institutions.

Pension Funds are Traditional Holders of Real Estate Investments

- Along with banks and insurance companies, pension funds are among the largest providers of capital to real estate.
- With nearly \$2 trillion in assets, America's corporate pension funds are a continuing source of long-term investment capital.
- Most of the larger corporate funds have investment allocations in real estate ranging from 5 to 10%, with some funds at higher levels.

Removing Tax Code Impediments to Pension Fund Investing

- The proposals remove impediments to more efficient investing by pension funds in commercial properties.
- These changes lower the transaction costs associated with structuring an investment in the acquisition of a office building, hotel complex, or other long-term investments.

Fights the "Credit Crunch"

- These changes will enhance liquidity in the financial system by facilitating more purchases of properties held by the RTC or other financial institutions, such as banks and insurance companies.
- Greater participation in real estate markets by highly liquid, long-term investors like pension funds will improve prospects for sales and ultimately property values.

PROVIDE PASSIVE LOSS RELIEF FOR REAL ESTATE

Current Law

The passive loss limitation rules provide generally that if a taxpayer's losses from passive activities exceed his income from passive activities for a taxable year, the excess losses are disallowed and carried forward to the next taxable year. The purpose of the passive loss rules is to discourage tax-motivated investments in tax shelters that, prior to the 1986 Act, permitted taxpayers to offset their active business and other income by incurring tax losses on investments in which they took no active part.

To determine whether a taxpayer has passive losses for a taxable year under current law, a taxpayer's operations must be organized into activities that are either trade or business activities or rental activities. If a taxpayer conducts more than one trade or business operation in the same line of business, those operations may be treated as one activity. Income and losses from all operations included in a single activity are taken into account in determining the income or loss from the activity for any taxable year. In general, rental operations may not be treated as part of a trade or business activity.¹ Thus, an individual engaged in a real estate development business that derives 60 percent of his gross income from the construction of property and 40 percent of his gross income from the rental of property would be engaged in two activities (one trade or business and one rental) rather than one, notwithstanding the fact that the operations may be conducted as part of an integrated business.

Income or loss from a trade or business activity is passive unless the taxpayer materially participates in the activity. Regulations provide that, in general, the material participation standard is satisfied if a taxpayer participates for more than 500 hours in the activity for the taxable year. A taxpayer's participation in an activity is determined by taking the sum of the number of hours the taxpayer participates in each of the operations that are included with the activity.

In the case of rental activities, income and losses are passive, regardless of the level of the taxpayer's participation. Thus, in general, losses from rental activities may offset only rental income or other passive income. Under a limited exception to the rental rule, a taxpayer with modified adjusted gross income not greater than \$100,000 may treat up to \$25,000 of real estate rental losses as nonpassive if the taxpayer actively participates in the rental activities for the taxable year. Active participation is a lesser standard of involvement than material participation and generally requires that the taxpayer participate in making management decisions or arrange for others to provide services such as repairs in a significant and bona fide sense. A taxpayer is generally deemed not to satisfy the active participation standard with respect to property he holds through a limited partnership interest. The \$25,000 amount begins to phase out for taxpayers with modified adjusted gross income over \$100,000 and is completely phased out when a taxpayer's modified adjusted gross income reaches \$150,000. This exception applies only to the losses from the rental of real property in which the taxpayer holds at least a 10 percent interest.

¹An exception to this rule is made when one of the operations (either rental or trade or business) generates more than 80 percent of the total gross income of the combined operations.

The passive loss limitation rules apply to individuals, estates, trusts and personal service corporations. Closely-held corporations may offset passive losses against active income but may not offset passive losses against portfolio income, such as interest and dividends.

Reasons for Change

A taxpayer whose principal business consists of real estate development may materially participate in a variety of endeavors, including the management, renovation, construction, ownership and rental of real estate. Nevertheless, losses arising from the rental of real property the taxpayer has developed may not be used to offset income from the taxpayer's nonrental real estate operations that are part of the same real estate development business except to the extent of the limited exception described above. As a result, taxpayers who develop real property for rental are required to treat what is a single integrated business as two separate activities, one active and one passive. The separation of these activities may result in income distortions.

Proposal

The passive loss rules would be amended to permit taxpayers to treat their real estate development operations as a single trade or business activity. Real estate development activity would include real estate development operations (as defined below) in which the taxpayer actively participates. Income and loss from this activity would be nonpassive if the taxpayer materially participates in the activity. Real estate development operations would be defined as (1) the construction, substantial renovation and management of real property, regardless of whether the taxpayer holds an interest in the property; (2) the lease-up and sale of real property in which the taxpayer has at least a 10-percent ownership interest; and (3) the rental of property that was developed by the taxpayer. Property would be treated as having been developed by the taxpayer only if the taxpayer materially participated in the construction or substantial renovation of the property. No operations would be included in the real estate development activity unless the taxpayer meets the active participation standard with respect to the operations. The proposed amendment would be effective for taxable years ending on or after December 31, 1992.

Effects of Proposal

The proposal would permit taxpayers who actively participate in the rental of the properties they develop to offset their rental losses against income from other real estate development operations in which they actively participate, as well as income not related to real estate development operations. This relaxation of the passive loss rules will ease the income distortions affecting taxpayers who develop real property for rental. At the same time, this modification will not undermine the important purpose of the passive loss rules, *i.e.*, to curb tax shelters. The provision is limited to rental losses from properties the taxpayer has developed and is therefore targeted to those taxpayers in the best position to make investments based on economic rather than tax considerations.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Provide passive loss relief for real estate:	-0.1	-0.4	-0.4	-0.4	-0.5	-0.6	-2.5

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

EMBARGOED FOR RELEASE
November 7, 1991
2:00 PM

Contact: Claire Buchan
(202) 566-8773

Statement of Secretary of the Treasury
Nicholas F. Brady
on Credit Crunch Guidelines

I am pleased with today's announcement by the financial institutions regulators on guidelines for certain regulatory policies. The new guidelines will increase flexibility and improve consistency in bank regulation.

Treasury has been working with regulators, business leaders and bankers for more than a year to develop a coordinated, sensible approach to alleviate the credit crunch. Today's guidelines demonstrate the regulators' continued commitment to evenhanded, common-sense supervisory policies, and follow through on the goals outlined by the Economic Policy Council in October.

Improving credit availability is necessary to sustaining economic recovery. Passage by Congress of the Administration bank reform and the President's economic growth package are also vital to ensuring that the recovery is vibrant.

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NFB-1540

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

NEWS RELEASE

EMBARGOED FOR RELEASE at 2 p.m. EST
Thursday, November 7, 1991

FINANCIAL REGULATORS ISSUE JOINT SUPERVISORY POLICY STATEMENT

WASHINGTON, D.C., Nov. 7, 1991 -- The four federal regulators of bank and thrift institutions issued a joint statement today on the review and classification of commercial real estate loans. Today's action is another step by the agencies to ensure that misunderstandings about supervisory policies do not impede the availability of credit to sound borrowers. Development of this document was announced in the Administration's October 8th statement on "Easing The Credit Crunch To Promote Economic Growth."

The policy statement provides clear and comprehensive guidance on the review and classification of commercial real estate loans. The detailed guidelines, which will be sent to the chief executive officer of each depository institution and each bank and thrift examiner, cover loan portfolio review procedures, indicators of troubled loans, analysis of loans and collateral values, and the review of institutions' loss allowances.

The four regulatory agencies that issued today's guidelines are the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board

-more-

(FRB), and the Office of Thrift Supervision (OTS). Together, the four agencies supervise the activities of the nation's 12,000 commercial banks and 2,200 thrift institutions.

In addition to today's issuance, the regulatory agencies are undertaking three other actions:

- o National Meeting of Examiners

The agencies will hold a national meeting of senior examination personnel in Baltimore, Md., on December 16 and 17 to review the policy statement and other initiatives related to credit availability.

- o Random Audit Program

To assess the quality of examiners' review of collateral value, the regulatory agencies will implement a random audit program to determine how examiners review and analyze the assumptions contained in appraisals as part of their loan review process.

- o Holding Company Preferred Stock

The Federal Reserve Board, in a move designed to grant bank holding companies greater flexibility in raising capital, has issued for public comment a proposal to lift the limit on the amount of noncumulative perpetual preferred stock that bank holding companies may include in Tier 1 capital. This proposal, if adopted, can assist organizations in strengthening their capital positions and expanding their ability to extend credit to sound borrowers.

All of these steps follow previous actions by the regulatory agencies in March and July to address credit availability concerns.

**Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision**

**Interagency Policy Statement on the Review and
Classification of Commercial Real Estate Loans**

November 7, 1991

The recent decline in credit extended by depository institutions has been attributed to many factors. These factors include the general slowdown in the economy, the overbuilding of commercial real estate properties in some markets, the desire of some household and business borrowers, as well as some depository institutions, to strengthen their balance sheets, changes by lenders in underwriting standards, and concerns about the potential impact of certain supervisory policies or actions. To ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers, the four Federal regulators of banks and thrifts have taken a number of steps to clarify and communicate their policies. The attached policy statement is a further step in this effort.

On March 1, 1991, the four agencies — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision — issued general guidelines that addressed a wide range of supervisory policies. Included in the March issuance were brief discussions of the workout of problems loans, lending by undercapitalized institutions, and a general statement on the valuation of real estate loans.

The attached policy statement expands upon the March 1 and subsequent guidance as it relates to the review and classification of commercial real estate loans.

The intent of the statement by the agencies is to provide clear and comprehensive guidance to ensure that supervisory personnel are reviewing loans in a consistent, prudent, and balanced fashion and to ensure that all interested parties are aware of the guidance.

The policy statement emphasizes that the evaluation of real estate loans is not based solely on the value of the collateral, but on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the properties.

The policy statement also provides guidance on how supervisory personnel analyze the value of collateral. In general, examiners consider the institution's appraisals of collateral (or internal evaluations, when applicable) to determine value and they review the major facts, assumptions and approaches used in determining the value of the collateral. Examiners seek to avoid challenges to underlying assumptions that differ in only a limited way from norms that would generally be associated with the property under review. Nonetheless, when reviewing the value of the collateral and any related management adjustments, examiners ascertain that the value is based on assumptions that are both prudent and realistic, and not on overly optimistic or overly pessimistic assumptions.

The policy statement covers a wide range of specific topics, including:

- the general principles that examiners follow in reviewing commercial real estate loan portfolios;
- the indicators of troubled real estate markets, projects, and related indebtedness;
- the factors examiners consider in their review of individual loans, including the use of appraisals and the determination of collateral value;
- a discussion of approaches to valuing real estate, especially in troubled markets;
- the classification guidelines followed by the agencies, including the treatment of guarantees; and
- the factors considered in the evaluation of an institution's allowance for loan and lease losses.

This statement is intended to ensure that all supervisory personnel, lending institutions and other interested parties have a clear understanding of the agencies' policies.

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans¹

Introduction

This policy statement addresses the review and classification of commercial real estate loans by examiners of the federal bank and thrift regulatory agencies.² Guidance is also provided on the analysis of the value of the underlying collateral. In addition, this policy statement summarizes principles for evaluating an institution's process for determining the appropriate level for the allowance for loan and lease losses, including amounts that have been based on an analysis of the commercial real estate loan portfolio.³ These guidelines are intended to promote the prudent, balanced, and consistent supervisory treatment of commercial real estate loans, including those to borrowers experiencing financial difficulties.

The attachments to this policy statement address three topics related to the review of commercial real estate loans by examiners. The topics include the treatment of guarantees in the classification process (Attachment 1); background information on the valuation of income-producing commercial real estate loans in the examination process (Attachment 2); and definitions of classification terms used by the federal bank and thrift regulatory agencies (Attachment 3).

Examiner Review of Commercial Real Estate Loans

Loan Policy and Administration Review. As part of the analysis of an institution's commercial real estate loan portfolio, examiners review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough

¹ For purposes of this policy statement, "commercial real estate loans" refers to all loans secured by real estate, except for loans secured by 1 - 4 family residential properties. This does not refer to loans where the underlying collateral has been taken solely through an abundance of caution where the terms as a consequence have not been made more favorable than they would have been in the absence of the lien.

² The agencies issuing this policy statement are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

³ For analytical purposes, as part of its overall estimate of the allowance for loan and lease losses (ALLL) management may attribute a portion of the ALLL to the commercial real estate loan portfolio. However, this does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

For savings institutions, the ALLL is referred to as the "general valuation allowance" for purposes of the Thrift Financial Report.

loan documentation are essential to the institution's management of the lending function.

The policies governing an institution's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The institution must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the institution's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

Indicators of Troubled Real Estate Markets and Projects, and Related

Indebtedness. In order to evaluate the collectibility of an institution's commercial real estate portfolio, examiners should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

Available indicators, such as permits for — and the value of — new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.

- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a commercial real estate project become more pronounced, problems with the related indebtedness may also arise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound or a liberal basis. Common examples of these types of problems include:

- Loans with no or minimal borrower equity.
- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.
- Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.
- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.
- Loans to borrowers with no development plans or noncurrent development plans.
- Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.⁴

Examiner Review of Individual Loans, Including the Analysis of Collateral Value.

The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources if necessary. In evaluating the overall risk associated with

⁴ As discussed more fully in the section on classification guidelines, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

a commercial real estate loan, examiners consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.⁵ However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral's value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met.⁶ Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property.⁷ Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic.

An examiner analyzes the collateral's value as determined by the institution's most recent appraisal (or internal evaluation, as applicable). An examiner reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the examiner may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral.⁸ This approach is discussed in more detail in Attachment 2. This analysis should not be based solely on the current performance of the collateral or similar properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

⁵ The treatment of guarantees in the classification process is discussed in Attachment 1.

⁶ Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90-16); Board of Governors of the Federal Reserve System, 12 CFR Parts 208 and 225 (Regulation H and Y; Docket No. R-0685); Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064-AB05); Department of the Treasury, Office of Thrift Supervision, 12 CFR Part 564 (Docket No. 90-1495).

⁷ Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions.

⁸ The real estate appraisal regulations of the federal bank and thrift regulatory agencies include a requirement that an appraisal (a) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (b) reconcile these approaches; and (c) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners may evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization ("cap") rates.⁹

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Examiners do not make adjustments to appraisal assumptions for credit analysis purposes based on worst case scenarios that are unlikely to occur. For example, an examiner would not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and "cap" rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, "cap" rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be

⁹ Attachment 2 includes a discussion of discount rates and direct capitalization rates.

given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and "cap" rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

Classification Guidelines

As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or criticized unless well-defined weaknesses exist that jeopardize repayment. An institution will not be criticized for continuing to carry loans having weaknesses that result in classification or criticism as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these loans.

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions (Attachment 3).¹⁰ In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and cash flow provided by, all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan's record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.¹¹

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics

¹⁰ These definitions are presented in Attachment 3 and address assets classified "substandard," "doubtful," or "loss" for supervisory purposes.

¹¹ Another issue that arises in the review of a commercial real estate loan is the loan's treatment as an accruing asset or as a nonaccrual asset for reporting purposes. The federal bank and thrift regulatory agencies have provided guidance on nonaccrual status in the instructions for the Reports of Condition and Income (Call Reports) for banks, and in the instructions for the Thrift Financial Report for savings associations, and in related supervisory guidance of the agencies.

affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

Classification of troubled project-dependent commercial real estate loans.¹² The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment.

As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified "loss."¹³ The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than "substandard." The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified "doubtful" when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined.

If warranted by the underlying circumstances, an examiner may use a "doubtful" classification on the entire loan balance. However, this would occur infrequently.

Guidelines for classifying partially charged-off loans. Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When an institution has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than "substandard."

A more severe classification than "substandard" for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

¹² The discussion in this section is not intended to address loans that must be treated as "other real estate owned" for bank regulatory reporting purposes or "real estate owned" for thrift regulatory reporting purposes. Guidance on these assets is presented in supervisory and reporting guidance of the agencies.

¹³ For purposes of this discussion, the "value of the collateral" is the value used by the examiner for credit analysis purposes, as discussed in a previous section of this policy statement.

Guidelines for classifying formally restructured loans. The classification treatment previously discussed for a partially charged off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable *modified terms*.¹⁴ Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit review system, and closely monitored by management.

Review of the Allowance for Loan and Lease Losses (ALLL)¹⁵

The adequacy of a depository institution's ALLL, including amounts based on an analysis of the commercial real estate portfolio, must be based on a careful, well documented, and consistently applied analysis of the institution's loan and lease portfolio.¹⁶

The determination of the adequacy of the ALLL should be based upon management's consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient without further analysis and cannot produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should also consider other factors, including changes in the nature and volume of the portfolio; the experience, ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans and commitments. In addition, this analysis should consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems. Furthermore, management should consider external factors such as local and national economic conditions and

¹⁴ An example of a restructured commercial real estate loan that does *not* have reasonable modified terms would be a "cash flow" mortgage which requires interest payments *only* when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

¹⁵ Each of the federal bank and thrift regulatory agencies have issued guidance on the allowance for loan and lease losses. The following discussion summarizes general principles for assessing the adequacy of the allowance for loan and lease losses.

¹⁶ The estimation process described in this section permits for a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

developments; competition; and legal and regulatory requirements; as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the institution and provide for sufficient flexibility to accommodate changing circumstances.

Examiners will evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL in order to assure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the overall estimate of the ALLL and the range of possible credit losses estimated by management will be reviewed for reasonableness in view of these factors. This examiner analysis will also consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems.

As discussed in the previous section on classification guidelines, the value of the collateral is considered by examiners in reviewing and classifying a commercial real estate loan. However, for a performing commercial real estate loan, the supervisory policies of the agencies do *not* require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL during examinations, it is important to recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of anticipated losses may not be precise due to the wide range of factors that must be considered. Further, the ability to estimate anticipated loss on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. When management has (a) maintained effective systems and controls for identifying, monitoring and addressing asset quality problems *and* (b) analyzed all significant factors affecting the collectibility of the portfolio, considerable weight should be given to management's estimates in assessing the adequacy of the ALLL.

Attachment 1

TREATMENT OF GUARANTEES IN THE CLASSIFICATION PROCESS

Initially, the original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets.¹ The federal bank and thrift regulatory agencies will, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a "financially responsible guarantor," as described below, may be sufficient to preclude classification or reduce the severity of classification.

For purposes of this discussion, a guarantee from a "financially responsible guarantor" has the following attributes:

- The guarantor must have *both* the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and²
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

Considerations relating to a guarantor's financial capacity. The lending institution must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by a guarantor, in order to determine that the guarantor has the financial capacity to fulfill the contingent claims that exist.

Considerations relating to a guarantor's willingness to repay. Examiners normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified

¹ Some loans are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the loan based upon the guarantor's ability to repay the loan.

² Some guarantees may only provide for support for certain phases of a real estate project. It would not be appropriate to rely upon these guarantees to support a troubled loan after the completion of these phases.

based on the "track record" of the guarantor, including payments made to date on the asset under review or other obligations.

Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. However, examiners give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review.

Examiners also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
- Where the guarantees are collateralized by readily marketable assets that are under the control of a third party.

Other considerations. In general, only guarantees that are legally enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.

Attachment 2

THE VALUATION OF INCOME-PRODUCING REAL ESTATE

Approaches to the Valuation of Real Estate

Appraisals are professional judgments of the market value of real property. Three basic valuation approaches are used by professional appraisers in estimating the market value of real property -- the cost approach, the market data or direct sales comparison approach, and the income approach. The principles governing the three approaches are widely known in the appraisal field and were recently referenced in parallel regulations issued by each of the federal bank and thrift regulatory agencies. When evaluating the collateral for problem credits, the three valuation approaches are not equally appropriate.

1. **Cost Approach.** In the cost approach, the appraiser estimates the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land. The cost approach is particularly helpful when reviewing draws on construction loans. However, as the property increases in age, both reproduction cost and depreciation become more difficult to estimate. Except for special purpose facilities, the cost approach is usually inappropriate in a troubled real estate market because construction costs for a new facility normally exceed the market value of existing comparable properties.
2. **Market Data or Direct Sales Comparison Approach.** This approach examines the price of similar properties that have sold recently in the local market, estimating the value of the subject property based on the comparable properties' selling price. It is very important that the characteristics of the observed transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data are typically available. When adequate sales data are available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties are not sufficient to justify a conclusion.
3. **The Income Approach.** The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in markets that are thin or subject to disorderly or unusual conditions, market value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property.

The income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is often used to estimate the present value of future income streams. For troubled properties, however, examiners typically utilize the more explicit discounted cash flow (net present value) method for analytical purposes. In that method, a time frame for achieving a "stabilized", or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Valuation of Troubled Income-Producing Properties

When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales often are difficult to obtain. Troubled properties may be hard to market, and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity — not just in today's market but over time — offers the most appropriate method of valuation in the supervisory process.

Estimates of the property's value should be based upon reasonable and supportable projections of the determinants of future net operating income: rents (or sales), expenses and rates of occupancy. Judgment is involved in estimating all of these factors. The primary considerations for these projections include historical levels and trends, the current market performance achieved by the subject and similar properties, and economically feasible and defensible projections of future demand and supply conditions. To the extent that current market activity is dominated by a limited number of transactions or liquidation sales, high "capitalization" and discount rates implied by such transactions should not be used. Rather, analysts should use rates that reflect market conditions that are *neither* highly speculative nor depressed for the type of property being valued and that property's location.

Technical Notes

In the process of reviewing a real estate loan and in the use of the net present value approach of collateral valuation, several conceptual issues often are raised. The following discussion sets forth the meaning and use of those key concepts.

The Discount Rate. The discount rate used in the net present value approach to convert future net cash flows of income-producing real estate into present market value terms is the rate of return that market participants require for this type of real estate investment. The discount rate will vary over time with changes in overall interest rates and in the risk associated with the physical and financial characteristics of the property. The riskiness of the property depends both on the type of real estate in question and on local market conditions.¹

The Direct Capitalization ("Cap" Rate) Technique. The use of "cap" rates, or direct income capitalization, is a method used by many market participants and analysts to relate the value of a property to the net operating income it generates. In many applications, a "cap" rate is used as a short cut for computing the discounted value of a property's income streams.

The direct income capitalization method calculates the value of a property by dividing an estimate of its "stabilized" annual income by a factor called a "cap" rate. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The "cap" rate — usually defined for each property type in a market area — is viewed by some analysts as the required rate of return stated in terms of current income. That is to say, the "cap" rate can be considered a direct observation of the required earnings-to-price ratio in current income terms. The "cap" rate also can be viewed as the number of cents per dollar of today's purchase price investors would require annually over the life of the property to achieve their required rate of return.

The "cap" rate method is appropriate if the net operating income to which it is applied is representative of all future income streams or if net operating income and the property's selling price are expected to increase at a fixed rate. The use of this technique assumes that either the stabilized income or the "cap" rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

¹ Regulatory policy of the Office of Thrift Supervision specifies that, for supervisory purposes, thrifts are to use discount rates that are consistent with generally accepted accounting principles for thrifts (which allow the use of an average-cost-of-capital-funds rate to calculate net realizable value) or discount rates that are consistent with the practices of the federal banking agencies.

This method alone is not appropriate for troubled real estate since income generated by the property is not at normal or stabilized levels. In evaluating troubled real estate, ordinary discounting typically is used for the period before the project reaches its full income potential. A "terminal" "cap" rate is then utilized to estimate the value of the property (its reversion or sales price) at the end of that period.

Differences Between Discount and Cap Rates. When used for estimating real estate market values, discount and "cap" rates should reflect the current market requirements for rates of return on properties of a given type. The discount rate is the required rate of return including the expected increases in future prices and is applied to income streams reflecting inflation. In contrast, the "cap" rate is used in conjunction with a stabilized net operating income figure. The fact that discount rates for real estate are typically higher than "cap" rates reflects the principal difference in the treatment of expected increases in net operating income and/or property values.

Other factors affecting the "cap" rate used (but not the discount rate) include the useful life of the property and financing arrangements. The useful life of the property being evaluated affects the magnitude of the "cap" rate because the income generated by a property, in addition to providing the required return on investment, must be sufficient to compensate the investor for the depreciation of the property over its useful life. The longer the useful life, the smaller is the depreciation in any one year; hence, the smaller is the annual income required by the investor, and the lower is the "cap" rate. Differences in terms and the extent of debt financing and the related costs must also be taken into account.

Selecting Discount and Cap Rates. The choice of the appropriate values for discount and "cap" rates is a key aspect of income analysis. Both in markets marked by lack of transactions and those characterized by highly speculative or unusually pessimistic attitudes, analysts consider historical required returns on the type of property in question. Where market information is available to determine current required yields, analysts carefully analyze sales prices for differences in financing, special rental arrangements, tenant improvements, property location, and building characteristics. In most local markets, the estimates of discount and "cap" rates used in income analysis should generally fall within a fairly narrow range for comparable properties.

Holding Period vs. Marketing Period. When the income approach is applied to troubled properties, a time frame is chosen over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). That time period is sometimes referred to as the "holding period." The longer the period before stabilization, the smaller will be the reversion value included in the total value estimate.

The holding period should be distinguished from the concept of "marketing period" — a term used in estimating the value of a property under the sales comparison approach

Glossary

Appraisal. A written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.

Capitalization rate. A rate used to convert income into value. Specifically, it is the ratio between a property's stabilized net operating income and the property's sales price. Sometimes referred to as an overall rate because it can be computed as a weighted average of component investment claims on net operating income.

Discount rate. A rate of return used to convert future payments or receipts into their present value.

Holding period. The time frame over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income).

Market value. The most probable cash sale price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated (i.e., motivated by self-interest);
2. both parties are well informed or well advised, and acting in what they consider their own best interests;
3. a reasonable time is allowed for exposure in the open market;
4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Marketing period. The term in which an owner of a property is actively attempting to sell that property in a competitive and open market.

Net operating income (NOI). Annual income after all expenses have been deducted, except for depreciation and debt service.

Attachment 3

Classification Definitions¹

The federal bank and thrift regulatory agencies currently utilize the following definitions for assets classified "substandard," "doubtful," and "loss" for supervisory purposes:

Substandard Assets. A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets. An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss Assets. Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

¹ Office of the Comptroller of the Currency, *Comptroller's Handbook for National Bank Examiners*, Section 215.1, "Classification of Credits;" Board of Governors of the Federal Reserve System, *Commercial Bank Examination Manual*, Section 215.1, "Classification of Credits;" Office of Thrift Supervision, *Thrift Activities Regulatory Handbook*, Section 260, "Classification of Assets;" Federal Deposit Insurance Corporation, *Division of Supervision Manual of Examination Policies*, Section 3.1, "Loans."

FEDERAL RESERVE press release



For immediate release

October 31, 1991

The Federal Reserve Board today requested public comment on a proposal to permit bank holding companies to raise additional tier one risk-based capital through the sale of perpetual preferred stock.

Comment should be received by the Board by November 22.

Under present risk-based capital guidelines, bank holding companies are permitted to count perpetual preferred stock up to 25 percent of their tier one capital. The proposal would remove the limitation for noncumulative perpetual preferred stock but continue to limit cumulative perpetual preferred to 25 percent of tier one capital.

A copy of the Board's order is attached.

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Attachment

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulation H, Regulation Y; Docket No. R-0740]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of Proposed Revisions to Capital Adequacy Guidelines.

SUMMARY: The Board is proposing to remove the limit on the amount of noncumulative perpetual preferred stock bank holding companies may include in Tier 1 capital. Cumulative perpetual preferred stock would continue to be included in Tier 1 capital for bank holding companies, up to a limit of 25 percent of Tier 1 capital.

DATE: Comments on the proposed revisions to the Federal Reserve Board's risk-based capital guidelines and leverage capital guidelines should be submitted on or before November 22, 1991.

ADDRESS: Comments, which should refer to docket No. R-0740, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenues, N.W., Washington, D.C. 20551; or delivered to Room B-2223, Eccles Building, between 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in section 2612.8

of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Roger T. Cole, Assistant Director (202/452-2618), Rhoger H Pugh, Manager (202/728-5883), Norah M. Barger, Supervisory Financial Analyst (202/452-2402), Robert E. Motyka, Senior Financial Analyst (202/452-3621), Division of Banking Supervision and Regulation; and Michael J. O'Rourke, Senior Attorney (202/452-3288), Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION

I. BACKGROUND

The international bank capital standards (Basle Accord)¹ allow banks to include noncumulative perpetual preferred stock place in Tier 1 capital and place no formal limit on the amount of such instruments that may be included in Tier 1.² The Basle framework, which by its terms applies only to

¹ The Basle Accord is a risk-based capital framework that was proposed by the Basle Committee on Banking Regulations and Supervisory Practices and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Committee is comprised of representatives of the central banks and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.

² Noncumulative perpetual preferred stock is perpetual preferred stock whose dividends, if missed, do not accrue and will never be paid. Cumulative perpetual preferred stock is preferred stock whose dividends, if missed because of insufficient earnings

internationally active banks, was adopted by the Federal Reserve for state nonmember banks. In addition, the Board chose to apply a risk-based capital framework similar to the Basle Accord to U.S. bank holding companies generally on a consolidated basis.³ Under the Federal Reserve's bank holding company capital guidelines, holding companies are allowed to include both noncumulative and cumulative perpetual preferred stock in Tier 1 capital, but the total of all perpetual preferred stock includable in Tier 1 capital is limited to 25 percent of Tier 1.⁴ Amounts of such stock in excess of the limitation may be included in Tier 2 capital. The limit on preferred stock is consistent with the Board's long-standing view that common equity should remain the dominant form of a banking organization's capital structure.

A principal reason for the Board's decision to limit the amount of perpetual preferred stock in bank holding Tier 1 capital is the fact that cumulative preferred, the type of perpetual preferred most prevalent in U.S. financial markets,

or any other reason, accumulate until all arrearages are paid out. Cumulative preferred dividends have preference over common dividends, which cannot be paid out as long as any cumulative preferred dividends remain unpaid.

³ For bank holding companies with consolidated assets of less than \$150 million in assets, the risk-based capital guidelines generally are applied on a bank-only basis.

⁴ Under the risk-based capital guidelines, certain types of perpetual preferred stock do not qualify for inclusion in Tier 1 capital. For example, perpetual preferred stock in which the dividend is reset periodically based, in whole or in part, upon the banking organization's credit standing is excluded from Tier 1 capital, but may be included in Tier 2 capital.

normally involves preset dividends that cannot be cancelled, but only deferred. An institution that passes dividends on cumulative preferred stock must pay off any accumulated arrearages before it can resume payment of its common stock dividends. Thus, undue reliance on cumulative perpetual preferred stock and the related possibility of large dividend arrearages could complicate an organization's ability to raise new common equity in times of financial difficulty. On the other hand, dividends on noncumulative preferred, like dividends on common stock, may be cancelled. Thus, with respect to dividends, noncumulative preferred stock has characteristics that are consistent with common stock, the principal component of Tier 1 capital.

Conditions in the banking industry underscore the desirability of affording banking organizations greater flexibility in raising capital. This can assist organizations in strengthening their capital positions and expanding their ability to extend credit to sound borrowers. In view of these considerations, the Board is proposing to lift the limit on the amount of noncumulative preferred stock that bank holding companies may include in Tier 1 capital. This proposal is consistent with other steps initiated by the Federal bank regulatory agencies, in conjunction with the Treasury Department, to address concerns relating to the availability of credit to sound borrowers.

II. Proposal

The Board is proposing to remove the limit on the amount of noncumulative perpetual preferred stock a bank holding company may include in its Tier 1 capital. Cumulative perpetual preferred stock would continue to be included in Tier 1 capital for bank holding companies, up to a limit of 25 percent of Tier 1 capital.

By removing the limit for noncumulative perpetual preferred stock, this proposal will achieve parity with regard to the treatment of noncumulative perpetual preferred stock between the U.S. risk-based capital guidelines for bank holding companies and the Basle framework for banks. Thus, the proposal will place U.S. bank holding companies on a more equal footing with foreign banks subject to the Basle Accord with regard to their ability to augment Tier 1 capital through the issuance of noncumulative perpetual preferred stock. The additional flexibility provided by this step may assist bank holding companies to strengthen their capital positions and expand their lending capacity.

Although the Board is proposing to lift the limit on noncumulative perpetual preferred stock, it continues to believe that bank holding companies should avoid overreliance on preferred stock within Tier 1 capital. In proposing this step, the Board notes that the capital structure of a bank holding company is subject to quarterly review (through the analysis of financial reports filed with the Federal Reserve), and the composition of an organization's capital base and its capital

plans are subject to in-depth assessment during annual inspections and as part of the Federal Reserve's consideration of applications. The language of the Federal Reserve's risk-based capital guidelines makes clear the Board's long-standing belief that banking organizations should avoid overreliance on nonvoting equity instruments, including preferred stock, in Tier 1 capital. Capital structures that are inconsistent with this principle may result in supervisory or enforcement actions, including possible denial of applications filed with the Federal Reserve. In addition, rating agencies take the amount of common equity and preferred stock an organization has, as well as the overall composition of the organization's core capital, into account in determining the organization's financial ratings. Thus, there are a number of mechanisms in place to monitor banking organizations' use of preferred stock and to discourage undue reliance on such instruments.

III. Regulatory Flexibility Act Analysis

The Federal Reserve Board does not believe adoption of this proposal would have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations), in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). 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 proposal will

not affect such companies.

List of Subjects

12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, Banking, Branches, Capital adequacy, Confidential business information, Currency, Dividend payments, Federal Reserve System, Flood insurance, Publication of reports of condition, Reporting and recordkeeping requirements, Securities, State member banks.

12 CFR Part 225

Administrative practice and procedure, Appraisals, Banks, Banking, Capital adequacy, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities, State member banks.

For the reasons set forth in this notice, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956 (12 U.S.C. 1844(b)), and section 910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3909), the Board is amending 12 CFR Parts 208 and 225 to read as follows:

PART 208 - MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE
FEDERAL RESERVE SYSTEM

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

AUTHORITY: Sections 9, 11(a), 11(c), 19, 21, 25, and 25(a) of the Federal Reserve Act, as amended (12 U.S.C. 321-338, 248(a), 248(c), 461, 481-486, 601, and 611, respectively); sections 4 and 13(j) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1814 and 1823(j), respectively); section 7(a) of the International Banking Act of 1978 (12 U.S.C. 3105); sections 907-910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3906-3909); sections 2, 12(b), 12(g), 12(i), 15B(c) (5), 17, 17A, and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78b, 781(b), 781(g), 781(i), 78o-4(c) (5), 78q, 78q-1, and 78w, respectively); section 5155 of the Revised Statutes (12 U.S.C. 36) as amended by the McFadden Act of 1927; and sections 1101-1122 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (12 U.S.C. 3310 and 3331-3351).

Appendix A - [Amended]

2. The footnote designator in the text is removed and footnote 6 is removed and reserved.

PART 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

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

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

Appendix A - [Amended]

2. Appendix A is amended by revising paragraphs (ii) and (iii) and adding paragraph (iv) in II.A.1., and by removing the last three sentences in the third paragraph and the entire fourth paragraph in II.A.1.b. and replacing them, to read as follows:

II. ***

A. ***

(i) ***

(ii) qualifying noncumulative perpetual preferred stock (including related surplus).

(iii) qualifying cumulative perpetual preferred stock (including related surplus), subject to certain limitations described below.

(iv) minority interest in the equity accounts of consolidated subsidiaries.

10

b. *** However, the aggregate amount of cumulative perpetual preferred stock that may be included in a holding company's tier 1 is limited to one-third of the sum of core capital elements, excluding the cumulative perpetual preferred stock (that is, items i, ii, and iv above). Stated differently, the aggregate amount may not exceed 25 percent of the sum of all core capital elements, including cumulative perpetual preferred stock (that is, items, i, ii, iii, and iv above). Any cumulative perpetual preferred stock outstanding in excess of this limit may be included in tier 2 capital without any sublimits within that tier (see discussion below).

While the guidelines allow for the inclusion of noncumulative perpetual preferred stock and limited amounts of cumulative perpetual preferred stock in tier 1, it is desirable from a supervisory standpoint that voting common equity remain the dominant form of tier 1 capital. Thus, bank holding companies should avoid overreliance on preferred stock or nonvoting equity elements within tier 1.*****

Appendix D - [Amended]

3. Appendix D is amended by removing the first two sentences in footnote 3 and replacing them, to read as follows:

11

II. ***

' At the end of 1992, Tier 1 capital for bank holding companies 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.)***

Board of Governors of the Federal Reserve System,
October 31, 1991.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date: January 16, 1992

To Board of Governors

From Division of Banking
Supervision and Regulation
(Messrs. Struble, Cole,
Lovette, Glissman, Spaniel,
and Young)

Subject: Definition of Highly-
Leveraged Transactions (HLTs)

Action Requested

Staff seeks the Board's approval of an interagency proposal (Attachment C) to phase out the supervisory definition of highly-leveraged transactions (HLTs). The agencies intend to phase out use of the definition and to discontinue regulatory reporting of HLTs by banking organizations effective after the June 30, 1992 reporting date. Certain revisions to the definition, developed in coordination with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), are also proposed for the interim period. In that regard, a proposed Federal Register notice (Attachment B) implementing these changes on behalf of banking organizations regulated by the Board is also attached for the Board's consideration.

As the definition is common among the three federal bank regulatory agencies, Board staff will coordinate wording of the interagency document with the staffs of the other agencies. Therefore, staff seeks approval to make minor or technical changes in wording, if necessary, to prepare an interagency

document. Any significant changes would be brought to the Board for discussion or placed on notation vote.

Summary

The three federal bank regulatory agencies have had under consideration for some time the status of the HLT definition. On July 10, 1991, the agencies jointly sought public comment on the supervisory definition. The comment period expired on September 23, 1991, with over 260 comments received from the public. A summary of comments received is attached (Attachment A).

On the basis of a review of comments received and an assessment of the HLT definition and the impact the definition has had, staff at the three banking agencies have unanimously concluded that the definition has largely served the purposes for which it was adopted and should now be phased out. Therefore, staff recommends that the Board discontinue use of the HLT definition after June 30, 1992 regulatory reporting by banking organizations.

In making this recommendation, staff believes the definition has largely accomplished its original purposes, as discussed beginning on page 8. Circumstances have also changed since the definition was implemented. Merger and acquisition activity has declined significantly, and companies have more recently been improving their capitalization and credit standing by deleveraging and issuing equity. It is also recognized that

the HLT definition may be having an undue effect on pricing and availability of credit to certain highly-leveraged borrowers.

Staff further recommends that before regulatory reporting of HLTs is discontinued that certain revisions be made to the definition, as discussed beginning on page 10, to respond to concerns expressed in comment letters. These revisions, developed in coordination with the other banking agencies, would become effective with reporting by banking organizations for the first quarter of 1992. The revisions include --

(1) Reducing the timeframes for delisting credits from HLT status (as discussed on pages 11 and 12):

More specifically, staff recommends that:

- (a) The delisting timeframe be shortened from 2 years to 1 year for companies that deleverage below 75 percent or were designated HLTs under the "doubling of liabilities to greater than 50 percent" leverage test; and
- (b) The delisting timeframe be shortened from 4 years to 3 years for companies that remain highly leveraged.

These proposed delisting timeframes would continue to encourage companies to improve their capitalization and credit standing by deleveraging and issuing additional equity.

(2) Allowing banking organizations to delist, on a case-by-case basis, companies from HLT status that adequately service debt and clearly demonstrate superior cash flow, relative to their respective industry or peer groups (as discussed beginning on page 12):

More specifically, staff recommends that banking organizations be permitted to delist highly-leveraged companies from HLT status that demonstrate superior cash flow coverages on a case-by-case basis, relative to their respective industry or peer groups. A company demonstrating such strong performance would become eligible for delisting once it has adequately serviced debt for a reasonable period of time since its last buyout, acquisition, or leveraged

recapitalization involving financing. Credits delisted in this manner would subsequently be reviewed, and potentially subject to relisting, by examiners during the normal course of an examination.

A majority of commenters strongly favored the implementation of a cash flow test in the HLT definition, particularly for purposes of delisting credits from HLT status. Although the review of cash flow has always been an integral part of the delisting process, companies that are adequately servicing debt have not previously been delisted based solely upon historical cash flow performance. A review of potential standardized cash flow measures indicated that it is extremely difficult to establish a specific level of cash flow that may be considered adequate yet equitable to all industries. Therefore, staff recommends that banking organizations be permitted to analyze pertinent cash flow ratios for individual HLT companies and make a determination as to the quality and strength of each company's cash flow performance, subject to examiner review.

- (3) **Delisting each company (with a previous HLT designation) emerging from Chapter 11 bankruptcy from the HLT designation whose leverage, after reorganization, is less than 75 percent (as discussed beginning on page 14):**

An amendment to the Federal Deposit Insurance Act contained in recent banking legislation passed by Congress appears to mandate this change.¹ It is noted that most reorganized companies emerging from Chapter 11 are no longer highly leveraged. Delisting such companies from HLT status immediately would also serve to emphasize the rehabilitative role played by the bankruptcy code and remove an implied hindrance to this type of lending.

- (4) **Excluding loans fully-collateralized with cash or cash equivalents from HLT reporting by banks (as discussed beginning on page 15):**

¹The Federal Deposit Insurance Act has just been amended by the Federal Deposit Insurance Corporation Improvement Act of 1991 (Section 474). This amendment prohibits the federal banking agencies from designating by regulation or otherwise "a corporation as highly leveraged or a transaction with a corporation as a highly-leveraged transaction solely because such corporation is or has been a debtor or bankrupt under title 11, United States Code, if, after confirmation of a plan of reorganization, such corporation would not otherwise be highly leveraged."

This change is intended to deal with infrequent situations that do not satisfy the intended purpose of the HLT definition. Rather, loans fully-collateralized with cash or cash equivalents often fulfill a non-operating purpose, such as assisting in the consummation of a tax-planning transaction. Moreover, the company would not have otherwise needed to borrow such funds because it already had sufficient liquid resources available on its balance sheet.

Although staff proposes to discontinue the use of the HLT definition in the near future and, therefore, no longer collect data from banking organizations on their HLT portfolios, all highly-leveraged credits would continue to be closely reviewed by examiners on an annual basis along with other commercial loans and would be subject to supervisory criticism when appropriate. Consistent with sound banking practice, banking organizations will continue to be expected to have systems in place to monitor the risks associated with segments of their lending portfolios, including highly-leveraged credits.

Background

The Federal Reserve, the OCC, and the FDIC adopted a common definition of highly-leveraged transactions (HLTs) in October 1989. This definition was issued in the form of supervisory guidance to examiners and bankers. The Securities and Exchange Commission (SEC) has also issued guidance to all publicly-held companies requiring adequate disclosure of HLTs in public financial statements.

A bank or bank holding company is currently considered to be involved in an HLT when credit is extended to or investment

is made in a business where the financing transaction involves the buyout, acquisition, or leveraged recapitalization of an existing business and one of the following criteria is met:

- (a) the transaction results in a liabilities-to-assets leverage ratio higher than 75 percent and a significant portion (25 percent or more) of the company's liabilities derive from buyouts, acquisitions, or leveraged recapitalizations; or
- (b) the transaction at least doubles the subject company's liabilities and results in a liabilities-to-assets leverage ratio higher than 50 percent; or
- (c) the transaction is designated an HLT by a syndication agent or a federal bank regulator.

Not all highly-leveraged companies have their credit facilities designated as HLTs. Only highly-leveraged companies that have been involved in buyouts, acquisitions, or leveraged recapitalizations and have a significant portion of their liabilities derived from this type of financing transaction qualify for designation as HLTs.

This definition played a role in helping the bank regulatory agencies initially identify these credits and monitor the risk of HLT portfolios. The definition has also accomplished the objective of encouraging financial institutions to focus attention on the need for internal control and review mechanisms to monitor this type of financing transaction. Furthermore, it has highlighted the need for financial institutions to structure highly-leveraged credits in a way that is consistent with the risks involved.

By itself, the HLT definition was never intended to imply any supervisory criticism of individual credits, although it has been interpreted as such by outside analysts, borrowers, and some bankers. As with any other commercial loan, an HLT credit has been subject to examiner criticism only after a thorough review of the borrower's financial condition, income, and cash flow; the value of any collateral or guarantees; the quality and continuity of the borrower's management; and the borrower's ability to service its debt obligations.

Despite issuing interpretations and clarifications of the definition in February 1990 and February 1991, the agencies continued to receive a number of questions and comments regarding the HLT definition. Many of these comments emanated from borrowers and specific industry groups. A number of these comments referenced concerns with pricing and availability of credit in conjunction with designation as an HLT. To address these concerns, the agencies sought public comment through September 23, 1991, on all aspects of the HLT definition and criteria. Comments were also sought on specified issues related to the definition. These included:

- (1) the use of a cash flow criterion in the definition;
- (2) specific criteria for delisting loans from HLT status;
- (3) treatment of highly-leveraged companies with investment-grade ratings;
- (4) the application of the HLT definition to parent companies and their subsidiaries; and

- (5) the level of flexibility and judgment allowed to bank management in designating credits as HLTs.

In seeking comments, the agencies also raised questions of whether the supervisory HLT definition should be eliminated and whether banks should be allowed to designate HLTs based upon their own internal loan review and categorization systems.

Discussion of Recommendations

Staff of the three federal bank regulatory agencies unanimously agree that use of the HLT definition should be phased out. It is recommended that use of the definition be discontinued effective after June 30, 1992 regulatory reporting by banking organizations. Staff also is recommending that certain revisions, developed in coordination with the OCC and the FDIC, be made to the definition for the interim period.

In reviewing options for responding to concerns with the HLT definition, staff at the banking agencies believe that the HLT definition has served a useful purpose but has now largely accomplished its original purposes. It has encouraged financial institutions to focus attention on the need for internal control and review mechanisms to monitor this type of financing transaction. The definition also highlighted the need for financial institutions to structure highly-leveraged credits in a way that is consistent with the risks involved.

It is also important to note that circumstances have changed since the HLT definition was implemented. Merger and

acquisition activity has declined significantly in recent months. Lending terms in this type of financing transaction have also become more conservative and comparable with traditional lending standards. In addition, companies have more recently been attempting to improve their capitalization and credit standing by deleveraging and issuing equity.

A review of comment letters indicates that the definition is having unintended and undue effects on the price and availability of credit to some highly-leveraged borrowers. While the HLT definition has never been intended to imply any supervisory criticism of individual credits, it has been interpreted as such by outside analysts, borrowers and some bankers.

Phasing out the HLT definition will not lessen the supervisory review of highly-leveraged credits by examiners. As with all commercial loans, these credits will continue to be subject to careful supervisory review and will be criticized when appropriate.² Examiners will continue to thoroughly review each borrower's financial condition, income, and cash flow; the value of any collateral or guarantees; the quality and continuity of the borrower's management; the borrower's ability to service its debt obligations; and other credit quality considerations.

²By definition, HLTs have involved financing transactions of \$20 million or more and have generally been subject to detailed review under the Shared National Credit Program. As with other large credits, these credits will continue to be subject to detailed review in this program.

Banking organizations will also be expected to continue monitoring the level and quality of these loans.

In the period preceding discontinuance of the definition, staff recommends that the HLT definition be refined to satisfy some of the concerns raised by the application and contents of the definition. It is envisioned that revisions would become effective with financial reporting by banking organizations for the first quarter of 1992. If financial institutions continue to disclose HLT information in public financial statements, then these revisions could potentially be utilized as guidelines by banking organizations in satisfying disclosure requirements after the definition is phased out by the bank regulatory agencies.

Recommended revisions include (1) reducing the timeframes for delisting credits from HLT status; (2) allowing banking organizations to delist certain companies from HLT status that adequately service debt and clearly demonstrate superior cash flow, relative to their respective industry or peer group; (3) delisting each company (with a previous HLT designation) emerging from Chapter 11 bankruptcy from the HLT designation whose leverage, after reorganization, is less than 75 percent; and (4) excluding certain loans from HLT reporting that are fully-collateralized with cash or cash equivalents. Each of these proposed revisions is discussed below.

1. Reduce Timeframes for Delisting:

Currently, to be removed from HLT status, a borrower, once meeting the criteria for being placed in this status, must show good performance for a minimum of two years. After two years, if leverage has been reduced below 75 percent, a borrower becomes eligible for delisting. If a borrower remains highly-leveraged, however, the borrower must demonstrate performance for up to four years before being delisted.

Reducing the timeframe in which companies must demonstrate performance before becoming eligible for removal from HLT status would be considered a significant change to the definition. An overwhelming majority of comments favored allowing a highly-leveraged company to be delisted in less than four years, if the company demonstrates performance and has adequate cash flow. Several companies recommended that a highly-leveraged company with good cash flow become eligible for delisting in as few as one or two years. The majority of bank comments suggested a two-year timeframe.

In light of the comments that have been received, the following changes to delisting timeframes are being recommended:

- (i) Reduce the delisting timeframe from two years to one year for companies that deleverage below 75 percent or were designated HLTs under the "doubling of liabilities to greater than 50 percent" leverage test. Of course, companies would have to continue to meet general performance criteria to be delisted.
- (ii) Reduce the delisting timeframe from four years to three years for companies that remain highly leveraged. A company would have to demonstrate performance for three consecutive years since its last highly-leveraged transaction and have a

positive net worth in order to be eligible for delisting. The requirement that a company's leverage ratio not significantly exceed its industry norm in order to be delisted would be eliminated.

These proposed changes to delisting criteria could be considered both substantive and responsive to requests. Allowing companies that deleverage themselves to be delisted sooner from HLT status will encourage companies to improve their capitalization and credit standing by deleveraging and issuing additional equity.

It is not possible to accurately assess how many companies could be removed from HLT status with these changes, but the number is considered significant given the number of HLTs that have now aged beyond three years.

2. Allow Certain Companies With Superior Cash Flow To Be Delisted:

Currently, no specific cash flow test exists in the HLT definition or delisting criteria although delisting criteria state that cash flow coverages are to be taken into consideration when reviewing the overall performance of a borrower for delisting. Although staff has always supported the close review of cash flow when analyzing credits, no specific cash flow test was originally included in the definition because (1) the definition was implemented to provide a consistent means of aggregating and monitoring a type of financing transaction, thus relying heavily on a purpose test and an easily-calculated leverage test; and (2) it was deemed problematic to develop a

universal cash flow measure that could be used for all industries.

A majority of commenters, representing both companies and banks, strongly favored the use of a cash flow test in the HLT definition, particularly for delisting purposes. Some favored a standardized cash flow test; others favored an industry-specific cash flow test; and some expressed a preference for both. Several banks stated, however, that it would be difficult to implement a cash flow measure for initially designating credits as HLTs because such an analysis would be based on cash flow projections and not on historical performance.

In light of the comments received, staffs of the banking agencies have closely reviewed potential cash flow measures including a debt service coverage ratio, an interest coverage ratio, and a ratio measuring the magnitude of debt in relationship to operating cash flow. All measures proved difficult to define adequately, particularly for use in analyzing companies in all industries. Moreover, it was found to be extremely difficult to establish a standardized level of "acceptable" cash flow that could be applied to all industries.

Rather than establish a standardized cash flow test, staff at the banking agencies concluded that the agencies could respond to commenters by permitting banking organizations to analyze pertinent cash flow ratios for individual HLT companies, then make a determination as to the quality and strength of each company's cash flow performance. More specifically, staff

recommends that credits of a highly-leveraged company could be considered eligible for delisting by banking organizations on a case-by-case basis, if the company demonstrates superior cash flow coverage, relative to the company's industry or peer group, and the company has adequately serviced debt for a reasonable period of time since its last buyout, acquisition, or leveraged recapitalization involving financing. Credits delisted in this manner would subsequently be reviewed, and potentially subject to relisting, by examiners during the normal course of an examination.

3. Delist Certain Companies Emerging From Chapter 11

Bankruptcy:

Currently, post-reorganization debt (after a company emerges from Chapter 11 bankruptcy) of a company that was designated HLT prior to bankruptcy proceedings retains the HLT designation until the company becomes eligible for delisting. Although a company is often deleveraged as a result of the reorganization, the company may not be delisted for at least two years.

Some money-center banks commenting on the definition state that a company should no longer be designated HLT upon emerging from Chapter 11 reorganization if leverage is below 75 percent. They indicate that continuing the HLT designation could interfere with the ability to obtain post-reorganization financing for these companies. The purpose of Chapter 11 being to help rehabilitate companies and help them start fresh with

creditors pursuant to a court-approved plan, it appears reasonable to delist HLT companies that are no longer highly leveraged and, in essence, are operating with a new balance sheet.

A compelling reason to make this change is that the Federal Deposit Insurance Act has just been amended by the Federal Deposit Insurance Corporation Improvement Act of 1991 (section 474). This amendment prohibits the federal banking agencies from designating by regulation or otherwise "a corporation as highly leveraged or a transaction with a corporation as a highly-leveraged transaction solely because such corporation is or has been a debtor or bankrupt under title 11, United States Code, if, after confirmation of a plan of reorganization, such corporation would not otherwise be highly leveraged."

Making such a change to the HLT definition would likely allow most HLT companies emerging from Chapter 11 to be immediately delisted from HLT status.

4. Exclude Certain Fully-Collateralized Credit Facilities:

Currently, some individual HLT borrowers have one or more individual loans (i.e., credit facilities) that are fully-collateralized with cash or cash equivalents. Cash equivalents would be deemed to include U.S. Government and certain other readily-marketable securities qualifying for a zero risk-weight under risk-based capital standards. The purpose of credit

facilities fully-collateralized with cash or cash equivalents is generally not to take on additional debt for acquisition or restructuring purposes. Rather, they often fulfill a non-operating purpose, such as assisting in the implementation of a tax-planning strategy.

Support for excluding certain fully-collateralized credit facilities from HLT reporting centers on the fact that a company would not have needed to borrow such funds because it already had sufficient liquid resources available on its balance sheet. In addition, it is noted that when credit facilities are fully-collateralized in this manner, they are generally excluded from regulatory limits on the level of total credit that may be granted to an individual borrower by a bank.

Discussion of Potential Revisions Not Recommended

A significant number of commenters expressed support for two potential revisions to the HLT definition that staff does not recommend for implementation during the interim period. These include (1) exempting companies with investment-grade senior debt from HLT designation and (2) excluding debt of certain subsidiaries from a parent company's HLT designation. Issues related to each of these items are discussed below.

1. Exempt Companies With Investment Grade Senior Debt:

Currently, it is possible for a company with investment grade senior debt to be designated an HLT if the company has been

involved in significant merger and acquisition activity and has very high leverage. Comment letters indicate there are very few HLT companies that have investment grade ratings. However, this possibility has frequently been highlighted by critics of the definition.

To date, investment grade companies have not been exempted from the HLT definition because of a desire to (1) avoid including credit quality criteria in the definition; (2) avoid appearing inequitable to companies that may meet investment grade criteria but are too small to be evaluated by the major rating agencies; and (3) avoid any dependence on outside credit rating agencies. In this regard, it is noted that credit ratings can quickly deteriorate under the burden of heavy debt.

Exempting companies with investment grade senior debt would appear to have little impact on the number of companies designated as HLTs, but it would serve to reinforce the perception that an HLT designation conveys credit quality information or criticism. Some commenters, including two banks, noted that banks could publicly disclose the level of investment grade companies in their HLT portfolios, thus mitigating criticism by analysts of this portion of their portfolios. Given that this revision could reinforce negative perceptions concerning the credit quality of HLT loans, it is not recommended.

2. Exclude Certain Subsidiaries From Parent HLT Designation:

Currently, if a company satisfies the HLT purpose and leverage tests on a consolidated basis, then a loan to any part of the organization is designated HLT. On the other hand, if only a subsidiary of a company satisfies the HLT tests, then the subsidiary stands alone as an HLT. However, if the subsidiary's debt level is significant enough to cause the consolidated organization to meet HLT leverage criteria, then all debt of the entire organization is designated HLT.

The review of financial statements and calculation of the leverage ratio for HLT purposes is conducted using generally accepted accounting principles (GAAP). Analyzing companies on a consolidated basis when determining HLT status is considered consistent with GAAP. More compelling, experience with consolidated organizations indicates that when one aspect of a company's operations becomes imperiled, the entire organization is negatively impacted.

A significant number of comments (representing 27 percent of all comments) favored excluding debt of certain subsidiaries from a parent company's HLT designation if appropriate protective covenants are maintained between the parent and subsidiary. These protective covenants would normally restrict movement of assets to the parent, limit upstreaming of dividends, restrict inter-company debt, and so forth. Only three percent of comments opposed allowing such an exclusion, while 70 percent had no comment on the issue.

No exclusions have been granted to certain subsidiaries of HLT parent companies with protective covenants because (1) the HLT definition leverage tests are applied on a consolidated basis in accordance with GAAP; (2) each protective covenant is unique and with varying degrees of merit, thus it would be very difficult and time consuming for examiners to review and evaluate each covenant; and (3) protective covenants do not always work as intended when a company is in financial difficulty or enters bankruptcy proceedings. Some commenters confirmed that experience has shown that technical separation through the use of loan covenants has not always proven to be adequate protection against liabilities emanating from a subsidiary or affiliate, especially in bankruptcy situations where the separation between parent and subsidiary can and has been breached.

Given the influence that parent companies can exert over so-called "stand alone" subsidiaries when financial needs arise and the difficulties involved in evaluating and enforcing protective covenants, staff does not recommend excluding certain subsidiaries of HLT parent companies from the HLT designation.

Attachment A: Summary of Comments

Attachment B: Draft Federal Register Notice

Attachment C: Draft Interagency Statement on HLTs

Attachment A

**SUMMARY OF COMMENTS
ON THE DEFINITION OF HIGHLY-LEVERAGED TRANSACTIONS**

INTRODUCTION

The Office of Comptroller of the Currency, Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System (Agencies) issued on July 10, 1991 a request for public comment regarding the supervisory definition of Highly-Leveraged Transactions (HLTs). The request asked for comments on all aspects of the definition and specifically requested comment on five areas: 1) the possible use of a cash flow criterion in identifying and delisting HLTs; 2) the specific criteria for removing loans from HLT status; 3) the treatment of highly leveraged firms with investment-grade debt ratings; 4) the application of the HLT definition to parent companies and their subsidiaries; and 5) the level of flexibility and judgement allowed to bank management by the HLT definition.

SUMMARY OF COMMENTS

The comment period ended on September 23, 1991, although comments were received through November 15, 1991. A total of 267 public comments were received by the three agencies. This included 176 comments from the cable/media industry, 50 comments from banks or bank associations, 20 comments from investment banks, 7 comments from manufacturing concerns, 7 comments from retail and service industries, and 3 comments from groceries.

The remaining comments were submitted by law firms, and a state government agency. It should be noted that while 64 percent of the comments were received from the cable/media industry, overall 81 percent, or 216 comments specifically referenced the cable/media industry. Table 1 presents a summary of the comments received including comments on specific issues.

Overall 95 percent of the comments favored some revision to the definition of HLT's. Forty-four percent of the comments favored the elimination of the HLT definition. Several comments provided specific guidelines and recommendations regarding the five issues outlined in the request, however, the majority did not provide specific comments on the issues cited.

Comments favoring the revision or elimination of the definitions stated that the HLT definition does in fact convey a supervisory criticism of the credit despite the agencies view of the definition as a delineation of a type of credit. Specifically, 146 comments stated that the HLT designation did convey credit quality information or criticism. One commentor stated that the HLT definition did not convey criticism of credit quality. In addition, comments favoring the revision or elimination of the definition noted credit pricing differences (increases) due to the designation as an HLT and a reluctance on the part of bankers to increase their exposure to HLTs.

The 31 comments opposing the elimination of the HLT definition stated that the definition provided an effective means of tracking bank exposure to leveraged buy-outs and acquisitions. Some comments also noted that the definition has served as an incentive to restructure HLTs by requiring more equity in merger and acquisition financings. The remainder of this memo summarizes the comments received regarding the five specific issues requested.

1. Use of a Cash Flow Criterion in Identifying or Delisting HLTs.

One-hundred thirty four comments favored the adoption of a cash flow criterion in conjunction with the designation or delisting of HLTs. Forty-two comments opposed the use of cash flow and 91 comments made no reference to the use of a cash flow criteria. Comments provided a wide range of cash flow measures for consideration including interest coverage ratios, debt service ratios and total debt to cash flow ratios. The level or cutoffs proposed for determining HLTs also varied among the comments from a low of 1.2 to 1 to a high of 7.0 to 1 depending on the specific cash flow ratio recommended. Comments favored the use of a cash flow criteria because it provides an effective measure of a company's ability to not only service high levels of debt, but also to absorb additional debt or expenditures. Comments opposed to the cash flow measures cited the difficulty

in determining either a standard cash flow indicator for all industries or maintaining cash flow criterion for a variety of industries. Comments opposing a cash flow criterion also noted that the selection of one cash flow ratio might not be appropriate to review a broad spectrum of industries or financing structures.

2. Revisions to the HLT Delisting Criteria.

One-hundred twenty nine comments favored revising, in some fashion, the delisting requirements for HLTs. The remainder of comments did not make a specific reference to the delisting criteria. Proposed revisions to the delisting criteria included: 1) adding a cash flow criteria (67 comments), 2) reducing the time frames required for delisting (87 comments) and 3) delisting companies emerging from bankruptcy. Comments favoring revisions to the delisting criteria stressed the importance of cash flow in determining a company's ability to service debt and stated that 2 to 3 years, rather than 4 years, was an appropriate time frame to review a company's performance as it related to servicing debt and meeting operational plans.

3. Exemption of Highly-Leveraged Transactions with Investment Grade Debt.

Forty-six comments responded to this concern. The majority (40) favored exempting companies with investment grade debt from

the HLT definition. Comments in favor of the exemption stated that investment grade companies had proven strengths which supported their ability to service debt, also investment grade companies receive their ratings after a careful review of the company by an independent third-party and should therefore not be subject to the criticism and pricing constraints associated with the HLT designation. Comments opposed to the exemption noted that only a small number of HLTs were investment grade and that the exemption of investment grade companies would favor large companies over smaller non-rated firms.

4. Application of the HLT Definition to Parent Companies and their Subsidiaries.

Seventy-five comments favored not consolidating a parent and its subsidiaries for purposes of determining the HLT designation. Comments favored this treatment because it acknowledges and gives credence to covenants associated with financing transactions that provide for separateness between a parent and its subsidiaries. Three comments were opposed to designating HLTs separately and favored the current consolidation treatment as being consistent with GAAP and acknowledging that parents and subsidiaries are interdependent, despite the use of lending covenants and corporate separateness.

5. Level of Flexibility and Judgement Allowed to Banks in Designating HLTs.

Fifty-seven comments responded to this issue. Thirty-seven favored allowing banks to designate HLTs according to the bank's own criteria and 20 comments (19 of these were banks) opposed allowing banks to designate HLTs. Comments favoring bank designated HLTs stated that bankers had the information necessary to make an informed decision and were particularly situated to uniquely assess the ability of borrowers to meet current commitments. Comments opposed to allowing banks to designate HLTs noted that inconsistencies in the application of the definition would result, and would therefore make any reporting requirements ineffective in comparing depository institutions.

**Summary of Comments Regarding the HLT Definition
January 16, 1992**

Table 1

Industry	Comments	Percent
Media	109	41%
Cable	67	25%
Banks/Assoc.	50	19%
Investment Banks	20	7%
Manufacturers	7	3%
Grocery	3	1%
Retail/Other	7	3%
Law Firms	3	1%
State Regulators	1	0%
Total	267	100%
Comments Referencing Cable/Media	216	81%

Analysis of Comments			
Subject	Favor/Yes	Opposed/No	No Comment
All Comments			
Should HLT be Eliminated	44%	12%	44%
Should HLT be Revised	95%	2%	3%
Does HLT Convey Credit Quality	54%	1%	45%
Use a Standardized Cash Flow	50%	16%	34%
Use an Industry Specific Cash Flow	39%	6%	55%
Treat Subsidiaries as Independent Entities	28%	1%	71%
Give Banks Added Flexibility	14%	7%	79%
Cable/Media			
Should HLT be Eliminated	59%	3%	38%
Should HLT be Revised	99%		1%
Does HLT Convey Credit Quality	49%		51%
Use a Standardized Cash Flow	52%	11%	37%
Use an Industry Specific Cash Flow	41%	2%	57%
Treat Subsidiaries as Independent Entities	22%		78%
Give Banks Added Flexibility	10%	1%	89%
Banks/Associations			
Should HLT be Eliminated	6%	38%	56%
Should HLT be Revised	80%	8%	12%
Does HLT Convey Credit Quality	62%	2%	36%
Use a Standardized Cash Flow	50%	28%	22%
Use an Industry Specific Cash Flow	30%	20%	50%
Treat Subsidiaries as Independent Entities	52%	6%	42%
Give Banks Added Flexibility	14%	32%	54%

**Summary of Comments Regarding the HLT Definition
January 16, 1992**

Analysis of Comments			
Subject	Favor/Yes	Opposed/No	No Comment
Grocery, Manufacturing and Retail/Other			
Should HLT be Eliminated	18%	24%	58%
Should HLT be Revised	100%		
Does HLT Convey Credit Quality	82%		18%
Use a Standardized Cash Flow	29%	29%	42%
Use an Industry Specific Cash Flow	29%		71%
Treat Subsidiaries as Independent Entities	24%		76%
Give Banks Added Flexibility	47%		53%
Investment Banks/Law Firms			
Should HLT be Eliminated	39%	4%	57%
Should HLT be Revised	100%		
Does HLT Convey Credit Quality	61%		39%
Use a Standardized Cash Flow	52%	13%	35%
Use an Industry Specific Cash Flow	48%	9%	43%
Treat Subsidiaries as Independent Entities	26%		74%
Give Banks Added Flexibility	17%	4%	79%

Attachment B

FEDERAL RESERVE SYSTEM

[Docket No. R-0734]

The Supervisory Definition of
Highly-Leveraged Transactions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) has approved, on a coordinated basis with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation: (1) the discontinuance, after June 30, 1992, of the supervisory definition of highly leveraged transactions (HLT's); and (2) the discontinuance of the reporting of HLT exposure by banking organizations regulated by the Board after the June 30, 1992 reporting date. In the interim, the Board has approved revisions to the supervisory definition of HLT's to be used by banks and bank holding companies for reporting their HLT exposure as of March 31, 1992 and June 30, 1992. Although the Board will phase out the use of the formal supervisory definition, guidance previously issued by the Board for assessing individual credits that finance corporate restructurings and for evaluating internal processes for initiating and reviewing these credits will continue to be used by examiners for this purpose. Due to the complex nature and level of risk associated with such financings, boards of directors and management at banking organizations will be expected to continue to monitor carefully their banking organization's risk exposure to these credits.

DATES: Effective Date. Upon publication in the Federal Register.

Compliance Dates. The use of the supervisory definition of highly leveraged transactions by the Board will be discontinued effective after the June 30, 1992 financial reporting date for banking organizations regulated by the Board. In the period preceding discontinuance of the definition, revisions to the definition have been approved for reporting HLT exposure as of March 31, 1992 and June 30, 1992.

FOR FURTHER INFORMATION CONTACT: Todd Glissman, Supervisory Financial Analyst (202/452-3953), or William Spaniel, Senior Financial Analyst (202/452-3469), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, D.C. 20551. For the hearing impaired only, Telecommunications Device for the Deaf ("TDD"), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: On July 10, 1991, the Board, in coordination with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, published for comment the supervisory definition of highly-leveraged transactions [56 FR 31464, July 10, 1991]. The agencies sought comment on all aspects of the HLT definition and criteria, as well as comments on specific issues raised by questions which the agencies had received. The comment period expired on September 26, 1991. The Board received 265 comments on the proposal.

After reviewing the status of the HLT definition, considering comments received from the public, and evaluating proposed revisions, the Board, in coordination with the other federal banking agencies, has approved the phase out of the supervisory definition of HLT's and the discontinuance of reporting of HLT's after the June 30, 1992 financial reporting by banking organizations. The Board has also approved revisions to the definition for use by banking organizations in reporting their HLT exposure as of March 30, 1992 and June 30, 1992.

The Board, in approving the phase out of the supervisory definition of HLT's, has taken under consideration the public comments received on the HLT definition, the current status of HLT credits, the reduced level of merger and acquisition activity in recent months, and the reluctance of lenders, in some cases, to extend credit to sound borrowers. The Board considered all options for maintaining or phasing out supervisory oversight of highly leveraged transactions. These included phasing out the definition, giving banks the flexibility to establish their own individual definitions, and proposing revisions to the supervisory definition. While the Board did not favor the immediate discontinuance of the definition, the Board believes that the HLT definition has largely accomplished its purposes and has approved the phase out of the definition. The definition encouraged financial institutions to focus attention on the need for internal controls and review mechanisms to monitor these types of financing transactions. The definition

also encouraged financial institutions to structure highly leveraged credits in a manner consistent with the risks involved. The HLT definition has played a role in helping the bank regulatory agencies identify these credits and monitor the risk associated with HLT portfolios over time. At the same time, the supervisory definition of highly leveraged transactions was not intended to impart supervisory criticism. With the phase out of the definition, Federal Reserve examiners will continue to evaluate, on an annual basis, all credits to assess the risk posed to insured depository institutions and holding companies by the individual credits and such credits will be subject to supervisory criticism when appropriate. Examiners will continue to thoroughly review each borrower's financial condition, income and cash flow; the value of any collateral or guarantees; the quality and continuity of the borrower's management; the borrower's ability to service its debt obligations; and other credit quality considerations. Consistent with sound banking practice, banking organizations will continue to be expected to have systems in place to monitor the risks associated with segments of their lending portfolios, including highly-leveraged credits.

The Board has adopted revisions to the definition to address concerns raised by the application and contents of the definition. These revisions in the definition are to be used by banking organizations during the period preceding the discontinuance of the definition to report the level of their HLT

exposure as of March 30, 1992 and June 30, 1992. These revisions include: (1) allowing banking organizations to delist certain companies from HLT status that adequately service debt and clearly demonstrate superior cash flow, relative to their respective industry or peer group; (2) reducing the timeframe in which a company's performance is evaluated before being delisted from HLT status; (3) delisting companies, previously designated as HLT's, emerging from Chapter 11 bankruptcy that are no longer highly leveraged; and (4) excluding certain loans from HLT reporting when fully collateralized by cash or readily-marketable securities.

Cash Flow Test:

A cash flow test was not included in the original supervisory HLT definition or delisting criteria. Although delisting criteria state that cash flow coverages are to be taken into consideration when reviewing the overall performance of a borrower for delisting, a specific measure was not defined. The reason for not incorporating a specific cash flow test was because (1) the definition was implemented to provide a consistent means of aggregating and monitoring a type of financing transaction, thus relying heavily on a purpose test and an easily-calculated leverage test; (2) it was deemed problematic to develop a universal cash flow measure that could be used for all industries; and (3) there was a desire to avoid any impression that the definition implied a supervisory criticism of

a credit, noting that cash flow is a primary factor in credit quality reviews.

The Board, in issuing the supervisory definition of highly leveraged transactions for comment, specifically sought comment of the appropriateness of the inclusion of a cash flow measure. A majority of comments from both companies and banks strongly favored the use of a cash flow test in the HLT definition, particularly for delisting purposes. Some favored a standardized cash flow test; others favored an industry-specific cash flow test; and some expressed a preference for both. Several banks stated, however, that it would be difficult to implement a cash flow measure for initially designating credits as HLTs because the analysis would have to be based on cash flow projections and not on historical performance. In light of the comments received, the Board reviewed potential cash flow measures including a debt service coverage ratio, an interest coverage ratio, and a ratio measuring the magnitude of debt in relationship to operating cash flow. All measures proved difficult to define adequately, particularly for use in analyzing companies in different industries. Moreover, it was found to be extremely difficult to establish a standardized level of "acceptable" cash flow that could be applied to all industries.

The Board concluded that it was not appropriate to adopt a standardized cash flow test; rather, the Board believes that banking organizations should analyze pertinent cash flow ratios for individual HLT companies, then make a determination as

to the quality and strength of each company's cash flow performance, subject to examiner review. Under the revision approved by the Board, the credits of a highly-leveraged company could be considered eligible for delisting by banking organizations on a case-by-case basis, if the company demonstrates superior cash flow coverage, relative to the company's industry or peer group, and the company has adequately serviced debt for a reasonable period of time since its last buyout, acquisition or leveraged recapitalization.

Reduce Timeframes for Delisting:

Presently, a borrower designated as an HLT must show good performance for a minimum of two years from the date of the transaction before being eligible for delisting from HLT status. After two years, if leverage¹ has been reduced below 75 percent, a borrower becomes eligible for delisting. If a borrower remains highly-leveraged, however, the borrower must demonstrate performance for a period of up to four years before being eligible to be delisted from HLT status.

Upon considering the comments received, the Board has determined that the delisting criteria should be amended by:

- (a) Reducing the delisting timeframe from two years to one year for companies that deleverage below 75 percent or were designated as HLTs under the "doubling of liabilities to greater than 50 percent" leverage test. Under this, companies would have to continue to meet general performance criteria to be delisted.

¹The leverage ratio is defined as total liabilities divided by total assets on the balance sheet prepared under generally accepted accounting principles (GAAP).

- (b) Reducing the delisting timeframe from four years to three years for companies that remain highly leveraged. A company would have to demonstrate performance for three consecutive years since its last highly-leveraged transaction and have a positive net worth in order to be eligible for delisting. The requirement that a company's leverage ratio not significantly exceed its industry norm in order to be delisted would be eliminated.

The Board believes that allowing companies that deleverage themselves to be delisted sooner from HLT status should encourage companies to improve their capitalization and credit standing by reducing leverage and issuing additional equity. These substantive changes to HLT delisting criteria are expected to allow a significant number of companies to be removed from HLT status, given the number of companies recently issuing equity and the number of HLTs that have now aged beyond three years.

Delist Certain Companies Emerging From Chapter 11 Bankruptcy:

In previous guidance, post-reorganization debt (after a company emerges from Chapter 11 bankruptcy) of a company that was designated HLT prior to bankruptcy proceedings retained an HLT designation until the company became eligible for delisting. Although a company was often deleveraged as a result of the reorganization, the company could not be delisted for at least two years.

Several comments stated that a company should not be designated HLT upon emerging from Chapter 11 reorganization if leverage is below 75 percent. It was indicated that continuing the HLT designation could interfere with the ability to obtain

post-reorganization financing for these companies. The Board recognizes that the purpose of Chapter 11 of the bankruptcy code is to help reorganize companies pursuant to a court-approved plan. Further, many reorganized companies emerging from bankruptcy are no longer highly leveraged and are, in essence, operating with a new balance sheet.

Reflecting these views, the Congress in the recently passed banking legislation "Federal Deposit Insurance Corporation Improvement Act of 1991" (Section 474) amended the Federal Deposit Insurance Act to prohibit a federal banking agency from designating by regulation or otherwise a corporation as a highly leveraged transaction (HLT) because such corporation is or has been a debtor or bankrupt under Title 11, if after confirmation of reorganization, such corporation would not otherwise be highly leveraged. In implementing this amendment, the Board believes that this should serve to emphasize the role played by the bankruptcy code and remove any implied hindrance to this type of lending.

Exclude Certain Fully-collateralized Loans from HLT Status:

Comments were received on the inclusion of certain loans fully-collateralized by cash or cash equivalent securities in a HLT's company's aggregate HLT exposure. It was indicated that the purpose of these fully-collateralized loans is generally not to take on additional debt for acquisition or restructuring purposes. It was also noted that a company arranging such a loan had sufficient liquid resources available on its balance sheet

and, therefore, would not have needed to borrow such funds. Given these reasons, the Board finds it appropriate to exclude certain fully-collateralized loans from HLT reporting by banking organizations.

Other Comments

Comment letters expressed support for several additional revisions to the HLT definition that the Board has decided not to adopt at this time. Potential revisions that were not adopted include (1) exempting companies with investment-grade senior debt from HLT designation and (2) excluding debt of certain subsidiaries from a consolidated company's HLT designation.

Under HLT guidelines, it is possible for a company with investment-grade senior debt to be designated an HLT if the company has been involved in significant merger and acquisition activity and has very high leverage. Comment letters indicated, however, that very few such companies exist.

To date, investment-grade companies have not been exempted from the HLT definition because of a desire to (1) avoid including credit quality criteria in the definition; (2) avoid inequitable treatment for companies that may meet investment grade criteria but are too small to be evaluated by the major rating agencies; and (3) avoid dependence on outside credit rating agencies, noting that credit quality of a company can quickly deteriorate under the burden of heavy debt.

Based on comment letters received, the Board has determined that exempting companies with investment-grade senior debt from HLT designation would appear to have little impact on the number of companies designated as HLTs, but it would serve to reinforce the perception that an HLT designation conveys credit quality information or criticism. Some comments noted that financial institutions could publicly disclose the level of investment-grade companies in their HLT portfolios, thus mitigating criticism by analysts of this portion of their portfolios. Given that exempting investment-grade companies from HLT designation could further reinforce negative perceptions concerning the overall credit quality of HLT loan portfolios, the Board decided not to adopt such a change.

Comments were also received on the inclusion of the debt of subsidiaries as part of the aggregate HLT exposure. According to the HLT guidelines, if a company satisfies the HLT purpose and leverage tests on a consolidated basis, then a loan to any part of the organization is designated HLT. However, if the subsidiary's debt level is significant enough to cause the consolidated organization to meet HLT leverage criteria, then all debt of the entire organization is designated HLT.

The review of financial statements and calculation of the leverage ratio for HLT purposes is conducted using generally accepted accounting principles (GAAP). Analyzing companies on a consolidated basis when determining HLT status is considered consistent with GAAP. Moreover, experience with consolidated

organizations has shown that when one aspect of a company's operations becomes imperiled, the entire organization is negatively impacted.

Although a significant number of comments favored excluding debt of certain subsidiaries from a parent company's HLT designation if appropriate protective covenants are maintained between the parent and subsidiary, the Board finds significant problems related to the use and review of protective covenants. Protective covenants cited as examples include restrictions on the movement of assets between parent and subsidiary companies, limitations on the payment of dividends to a parent company, restrictions on inter-company debt, and so forth. Each protective covenant, however, is unique, thus requiring a very difficult and time consuming review and evaluation process to determine its strength. Also, protective covenants are not known to work well when a company is in financial difficulty or enters bankruptcy proceedings.

Experience has shown that technical separation of companies through the use of loan covenants has not always been effective in protecting a company against liabilities emanating from its parent, subsidiary, or affiliate, especially in bankruptcy situations where the separation between parent and subsidiary can and has been breached.

Given a desire to adhere closely to GAAP, whenever possible; the influence that parent companies can exert over so-called "stand alone" subsidiaries when financial needs arise; and

the difficulties involved in evaluating and enforcing protective covenants, the Board has determined not to exclude certain subsidiaries of HLT parent companies from the HLT designation.

Definition and Guidance Regarding Highly-Leveraged Transactions ("HLTs"), As Revised

Summary of Definition

A bank or bank holding company is considered to be involved in a highly-leveraged transaction when credit is extended to or investment is made in a business where the financing transaction involves the buyout, acquisition, or recapitalization of an existing business and one of the following criteria is met:

- (a) the transaction results in a liabilities-to-assets leverage ratio higher than 75 percent; or
- (b) the transaction at least doubles the subject company's liabilities and results in a liabilities-to-assets leverage ratio higher than 50 percent; or
- (c) the transaction is designated an HLT by a syndication agent or a federal bank regulator.

Additional Guidance on the Definition of HLTs

A highly-leveraged transaction is a type of financing which involves the restructuring of an ongoing business concern financed primarily with debt. The purpose of an individual credit is most important when initially determining HLT status. Once an individual credit is designated as an HLT, all currently outstanding and future obligations of the same borrower are also included in HLT totals. This includes working capital loans and other ordinary credits, until such time as the borrower is delisted.

The regulatory purpose of the HLT definition is to provide a consistent means of aggregating and monitoring this type of financing transaction. It must be pointed out that the HLT designation does not imply a supervisory criticism of a credit. Before any HLT or any other credit is criticized, an examiner should review a whole range of factors on a credit-by-credit basis. These factors include cash flow, general ability to pay interest and principal on outstanding debt, economic conditions and trends, the borrower's future prospects, the quality and continuity of the borrower's management, and the lender's collateral position. Participation of banking organizations in

highly-leveraged transactions is not considered inappropriate so long as it is conducted in a sound and prudent manner, including the maintenance of adequate capital and loan loss reserves to support the risks associated with these transactions.

Borrowers having questions regarding the HLT definition should first refer these questions to their bankers. Bankers should then refer questions they cannot answer to the bank's primary federal regulator.

Purpose Test

To become eligible for designation as an HLT, a financing transaction must involve the buyout, acquisition, or recapitalization of an existing business, domestic or foreign. This definition encompasses traditional leveraged buyouts, management buyouts, corporate mergers and acquisitions, and significant stock buybacks. Leveraged Employee Stock Option Plans (ESOPs) are also included when used to acquire or recapitalize an existing business.

For purposes of satisfying the HLT purpose test, a leveraged recapitalization involves a replacement of equity with debt on a company's balance sheet by means of a stock repurchase or dividend payout. Refinancing existing debt in a company is not deemed to be a leveraged recapitalization.

Exclusions from the HLT Definition:

Single Asset or Lease: This purpose test excludes the acquisition or recapitalization of a single asset or lease (for e.g., a large commercial building or an aircraft), or a shell company formed to hold a single asset or lease, from the HLT definition. Although such an acquisition may be highly-leveraged, the asset or lease, in and of itself, is not considered an ongoing business concern and, therefore, is not intended to be included in the HLT category. However, the acquisition or recapitalization of a leasing corporation which invests in fleets of equipment for leasing, or a building company which invests in real estate projects would satisfy the HLT purpose test.

De Minimis Test: Loans and exposures to any obligor in which the total financing package, including all obligations held by all participants, does not exceed \$20 million, at the time of origination, may be excluded from HLT designation. Nonetheless, there may be some banking organizations that in the aggregate have significant exposure to transactions below the de minimis level. It is expected that those organizations would continue to monitor

closely these transactions as part of their aggregate HLT exposures.

Historical Cutoff Date: An HLT transaction not included in the Shared National Credit Program, that meets or exceeds the \$20 million test, may be excluded from HLT designation if it originated prior to January 1, 1987, the original terms and conditions of the credit are materially unchanged, the credit has not been criticized by examiners, and the financial condition of the debtor has not deteriorated.

Debtor-in-Possession Financings: Court-approved debtor-in-possession (or trustee-in-possession) financing for a business concern in Chapter 11 reorganization proceedings will generally be exempt from HLT designation. All pre-petition debt of an HLT borrower and any post-reorganization debt (after a company emerges from Chapter 11 bankruptcy) will continue to be included in HLT exposure until delisting occurs.

Loans Fully-Collateralized With Cash or Cash Equivalents: All loans (credit facilities) that are fully-collateralized with cash or cash equivalents are excluded from HLT reporting by banking organizations. Cash collateral consists of a deposit in the financial institution advancing the loan proceeds, segregated and under the control of the financial institution, and unequivocally pledged to secure the loan. Cash equivalents are deemed to include U.S. Government and certain other readily-marketable securities qualifying for a zero risk-weight under risk-based capital standards. Cash equivalents must be held in custody by and unequivocally pledged to the lending financial institution.

Leverage Tests

In addition to the purpose test, one of the following criteria must be met for the transaction to be considered an HLT:

- 1) **The transaction at least doubles the subject company's liabilities and results in a total liabilities to total assets (leverage) ratio higher than 50 percent.**

NOTE: The purpose of this leverage test is to capture transactions in which a company must suddenly deal with a substantially higher debt burden. The greatest risk in a credit exposure is not necessarily the absolute level of debt but may be the impact on a company of significant new debt. A key HLT success factor is ability to handle a sudden, large increase in debt.

The "doubling of liabilities" is intended to capture those transactions where new debt is used to facilitate the

buyout, acquisition, or recapitalization of a business. If the sum of the acquiring and acquired companies' liabilities would double as a result of the new debt taken on to effect the combination of the companies, then the transaction is considered an HLT, and all exposure to the company is designated an HLT. It is not intended to cover a doubling resulting from the simple addition of the existing liabilities of the two companies.

Any refinanced portion of old debt in a transaction should continue to be treated as old debt for purposes of applying this leverage test. Further, if there was no debt in either company prior to the transaction, then any new debt will result in a "doubling of liabilities."

In an acquisition involving one or more operating divisions of a company (as opposed to stand-alone subsidiaries), existing liabilities of the seller associated with specific operating assets being transferred in the transaction may be allocated to the resulting company for purposes of applying the "doubling of liabilities" test. The burden of proof is on the resulting company and its financial institution(s) to substantiate that the allocation of the seller's liabilities to the resulting company is appropriate.

When calculating a company's leverage for the purpose of this test, captive finance company subsidiaries and subsidiary depository institutions should be excluded from the consolidated organization.

- 2) **The transaction results in a total liabilities to total assets (leverage) ratio higher than 75 percent.**

NOTE: When a company's leverage ratio exceeds 75%, the determination of whether exposure to the company is designated an HLT further depends on the composition of the company's total liabilities after the transaction. If a significant portion of the liabilities (generally 25% or more of total liabilities) derives from buyouts, acquisitions, or recapitalizations, either past or present, then all exposure to the company is designated an HLT. If, after the transaction, debt related to buyouts, acquisitions, or recapitalizations, either past or present, represents less than 25% of total liabilities, then the exposure to the company need not be designated an HLT.

Again, when calculating a company's leverage for the purpose of this test, captive finance company subsidiaries and subsidiary depository institutions should be excluded from the consolidated organization.

3) The transaction is designated an HLT by a syndication agent.

In specific cases, the bank supervisory agencies may also designate a transaction as an HLT even if it does not meet the conditions outlined above. (It is anticipated that this would be done infrequently and only in material cases.)

Definition of the Leverage Ratio

The leverage ratio is total liabilities divided by total assets. Total assets of the resulting enterprise include intangible assets (such as goodwill). Total liabilities include all forms of debt (including any new debt taken on to facilitate the transaction) and claims, including all subordinated debt and non-perpetual preferred stock. Perpetual preferred stock is generally considered equity for purposes of calculating HLT leverage. However, exceptions could be made on a case-by-case basis if the stock has characteristics more akin to debt than equity.

Off-balance sheet exposure, including claims related to foreign exchange contracts, interest rate swaps, and other risk protection or cash management products may normally be excluded from HLT exposure as long as their credit equivalent exposure is small relative to other types of obligations. (It is expected, however, that internal management information and control systems be in place to capture these exposures.)

If a parent company uses "double leverage" (that is, takes on debt and downstreams it as equity to a subsidiary) to assist a subsidiary in an HLT purpose-related transaction, then the debt at the parent company will be considered HLT purpose-related debt when calculating leverage for the company on a consolidated basis.

In an acquisition involving a pure assumption of debt with no new debt issued, the transaction is not designated an HLT unless the resulting company's aggregate outstanding HLT purpose-related debt (from all previous transactions) is significant (generally 25 percent or more of total liabilities) and the 75 percent leverage test is satisfied.

Consolidation of HLT Exposure

All credit extended to, or investments made in an HLT should be aggregated with any ordinary business loans to, or investments in, the same obligor.

If a company satisfies the HLT purpose and leverage tests on a consolidated basis, then a loan to any part of the organization is deemed to be an HLT. On the other hand, if only a subsidiary of a company satisfies the HLT tests, then the subsidiary could

"stand alone" as an HLT; however, if the subsidiary's debt level is significant enough to cause the consolidated organization to meet HLT leverage criteria, then all debt of the entire organization is designated HLT.

Guarantees of Payment

If a parent company supplies an irrevocable, unconditional guarantee of payment on behalf of its subsidiary and the leverage of the consolidated organization does not meet HLT leverage criteria, then the subsidiary will generally not be designated an HLT. On the other hand, if the subsidiary's leverage is significant enough to cause the consolidated organization to meet HLT leverage criteria, then all debt of the entire organization is accorded HLT status. (NOTE: Third-party guarantees and guarantees by related subsidiaries of a company have no effect on the HLT designation. While these types of guarantees offer credit enhancement benefits which will be taken into consideration during the review of individual credits by examiners, they generally lack the stronger bonds of support inherent in the relationship between a parent and its subsidiary.)

When a foreign parent company provides the equivalent of an irrevocable and unconditional guarantee of payment on behalf of a subsidiary, the subsidiary's debt will normally not be designated as HLT debt as long as the consolidated organization does not meet HLT leverage criteria and the following two conditions are met:

- (1) Written opinions from legal counsels in the country of origin and the United States are provided which state that the equivalent of a written guarantee of debt repayment exists which is irrevocable and unconditional; and
- (2) The credit files in the U.S. banking organizations lending to the subsidiary contain consolidated financial statements for the foreign parent stated in U.S. dollars under U.S. accounting rules.

Agent and Lead Bank Responsibility

To ensure consistent application of the definition, the agent or lead bank is responsible for determining whether or not a transaction qualifies as an HLT. The agent or lead bank is charged with the timely notification to participants regarding the status of the transaction and of any change in that status, i.e. designation as an HLT or delisting as an HLT.

The responsibility of the agent or lead bank to determine HLT status does not preclude a participant bank from designating a transaction as a HLT or relieve a participant from performing

its own credit analysis. Examiners will review transaction for compliance with the HLT definition in the context of the Shared National Credit Program and during regular on-site examinations.

Delisting Criteria

HLT exposure of a given borrower may be removed from HLT status upon satisfying one of the following criteria:

(a) Credits of a company emerging from protection under Chapter 11 of the U.S. Bankruptcy Code at the consummation of a court-approved plan of reorganization will be immediately delisted from HLT status, if the company's leverage ratio is less than 75 percent at the time of reorganization.

(b) A borrower's credits that were designated as HLTs under the "doubling of liabilities to greater than 50 percent" leverage test or that have reduced leverage to less than 75 percent will be considered eligible for delisting if the company has performed well for one year (since its last buyout, acquisition, or leveraged recapitalization involving financing) and demonstrates an ability to continue satisfactorily servicing debt. To verify adequate performance and validate the appropriateness of financial projections of a company, the lender should conduct a thorough review of the obligor to include, at a minimum, overall management performance against the business plan, cash flow coverages, operating margins, industry risk, and status of asset sales, if applicable.

(c) Credits of a company whose leverage continues to exceed the 75 percent leverage test will be considered eligible for delisting by banking organizations on a case-by-case basis, if the company demonstrates superior cash flow coverage, relative to the company's industry or peer group, and the company has adequately serviced debt for a reasonable period of time since its last buyout, acquisition, or leveraged recapitalization involving financing. To verify strong performance, the lender should conduct a thorough review of the obligor to include, at a minimum, the quality and strength of cash flow coverages, operating margins, reduction in leverage, appropriateness of the company's financial projections, overall management performance against the business plan, industry risk, and status of asset sales, if applicable. Credits delisted in this manner will subsequently be reviewed, and potentially subject to relisting, by examiners during the normal course of an examination.

(d) Credits of a company whose leverage continues to exceed the 75 percent leverage test will be considered eligible for

delisting if the company has performed adequately for at least three years since its last buyout, acquisition, or leveraged recapitalization involving financing; and the company has a positive net worth. To verify adequate performance and validate the appropriateness of financial projections of a company, the lender should conduct a thorough review of the obligor to include, at a minimum, overall management performance against the business plan, cash flow coverages, operating margins, industry risk, and status of asset sales, if applicable.

It is expected that banks will maintain records of delisted exposures and reasons for delisting. After delisting, any significant changes in the obligor's financial condition should cause the exposure to be reviewed for relisting. Records pertaining to delisting and relisting of HLTs will be reviewed by examiners in the context of the Shared National Credit Program and/or regular on-site examinations.

If the HLT is shared, the lead or agent bank should inform all participants and its principal regulator of the decision to delist or relist.

By order of the Board of Governors of the Federal Reserve System,
January 21, 1992

William W. Wiles
Secretary

**Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board**

Highly-Leveraged Transactions

To address concerns with the supervisory definition of highly-leveraged transactions (HLTs), the federal bank regulatory agencies published a request for comment in the Federal Register on July 10, 1991. The agencies sought comment on all aspects of the HLT definition and criteria, as well as comments on specific issues raised by questions which the agencies had received.

Upon reviewing the current status of the HLT definition, considering over 260 comments received from the public, and evaluating various options, the agencies intend to phase out use of the definition and to discontinue regulatory reporting of HLTs by banking organizations effective after the June 30, 1992 reporting date.

In making a decision to phase out use of the HLT definition, the agencies determined that the definition has largely accomplished its original purposes. In particular, the HLT definition encouraged financial institutions to focus attention on the need for internal control and review mechanisms to monitor this type of financing transaction. It also highlighted the need for financial institutions to structure highly-leveraged credits in a way that is consistent with the risks involved.

Furthermore, circumstances have changed since the definition was implemented. Merger and acquisition activity has declined significantly. Companies have more recently been improving their capitalization and credit standing by deleveraging and issuing equity. Also, the agencies recognize that the HLT definition may be having an undue effect on pricing and availability of credit to certain highly-leveraged borrowers.

Although the banking agencies plan to discontinue use of the supervisory HLT definition and related reporting, all highly-leveraged credits will continue to be closely reviewed in the examination process. As with any commercial loan, an examiner will continue to thoroughly review the borrower's financial condition, income, and cash flow; the value of any collateral or guarantees; the quality and continuity of the borrower's management; and the borrower's ability to service its debt obligations. Guidance previously issued by each agency for assessing individual credits that finance corporate restructurings and for evaluating internal processes for initiating and reviewing such credits will continue to be used by

examiners for this purpose. Due to the complex nature and level of risk associated with such financings, boards of directors and management at banking organizations will be expected to continue to monitor carefully their bank's risk exposure to these credits.

In response to concerns expressed in comment letters, the agencies are also making certain interim revisions to the HLT definition. Revisions are effective with first quarter reporting by banking organizations. They include (1) **reducing the timeframes for delisting credits from HLT status**; (2) **allowing banking organizations to delist certain companies from HLT status that adequately service debt and clearly demonstrate superior cash flow, relative to their respective industry or peer groups**; (3) **delisting each company (with a previous HLT designation) emerging from Chapter 11 bankruptcy from the HLT designation whose leverage, after reorganization, is less than 75 percent**; and (4) **excluding certain loans from HLT reporting that are fully-collateralized with cash or cash equivalents**.

To implement these revisions, the following changes are being made to the HLT definition:

- * All delisting criteria will be replaced with the following:

HLT exposure of a given borrower may be removed from HLT status upon satisfying one of the following criteria:

(a) Credits of a company emerging from protection under Chapter 11 of the U.S. Bankruptcy Code at the consummation of a court-approved plan of reorganization will be immediately delisted from HLT status, if the company's leverage ratio is less than 75 percent at the time of reorganization.

(b) A borrower's credits that were designated as HLTs under the "doubling of liabilities to greater than 50 percent" leverage test or that have reduced leverage to less than 75 percent will be considered eligible for delisting if the company has performed well for one year (since its last buyout, acquisition, or leveraged recapitalization involving financing) and demonstrates an ability to continue satisfactorily servicing debt. To verify adequate performance and validate the appropriateness of financial projections of a company, the lender should conduct a thorough review of the obligor to include, at a minimum, overall management performance against the business plan, cash flow coverages, operating margins, industry risk, and status of asset sales, if applicable.

(c) Credits of a company whose leverage continues to exceed the 75 percent leverage test will be considered eligible for delisting by banking organizations on a case-by-case basis,

if the company demonstrates superior cash flow coverage, relative to the company's industry or peer group, and the company has adequately serviced debt for a reasonable period of time since its last buyout, acquisition, or leveraged recapitalization involving financing. To verify strong performance, the lender should conduct a thorough review of the obligor to include, at a minimum, the quality and strength of cash flow coverages, operating margins, reduction in leverage, appropriateness of the company's financial projections, overall management performance against the business plan, industry risk, and status of asset sales, if applicable. Credits delisted in this manner will subsequently be reviewed, and potentially subject to relisting, by examiners during the normal course of an examination.

(d) Credits of a company whose leverage continues to exceed the 75 percent leverage test will be considered eligible for delisting if the company has performed adequately for at least three years since its last buyout, acquisition, or leveraged recapitalization involving financing; and the company has a positive net worth. To verify adequate performance and validate the appropriateness of financial projections of a company, the lender should conduct a thorough review of the obligor to include, at a minimum, overall management performance against the business plan, cash flow coverages, operating margins, industry risk, and status of asset sales, if applicable.

* Certain fully-collateralized loans will be excluded from HLT reporting by banking organizations as follows:

All loans (credit facilities) that are fully-collateralized with cash or cash equivalents are excluded from HLT reporting by banking organizations. Cash collateral consists of a deposit in the financial institution advancing the loan proceeds, segregated and under the control of the financial institution, and unequivocally pledged to secure the loan. Cash equivalents are deemed to include U.S. Government and certain other readily-marketable securities qualifying for a zero risk-weight under risk-based capital standards. Cash equivalents must be held in custody by and unequivocally pledged to the lending financial institution.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date: January 16, 1992

To: Board of Governors

Subject: Regulatory Capital

From: Division of Banking
Supervision and Regulation*

Treatment of Identifiable
Intangible Assets

ACTION REQUESTED: The Board's approval to request public comment for a 30-day period on a proposal developed on a coordinated basis by the staffs of the OCC, FDIC, OTS, and the Federal Reserve to achieve uniformity in the treatment of intangible assets for regulatory capital purposes.

As described below, the interagency staff proposal would establish the types of and quantitative limits on intangible assets includable in capital for purposes of calculating risk-based and leverage capital ratios. Purchased mortgage servicing rights ("PMSRs") and purchased credit card relationships ("PCCRs"), subject to an overall aggregate limit of 50 percent of Tier 1 capital and a separate sublimit of 25 percent of Tier 1 capital for PCCRs, would qualify for inclusion in capital. The proposal excludes all core deposit intangibles ("CDIs") from capital. In addition, goodwill will continue to be excluded from capital consistent with longstanding policy and the risk-based capital framework. Staff is also proposing that the

* Messrs. Struble, Cole, Pugh, and Holm and Ms. Barger.

suggested changes in the capital treatment of intangible assets be incorporated into the capital ratios used for both examinations and applications purposes. Consistent with the Board's existing capital guidelines, however, the Board may in certain cases continue to evaluate an organization's tangible capital ratios (after deducting all intangibles) in assessing its overall capital adequacy, if warranted by the condition of the organization.

The attached draft Federal Register notice requesting public comment sets forth in detail the revisions to the Board's risk-based and leverage capital guidelines that would be necessary if, after reviewing the comments and further consideration, the Board decides to implement the interagency staff proposal.¹

SUMMARY: With the Board's approval, public comment will be sought on proposed revisions to the Federal Reserve's capital adequacy guidelines that would provide explicit guidance to state member banks and bank holding companies on the treatment of identifiable intangible assets for purposes of calculating their risk-based and leverage capital ratios. The proposal was developed and is being released for public comment on a

¹Prior to publication of this proposal in the Federal Register, Board staff will consult upon the final wording of the proposal with the staffs of the FDIC, OCC, and OTS. Accordingly, staff seeks approval to make insignificant changes in wording, if and as necessary, to achieve final interagency agreement. Any significant changes would be referred to the Board for discussion or notation vote as appropriate.

coordinated basis with the FDIC, OCC, and OTS in order to achieve uniformity among the banking agencies in the capital treatment of these assets in a manner that is consistent with the international risk-based capital standards.

The proposal would permit banking organizations to include in capital (that is, not deduct from capital) purchased mortgage servicing rights ("PMSRs") and purchased credit card relationships ("PCCRs"), provided that, in the aggregate, they do not exceed 50 percent of Tier 1 capital. PCCRs would be subject to a separate sublimit of 25 percent of Tier 1. PMSRs and PCCRs in excess of these limits, as well as core deposit intangibles and all other identifiable intangible assets, would be deducted from Tier 1. A reasonably active and liquid market exists for the identifiable intangible assets that are being proposed for inclusion in Tier 1 capital, i.e., PMSRs and PCCRs. In addition, the market values of these assets generally are not affected by the financial condition of the organization that owns them.

In order to implement a provision of the Federal Deposit Insurance Corporation ("FDIC") Improvement Act of 1991 and to achieve consistency with current FDIC and OTS rules regarding the valuation of PMSRs, the proposal states that the fair market value and book value of PMSRs must be determined at least quarterly in accordance with certain criteria and that, for purposes of calculating regulatory capital (but not for financial statement purposes), the amount of PMSRs reported on the balance sheet would be reduced to the lesser of: 90 percent of their

fair market value, 90 percent of their original purchase price, or 100 percent of their remaining unamortized book value. The proposal would also require banking organizations to subject their PCCRs to the same valuation and discounting approaches as those proposed for PMSRs.

BACKGROUND: Currently, the four federal banking agencies differ somewhat with regard to the treatment of identifiable intangible assets (that is, intangible assets other than goodwill) in the calculation of regulatory capital ratios. The FDIC and OCC fully deduct all intangibles other than PMSRs from Tier 1 capital. The Federal Reserve does not automatically deduct any identifiable intangible assets from Tier 1 capital, but determines the appropriateness of their inclusion in an organization's capital position on a case-by-case basis and has long considered the level and quality of identifiable intangible assets in assessing the capital adequacy and overall asset quality of banking institutions. In addition, in reviewing expansionary proposals by banking organizations, the Federal Reserve considers both an organization's stated capital as well as its tangible capital. The OTS deducts all intangibles other than PMSRs unless an institution can document that its holdings of other intangibles meet certain criteria, in which case they may be included in capital.

All the agencies specify limits for the amount of intangibles that institutions can include in capital. The OCC

permits PMSRs to account for up to 25 percent of Tier 1 capital, while the FDIC permits them to account for up to 50 percent of Tier 1. The OTS also permits PMSRs to be included up to 50 percent of Tier 1 capital and limits other qualifying intangibles (e.g., CDIs) to 25 percent of Tier 1 capital. The Board's current risk-based capital guidelines indicate that while all intangible assets will be monitored, identifiable intangible assets in excess of 25 percent of Tier 1 capital are subject to particularly close scrutiny.

The FDIC and OTS also subject PMSRs to certain valuation and discounting requirements. These agencies require institutions to determine the fair market value of PMSRs by applying an appropriate market discount rate to the net servicing cash flows, taking into account any significant changes in original valuation assumptions such as prepayment estimates. The FDIC and OTS rules also require that the book value of PMSRs be reviewed quarterly. If an institution wishes to allow PMSRs to be recognized for inclusion in regulatory capital, it must carry them at a book value equal to the discounted value of their future net servicing income.

For some time, the banking agencies have been reviewing the capital treatment of identifiable intangible assets with the aim of developing greater uniformity among the agencies in the treatment of these assets for capital adequacy purposes. On the basis of this review, the staff is proposing to issue for public comment revisions to the Board's capital adequacy guidelines to

provide explicit guidance on the types of intangible assets that state member banks and bank holding companies may include in capital and specifications on appropriate limits within capital. The proposal, which is set forth in the attached draft Federal Register notice, is based on a tentative agreement on the treatment of intangible assets reached by the staffs of the Federal Reserve, the FDIC, the OCC, and the OTS. The proposal is released for public comment on a coordinated basis with these other agencies in order to achieve uniformity among the banking agencies in the capital treatment of these assets. The proposal is consistent with international capital standards.

The proposal states that banking organizations would be permitted to include PMSRs and PCCRs in capital, provided that, in the aggregate, the amount of these assets included does not exceed 50 percent of an organization's Tier 1 capital. PCCRs would be subject to a separate sublimit of 25 percent of Tier 1.² Amounts of PMSRs and PCCRs in excess of these amounts, as well as all other identifiable intangible assets, including CDIs, would be deducted from Tier 1 for purposes of calculating regulatory capital ratios. As set forth in more detail in the attached Federal Register notice, the exclusion of CDIs from Tier 1 capital reflects the interagency staff consensus that these intangible assets have many of the characteristics of goodwill

²For purposes of calculating the limitations on PMSRs and PCCRs includable in capital as a percentage of Tier 1 capital, Tier 1 is defined as the sum of core capital elements net of goodwill and identifiable intangible assets other than PMSRs and PCCRs.

and that their value tends to fall significantly when a depository institution experiences financial difficulty.

Staff believes that this proposal represents a reasonable compromise among the banking agencies' current rules with regard to the types and amounts of intangible assets that may be included in capital. In staff's view, the proposed approach offers a basis for achieving consistency among the banking agencies in their capital treatment of identifiable intangible assets while preserving the integrity of the capital definition.

The proposal also deals with the valuation of PMSRs consistent with provisions of the FDIC Improvement Act of 1991, which was recently signed into law. Section 475 of the Act requires that the value of PMSRs included in calculating an institution's capital not exceed 90 percent of their fair market value and that such value be determined at least quarterly. In order to implement the valuation provisions of section 475 and in the interests of achieving consistency in the treatment of intangible assets among the banking agencies, the proposal states that institutions must determine the fair market value and the book value of their PMSRs at least quarterly in accordance with the criteria discussed above that the FDIC and OCC currently employ in their rules regarding PMSRs. The proposal also indicates that the discount rate used for the calculation of book value should not be less than that derived at the time of acquisition, based upon the estimated cash flows and the price

paid for the asset at the time of purchase.

In order to implement the discount on PMSRs required under section 475, the proposal states that, for purposes of calculating regulatory capital (but not for financial statement purposes), the amount of PMSRs reported on the balance sheet asset would be reduced to the lesser of:

- (i) 90 percent of the fair market value of the PMSRs; or
- (ii) 90 percent of the original purchase price paid for the PMSRs; or
- (iii) 100 percent of the remaining unamortized book value of the PMSRs.

This discounting approach is the same as that which the FDIC and OTS currently require state nonmember banks and savings associations to apply to their holdings of PMSRs. Staff is proposing that the Board seek specific public comment on the approach discussed above to the valuation and discounting for PMSRs includable in capital.

Since the calculation of the fair market value for PCCRs is at least as subjective as it is for PMSRs, the proposal also would require that PCCRs be subject to a discount. In order to achieve consistency in the valuation of identifiable intangible assets included in capital, the proposal indicates that banking organizations will also be required to determine the fair market value and book value of their PCCRs at least quarterly, using the same criteria as those proposed for PMSRs, and to subject their PCCRs to the same value adjustment as that proposed for PMSRs. In this connection, the proposal

specifically seeks public comment on this approach to the valuation and discounting for PCCRS.

Staff is also proposing that the suggested changes in the capital treatment of intangible assets be incorporated into the capital ratios used for both examinations and applications purposes. Consistent with the Board's existing capital guidelines, however, the Board may in certain cases continue to evaluate an organization's tangible capital ratios (after deducting all intangibles) in assessing its overall capital adequacy, if warranted by the condition of the organization.

Attachment

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulation H, Regulation Y; Docket No. _____]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of Proposed Revisions to Capital Adequacy Guidelines.

SUMMARY: The Board is seeking comment on a proposal to revise the Federal Reserve's capital adequacy guidelines for bank holding companies and state member banks to provide explicit guidance on the types of intangible assets that may be included (i.e., not deducted) in the Tier 1 capital calculation for risk-based and leverage capital purposes. The proposal also includes limits and discounts that would be applicable to such intangibles includable in capital. The proposal, which was developed in conjunction with the staffs of the four federal banking agencies, is aimed at achieving greater consistency among the agencies with respect to the capital treatment of intangible assets and is being released for public comment on a coordinated basis with these agencies. The proposal is consistent with the international capital standards.

Under the proposal, purchased mortgage servicing rights ("PMSRs") and purchased credit card relationships ("PCCRs") would be includable in the Tier 1 capital computation provided that, in

the aggregate, they do not exceed a limit of 50 percent of Tier 1 capital and provided that PCCRs not exceed a sublimit of 25 percent of Tier 1. PMSRs and PCCRs in excess of these limits, as well as core deposit intangibles ("CDIs") and all other intangible assets, would be deducted from the sum of the core capital elements in determining Tier 1 capital.

In order to implement a provision of the Federal Deposit Insurance Corporation ("FDIC") Improvement Act of 1991 and to conform to the current rules of the FDIC and the Office of Thrift Supervision ("OTS"), the Board also is proposing that institutions be required to determine the fair market value and book value of their PMSRs at least quarterly in accordance with certain criteria. In addition, for purposes of calculating regulatory capital (but not for financial statement purposes), institutions would be required to reduce the amount of PMSRs reported on the balance sheet to the lesser of 90 percent of their fair market value, 90 percent of their original purchase price, or 100 percent of remaining unamortized book value.

The proposal states that organizations must also determine the fair market value and book value of PCCRs at least quarterly, in accordance with certain criteria, and subject PCCRs to the same value adjustment as that proposed for PMSRs. The Board is specifically seeking comment on this approach to valuing and discounting PMSRs and PCCRs.

The proposed changes in the capital treatment of intangible assets would be incorporated into the capital ratios

used for both examinations and applications purposes. Consistent with the Board's existing capital guidelines, however, the Board may in certain cases continue to evaluate an organization's tangible capital ratios (after deducting all intangibles) in assessing its overall capital adequacy, if warranted by the condition of the organization.

DATE: Comments on the proposed revisions to the Federal Reserve Board's risk-based capital guidelines and leverage capital guidelines should be submitted on or before [30 days after publication].

ADDRESS: Comments, which should refer to docket No. _____, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenues, N.W., Washington, D.C. 20551; or delivered to Room B-2223, Eccles Building, between 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in section 2612.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Rhoger H Pugh, Manager (202/728-5883), Norah M. Barger, Supervisory Financial Analyst (202/452-2402), Charles H. Holm, Supervisory Financial Analyst (202/452-3502), Division of Banking Supervision and Regulation;

and Scott G. Alvarez, Associate General Counsel (202/452-3583), Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

I. Background

The Board is proposing to revise the Federal Reserve's capital adequacy guidelines for bank holding companies and state member banks to provide explicit guidance on the types of intangible assets that may be included in (i.e., not deducted from) the Tier 1 capital calculation for risk-based and leverage capital purposes and the limits and discounts that would be applicable to such intangibles includable in capital. The proposal is based on a tentative agreement on the treatment of intangible assets reached by the staffs of the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency ("OCC"), and the OTS. It is being released for public comment on a coordinated basis with these other agencies in order to achieve uniformity among the banking agencies in the capital treatment of these assets in a manner that is consistent with the international capital standards (Basle Accord).¹

¹The Basle Accord is a risk-based capital framework that was proposed by the Basle Committee on Banking Regulations and Supervisory Practices and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Committee is comprised of representatives of the central banks and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.

The Basle Accord requires that banks deduct goodwill from their core capital elements in determining Tier 1 capital for risk-based capital purposes.² The Basle framework, which by its terms applies only to internationally active banks, was adopted by the Federal Reserve for all state member banks. In addition, the Board chose to apply a risk-based capital framework similar to the Basle Accord to U.S. bank holding companies, generally on a consolidated basis.³ Under this framework, bank holding companies are also required to deduct goodwill from Tier 1 capital. Furthermore, the Board has adopted a leverage capital standard for state member banks and bank holding companies.⁴ Since Tier 1 capital serves as the numerator of the leverage ratio, goodwill also is deducted from the core capital elements for purposes of the leverage standard.

The Basle Accord does not address the treatment of intangible assets other than goodwill, that is, identifiable intangible assets. Consequently, U.S. bank regulators have discretion in specifying the treatment of these other intangible

²The risk-based capital guidelines utilize the ratio of a banking organization's Tier 1 capital, which is composed of core capital elements such as common and perpetual preferred stock, and Tier 2 capital, which is composed of supplementary capital elements such as the allowance for loan and lease losses and subordinated debt, to the organization's total on-balance sheet assets and off-balance credit arrangements, adjusted for their relative risks.

³For bank holding companies with consolidated assets of less than \$150 million in assets, the risk-based capital guidelines generally are applied on a bank-only basis.

⁴The leverage capital guidelines utilize a ratio of the bank's Tier 1 capital elements to its total on-balance sheet assets.

assets, provided that such treatment is consistent with the spirit of the Basle Accord. The basic approach taken by the Federal Reserve and the other U.S. banking agencies in determining the treatment of identifiable intangible assets has been to evaluate them on the basis of the following criteria:

1. The reliability and predictability of any cash flows associated with the asset and the degree of certainty that can be achieved in periodically determining the asset's useful life and value;
2. The marketability of the asset, i.e., the existence of an active and liquid market; and
3. The salability of the asset, i.e., the feasibility of selling the asset apart from the banking organization or from the bulk of its assets.

All the agencies have determined that PMSRs generally meet these criteria and all allow such assets in Tier 1 capital, subject to certain limits. The agencies differ on the extent to which other intangibles meet the criteria and follow somewhat different procedures regarding their treatment.

The FDIC and OCC fully deduct all intangibles other than PMSRs from Tier 1 capital. The Federal Reserve does not automatically deduct any identifiable intangible asset from Tier 1 capital, but determines the appropriateness of their inclusion in the calculation of an organization's capital position on a case-by-case basis. Because even those intangible assets that meet the above criteria generally contain a high degree of risk,

the Board has long considered the level and quality of identifiable intangible assets in assessing the capital adequacy and overall asset quality of banking institutions. The OTS has concluded that, at least in some cases, certain other identifiable intangible assets (e.g., CDIs) may meet the three criteria and, therefore, has not required the deduction of some of these other identifiable intangible assets in calculating capital ratios.

All the agencies specify limits for the amount of intangibles that institutions can include in capital. The OCC permits PMSRs to account for up to 25 percent of Tier 1 capital. The OTS permits PMSRs to be included up to 50 percent of Tier 1 capital, and other qualifying intangibles (e.g., CDIs) are limited to 25 percent of Tier 1 capital. The FDIC permits PMSRs up to 50 percent of Tier 1 capital. The Board's current risk-based capital guidelines indicate that while all intangible assets will be monitored, identifiable intangible assets in excess of 25 percent of Tier 1 capital are subject to particularly close scrutiny, both through the inspection and examination process and by other appropriate means.

The FDIC and the OTS also impose certain valuation requirements for determining the fair market value and book value of PMSRs. In addition, their capital rules state that for purposes of calculating regulatory capital (but not for financial statement purposes) the amount of PMSRs reported on the balance sheet will be reduced to the lesser of:

- (i) 90 percent of the fair market value of the PMSRs; or
- (ii) 90 percent of the original purchase price paid for the PMSRs; or
- (iii) 100 percent of the remaining unamortized book value of the PMSRs.

For some time, the banking agencies have been reviewing the capital treatment of identifiable intangible assets with the aim of developing greater uniformity among the agencies in the treatment of these assets for capital adequacy purposes. On the basis of this review, the Board is now proposing to issue for public comment revisions to its capital adequacy guidelines to provide explicit guidance on the types of intangible assets that may be included in capital and specifications on appropriate limits within capital. The proposed revisions are based on a tentative agreement reached by the staffs of the four federal banking agencies with respect to the regulatory capital treatment of intangible assets.

The Federal Reserve is also proposing that PMSRs be subject to certain valuation requirements that are consistent with provisions of the FDIC Improvement Act of 1991 and with the current FDIC and OTS rules regarding PMSRs. The Act requires that the value of readily marketable PMSRs included in the calculation of an institution's capital not exceed 90 percent of their fair market value and that such value be determined at least quarterly. The current FDIC and OTS rules regarding PMSRs set down criteria for determining both the fair market value and

book value of these assets. Since the calculation of the fair market value for PCCRs is at least as subjective than it is for PMSRs, the Federal Reserve is also proposing that PCCRs be subject to the same valuation requirements as PMSRs.

The proposed changes in the capital treatment of intangible assets would be incorporated into the capital ratios used for both examinations and applications purposes. Consistent with the Board's existing capital guidelines, however, the Board may in certain cases continue to evaluate an organization's tangible capital ratios (after deducting all intangibles) in assessing its overall capital adequacy, if warranted by the condition of the organization.

II. Proposal

The Board is proposing the following treatment for identifiable intangible assets for purposes of the risk-based and leverage capital guidelines:

1. PMSRs and PCCRs would be considered qualifying intangible assets. As such, they would not have to be deducted from capital provided that, in the aggregate, they do not exceed 50 percent of Tier 1 capital and provided that PCCRs do not exceed a sublimit of 25 percent of Tier 1 capital. PMSRs and PCCRs in excess of these limits would be deducted from the core capital elements in determining Tier 1 capital.
2. The limits on PMSRs and PCCRs would be based on a

percentage of Tier 1 capital before excess holdings of these assets are deducted, but after goodwill and all other nonqualifying identifiable intangible assets (e.g., CDIs) are deducted.

3. Institutions would be required to determine the fair market value and to review the book value of their PMSRs and PCCRs at least quarterly. Banking organizations that wish to include these assets in capital will be not be able to carry them at a book value that exceeds the discounted value of their future net income.
4. For purposes of calculating regulatory capital (but not for financial statement purposes) the amount of PMSRs and PCCRs reported on the balance sheet asset would be reduced to the lesser of 90 percent of their fair market value, 80 percent of their original purchase price, or 100 percent of their remaining unamortized book value. The Board is seeking specific public comment on the proposed approach to discounting PMSRs and PCCRs, which is currently employed by the FDIC and the OTS for PMSRs.
5. CDIs and all other identifiable intangible assets would be deducted from the core capital elements for purposes of calculating an institution's Tier 1 capital, just as, in accordance with the Basle Accord, goodwill is deducted.

Including and Limiting PMSRs and PCCRs within Capital

The Board believes that PMSRs and PCCRs for the most part meet the three criteria outlined in the previous section that the agencies use to evaluate identifiable intangible assets. Thus, deduction of such assets for purposes of calculating the risk-based and leverage capital ratios generally would not be necessary provided these assets do not exceed specified limits.

With regard to the two criteria that pertain to the marketability and salability of intangible assets, the Board believes that fairly active and liquid markets exist for PMSRs and credit card portfolios, and thus it is feasible to sell these assets apart from the banking organization or the bulk of its assets. Since the reliability of cash flows and market value of these assets can vary significantly, however, the Board is proposing to limit the amount of PMSRs and PCCRs includable in capital.

The uncertainty associated with the cash flows and market value of PMSRs stems from the fact that changes in the level of interest rates can have a significant effect on mortgage prepayment expectations. Furthermore, the cash flows and value of PMSRs are affected by credit quality risks and operating risks associated with mortgage servicing rights. Because the servicer is generally obligated to provide a steady cash flow to the owner of the mortgage and undertake normal collection efforts and foreclosure, the servicer can incur a significant increase in collection and administrative costs when a mortgage becomes

delinquent. In addition, under some arrangements, known as "recourse" servicing arrangements, the servicer also guarantees the repayment of the loans. The ability of borrowers to repay the loans can have the greatest impact on the value of the servicing in such arrangements.

The value and cash flows associated with PCCRs, like those associated with PMSRs, are affected by changes in interest rates and credit quality factors. They also can be significantly affected by the amount of future borrowings under the credit card lines of credit; the attrition rate, i.e., the rate at which credit cardholders terminate their relationships, which could be due to the failure of the bank to offer competitive terms and features; and other factors.

Given the volatility of the cash flows and market values associated with PMSRs and PCCRs, the Board is proposing that the aggregate amount of such assets includable in capital be limited to 50 percent of Tier 1 capital. Furthermore, since the value of PCCRs is dependent upon many assumptions and the market for PCCRs is less mature and liquid than the market for PMSRs, the Board is proposing that PCCRs be subject to a separate sublimit of 25 percent of Tier 1 capital. During the period in which this proposal is out for public comment, the Board believes that it would be inadvisable for a banking organization to acquire intangible assets in an amount that would cause its total holdings of identifiable intangible assets, including PMSRs and PCCRs, to exceed 25 percent of Tier 1 capital, above which limit

intangible assets are subject to particularly close scrutiny under the Board's current risk-based capital guidelines.

In order to provide for a simple method of calculating these limits, the Board is proposing that the limits be based on a percentage of Tier 1 capital before excess holdings of these assets are deducted, that is, the sum of core capital elements (e.g., common and perpetual preferred equity) less goodwill and other nonqualifying intangible assets. This method of calculation could result in the inclusion in capital of PMSRs and PCCRs in an amount far greater than 50 percent, and of PCCRs in an amount far greater than 25 percent, of Tier 1 capital net of goodwill, other nonqualifying intangible assets, and deductible amounts of PMSRs and PCCRs. It would be possible for an institution to report positive Tier 1 capital even though its PMSRs and PCCRs exceed the sum of its core capital elements.

Accordingly, the Board is proposing to add cautionary language to its capital adequacy guidelines regarding excessive holdings of intangible assets included in capital, which may be viewed as an unsafe and unsound practice.

Valuation of PMSRs and PCCRs

Section 475 of the FDIC Improvement Act of 1991 requires that the amount of PMSRs included in the calculation of an institution's capital not exceed 90 percent of their fair market value, determined on a quarterly basis. The FDIC and OTS rules regarding PMSRs at present require institutions to

determine the fair market value of these assets by applying an appropriate market discount rate to the net servicing cash flows, taking into account any significant changes in original valuation assumptions such as prepayment estimates. The FDIC and OTS rules also contain certain requirements with regard to the determination of the book value of PMSRs, which is to be reviewed quarterly. Under these rules, if an institution wishes to include PMSRs assets in regulatory capital, the book value of these assets may not exceed the discounted amount of their estimated future net servicing income.

In order to implement the valuation provisions of Section 475 and in the interests of achieving consistency in the treatment of intangible assets among the banking agencies, the Board is proposing to require institutions to determine the fair market value and the book value of their PMSRs at least quarterly in accordance with the criteria established by the FDIC and the OTS in their rules regarding PMSRs. The discount rate used for the calculation of book value should not be less than that derived at the time of acquisition, based upon the estimated cash flows and the price paid for the asset at the time of purchase.

In order to implement the discount on PMSRs required under Section 475, the Board is also proposing to use the discounting approach currently employed by the FDIC and the OTS for state nonmember banks and savings associations. Under this approach, for purposes of calculating regulatory capital (but not for financial statement purposes), institutions would be required

to reduce the amount of PMSRs reported on the balance sheet asset to the lesser of:

- (i) 90 percent of their fair market value; or
- (ii) 90 percent of the original purchase price paid for the assets; or
- (iii) 100 percent of their remaining unamortized book value.

If both the application of the limit on PMSRs and the adjustment of the balance sheet asset for PMSRs would result in an amount being deducted from capital, the banking organization would deduct only the greater of the two amounts from the sum of its core capital elements in determining Tier 1 capital. While the Board is seeking public comment on all aspects of its proposal, it seeks specific comment on the approach discussed above to the valuation and discounting of PMSRs includable in capital.

As indicated earlier, the calculation of the fair market value for PCCRs is considered to be at least as subjective as the related calculation is for PMSRs. Consequently, the Board believes the valuation of PCCRs should be subject to the same requirements as those proposed for PMSRs and that these assets should also be discounted. In order to maintain consistency in the valuation of identifiable intangibles included in capital, the Board is proposing that organizations be required to determine the fair market and book value of their PCCRs at least quarterly, using the same criteria as those proposed for PMSRs, and to subject these assets to a value adjustment identical to

that proposed for PMSRs. The Board is seeking specific public comment on this approach to valuation and discounting of PCCRs.

Deduction of CDIs

The proposal would require a full deduction of other identifiable intangible assets, including CDIs, from Tier 1 capital, which is the same treatment as that accorded to goodwill. This treatment reflects the Board's general conclusion that CDIs have many of the same characteristics as goodwill, which the Basle Accord requires to be deducted from capital.

Although CDIs have value when an organization is financially strong, their value tends to fall significantly when the organization experiences financial difficulty. Depositors who are concerned about the viability of a problem institution are more likely to withdraw their funds, thus diminishing core deposits and the value of the related intangible asset. Moreover, a troubled institution may be required to raise the interest rates on its core deposits along with other sources of funds in order to retain depositors, which in turn can also reduce the value of CDIs. Thus, CDIs provide little protection for an institution in times of stress or for the bank insurance fund if the institution fails. This lack of protection has been evident in closed and assisted transactions handled by the FDIC and the Resolution Trust Corporation ("RTC") where the amount of the premium received on deposit transfer transactions is typically very low.

Moreover, CDIs are not purchased separately but as part of an acquisition of a depository institution or the purchase of some of its branches and the assumption of related deposits. Accordingly, CDIs are not generally salable apart from the branches of the depository institution and, thus, provide little liquidity to the institution. Consequently, CDIs do not fully meet the salability criterion the Board uses to evaluate identifiable intangibles, as described above. Furthermore, because CDIs are often acquired in a merger along with goodwill, institutions would have an incentive to assign higher amounts of the acquisition cost to CDIs rather than to goodwill if CDIs were to be included in the capital computation.

Active and liquid markets do not exist for CDIs and, thus their value is derived based on many highly subjective assumptions, which may be difficult for examiners to assess. Such assumptions include the length of time acquired deposits may remain with the acquiring organization, the expected future interest rate on funds generated by the deposits or on alternative sources of funds, and the expected future interest rate and servicing costs on the core deposits.

The Board has not yet determined that other identifiable intangibles meet the three criteria discussed above that the Board uses to evaluate intangible assets. Accordingly, the Board is proposing to deduct all these other intangible assets from Tier 1 for purposes of calculating risk-based and leverage capital ratios.

III. Regulatory Flexibility Act Analysis

The Federal Reserve Board does not believe adoption of this proposal would have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations), in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). In this regard, the vast majority of small banking organizations have very limited amounts of identifiable intangible assets, which are the subject of this proposal, as a component of their capital structures. 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 proposal will not affect such companies.

List of Subjects

12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, banking, Branches, Capital adequacy, Confidential business information, Currency, Dividend payments, Federal Reserve System, Flood insurance, Publication of reports of condition, Reporting and recordkeeping requirements, Securities, State member banks.

12 CFR Part 225

Administrative practice and procedure, Appraisals, Banks, banking, Capital adequacy, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities, State member banks.

For the reasons set forth in this notice, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956 (12 U.S.C. 2844(b)), and section 910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3909), the Board is amending 12 CFR Parts 208 and 225 to read as follows:

**PART 208 - MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE
FEDERAL RESERVE SYSTEM**

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

AUTHORITY: Sections 9, 11(a), 11(c), 19, 21, 25, and 25(a) of the Federal Reserve Act, as amended (12 U.S.C. 321-338, 248(a), 248(c), 461, 481-486, 601, and 611, respectively); sections 4 and 13(j) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1814 and 1823(j), respectively); section 7(a) of the

International Banking Act of 1978 (12 U.S.C. 3105); sections 907-910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3906-3909); sections 2, 12(b), 12(g), 12(i), 15B(c) (5), 17, 17A, and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78b, 781(b), 781(g), 781(i), 78o-4(c) (5), 78q, 78q-1, and 78w, respectively); section 5155 of the Revised Statutes (12 U.S.C. 36) as amended by the McFadden Act of 1927; and sections 1101-1122 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (12 U.S.C. 3310 and 3331-3351).

Appendix A - [Amended]

2. Appendix A is amended by removing the first three paragraphs of II.B.1.b. and replacing them with five new paragraphs, to read as follows:

II. ***

A. ***

B. ***

1. a.***

b. Other intangible assets. In determining the appropriateness of including particular types of intangible assets other than goodwill, that is, identifiable intangible assets, in a bank's capital calculation, the Federal Reserve considers a number of factors, including--

1. the ability to establish a market value for the asset on an annual basis through an identifiable stream of cash flows, the reliability and predictability of these cash flows, and the degree of certainty that the asset will hold this market value notwithstanding the future prospects of the bank;
2. the existence of an active and liquid market for the asset; and
3. the feasibility of selling the asset apart from the bank or from the bulk of its assets.

The Federal Reserve has determined that readily marketable purchased mortgage servicing rights and purchased credit card relationships generally meet these three criteria and, thus, may be included in (that is, not deducted from) a bank's capital, provided that, in the aggregate the total amount of these assets included in capital does not exceed 50 percent of tier 1 capital. Purchased credit card relationships are subject to a separate sublimit of 25 percent of tier 1 capital. Amounts of purchased mortgage servicing rights 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 a bank's core capital elements in determining tier 1 capital.

For purposes of calculating these limitations, tier 1 capital is defined net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights

and purchased credit card relationships. This method of calculation could result in the inclusion in capital of purchased mortgage servicing rights and purchased credit card relationships in an amount greater than 50 percent, and of purchased credit card relationships in an amount greater than 25 percent, of the amount of tier 1 capital used to calculate an institution's capital ratios. In such instances, the Federal Reserve may determine that a bank is operating in an unsafe and unsound manner because of overreliance on intangible assets in tier 1 capital.

Banks should determine the fair market value of their purchased mortgage servicing rights and purchased credit card relationships at least quarterly. The quarterly determination of the fair market value of these assets shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates. The valuation shall be based on an analysis of the current fair market value of the intangible assets, determined by applying an appropriate market discount rate to the net cash flows.

Banks should also review the book value of their purchased mortgage servicing rights and purchased credit card relationships at least quarterly and make adjustments to these values as necessary. These assets should be amortized over their estimated useful life, not to exceed 15 years. The book value of these assets shall not exceed the discounted amount of their

estimated future net income. At no time should the discount rate used for this calculation be less than that derived at the time of acquisition, based upon the estimated cash flows and the price paid for the asset at the time of purchase. If unanticipated prepayments occur, a writedown of the book value of intangible assets included in capital should be made to the extent that the discounted amount of future net income is less than the asset's carrying amount. An institution that includes purchased mortgage servicing rights and purchased credit card relationships in its regulatory capital may not carry these assets at a book value that exceeds the discounted value of their future net income. Examiners will review both the book value and the fair market value assigned to these assets, together with supporting documentation, during the examination process.

For regulatory capital purposes (but not for financial statement purposes), the amount of purchased mortgage servicing rights and purchased credit card relationships reported on a bank's balance sheet will be reduced to the lesser of:

- (a) 90 percent of their fair market value;
- (b) 90 percent of the original purchase price paid for the assets; or
- (c) 100 percent of their remaining unamortized book value.

If both the application of the limits on purchased mortgage servicing rights 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 would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

Whenever necessary--in particular, when assessing applications to expand or to engage in other activities that could entail unusual or higher-than-normal risks--the Board will, on a case-by-case basis, continue to consider the level of an individual bank's tangible capital ratios (after deducting all intangible assets), together with the quality and value of the bank's tangible and intangible assets, in making an overall assessment of capital adequacy.*****

Appendix B - [Amended]

2. Appendix B is amended by revising footnote 2 and revising the last sentence of the second paragraph in II., to read as follows:

II. ***

² At the end of 1992, Tier 1 capital for state member banks includes common equity, minority interests in the equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, Tier 1 capital excludes goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate,

exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; and all other intangible assets. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

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 Report"), less goodwill, amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other intangible assets; and any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital.³ **

PART 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

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

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

Appendix A - [Amended]

2. Appendix A is amended by removing the first three paragraphs of II.B.1.b. and replacing them, to read as follows:

II. ***

A. ***

B. ***

1.a.***

b. Other intangible assets. In determining the appropriateness of including particular types of intangible assets other than goodwill, that is, identifiable intangible assets, in a bank holding company's capital calculation, the Federal Reserve considers a number of factors, including--

1. the ability to establish a market value for the asset on an annual basis through an identifiable stream of cash flows, the reliability and predictability of these cash flows, and the degree of certainty that the asset will hold this market value notwithstanding the future prospects of the banking organization;
2. the existence of an active and liquid market for the asset; and
3. the feasibility of selling the asset apart from the bank or from the bulk of its assets.

The Federal Reserve has determined that readily marketable purchased mortgage servicing rights and purchased credit card relationships generally meet these three criteria and, thus, may be included in (that is, not deducted from) a bank holding company's capital, provided that, in the aggregate the total amount of these assets included in capital does not exceed 50 percent of tier 1 capital. Purchased credit card relationships are subject to a separate sublimit of 25 percent of tier 1 capital. Amounts of purchased mortgage servicing rights 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 a banking organization's core capital elements in determining tier 1 capital.

For purposes of calculating these limitations, tier 1 capital is defined net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships. This method of calculation could result in the inclusion in capital of purchased mortgage servicing rights and purchased credit card relationships in an amount greater than 50 percent, and of purchased credit card relationships in an amount greater than 25 percent, of the amount of tier 1 capital used to calculate a banking organization's capital ratios. In such instances, the Federal Reserve may determine that a banking organization is operating in

an unsafe and unsound manner because of overreliance on intangible assets in tier 1 capital.

Banking organizations should determine the fair market value of their purchased mortgage servicing rights and purchased credit card relationships at least quarterly. The quarterly determination of the fair market value of these assets shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates. The valuation shall be based on an analysis of the current fair market value of the intangible assets, determined by applying an appropriate market discount rate to the net cash flows.

Banking organizations should also review the book value of their purchased mortgage servicing rights and purchased credit card relationships at least quarterly and make adjustments to these values as necessary. These assets should be amortized over their estimated useful life, not to exceed 15 years. The book value of these assets shall not exceed the discounted amount of their estimated future net income. At no time should the discount rate used for this calculation be less than that derived at the time of acquisition, based upon the estimated cash flows and the price paid for the asset at the time of purchase. If unanticipated prepayments occur, a writedown of the book value of intangible assets included in capital should be made to the extent that the discounted amount of future net income is less than the asset's carrying amount. A banking organization that

includes purchased mortgage servicing rights and purchased credit card relationships in its regulatory capital may not carry these assets at a book value that exceeds the discounted value of their future net income. Examiners will review both the book value and the fair market value assigned to these assets, together with supporting documentation, during the inspection process.

For regulatory capital purposes (but not for financial statement purposes), the amount of purchased mortgage servicing rights and purchased credit card relationships reported on a banking organization's balance sheet will be reduced to the lesser of:

- (a) 90 percent of their fair market value;
- (b) 90 percent of the original purchase price paid for the assets; or
- (c) 100 percent of their remaining unamortized book value.

If both the application of the limits on purchased mortgage servicing rights 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 banking organization would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

Whenever necessary--in particular, when assessing applications to expand or to engage in other activities that could entail unusual or higher-than-normal risks--the Board will,

on a case-by-case basis, continue to consider the level of an individual bank's tangible capital ratios (after deducting all intangible assets), together with the quality and value of the bank's tangible and intangible assets, in making an overall assessment of capital adequacy.*****

Appendix D - [Amended]

2. Appendix D is amended by revising the last two sentences in footnote 3 and revising the last sentence of the second paragraph in II., to read as follows:

II. ***

³ ***In addition, Tier 1 capital excludes goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; and all other intangible assets. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

***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 banking organization's Consolidated Financial Statements ("FR Y-9C Report"), less goodwill; amounts

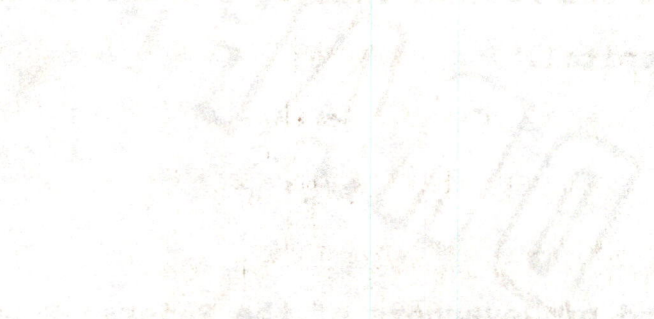
of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other intangible assets; and any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital.'

Board of Governors of the Federal Reserve System,

January _____, 1992.

William W. Wiles
Secretary of the Board

It is further stated that the said
all things that, in the opinion, are in excess of the
of the said subject's admitted purchase credit card
in excess of the amount of that credit card, and that
the said subject's admission to the said credit card
should be the subject of a separate report to the



The said subject's admission to the said credit card
should be the subject of a separate report to the

News Release

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NEW TAX WITHHOLDING RATES BOOST TAKE HOME PAY

Washington -- The majority of American workers will get an advance payment on next year's federal income tax refund with new tax withholding tables the Internal Revenue Service is sending to their employers.

The new withholding tables compensate for the fact that currently millions of Americans are overwithheld and end up giving the government an interest-free loan each year.

This permanent change in withholding will benefit low and middle income wage earners, increasing their take home pay by about \$25 billion over the next twelve months. The increase will be up to \$345 per job for workers withheld at the married rate and up to \$172 per job for those withheld at the single rate. In addition to workers, taxpayers who are retired and have tax withheld from their pensions will benefit from the changes.

The IRS estimates that taxpayers who file about 89 million returns fall into the low and middle income category and will benefit from the withholding table changes. At present about 72 million of those returns result in refunds.

The average income tax refund has grown substantially over the years. For tax year 1990, the average refund was over \$900 up from \$680 just ten years ago. Workers have too much tax withheld because they do not claim all the withholding allowances to which they are entitled. Eventually they receive the money in the form of a refund check when they file their returns -- but they have lost the use of the money during the year.

Since these low and middle income taxpayers will see their 1993 refunds moved into their 1992 paychecks, they will see smaller refunds next year. But about 88 percent of those who get refunds now will still get refunds. Others may find that they owe part of their tax liability when they file their 1992 tax returns. Similarly those who owe in 1992 may find they owe more in 1993. The IRS said that it plans to review all 1991 returns filed and will notify those taxpayers who may owe because of these changes, suggesting they review their withholding for 1992.

(MORE)

The IRS will waive penalties for any underpayment of estimated taxes in 1992 to the extent that the underpayment is caused by these adjustments to the withholding tables.

High income wage earners will not see a change in their withholding. There will be no change for workers withheld at the single rate if their wages subject to withholding are above \$53,200. Withholding is computed on the amount of total wages less \$2,300 for each withholding allowance claimed. For those withheld at the married rate, there is no change if wages subject to withholding exceed \$90,200.

The changes in withholding will be automatic for those taxpayers who will benefit from the change. However, some employees may want to keep their withholding at the current rate. To do this, they should give their employer a new Form W-4 claiming the same number of withholding allowances. But they should ask for extra tax to be withheld each payday. For those withheld at the married rate this amount would be \$345 divided by the number of pay periods in the year. Those at the single rate should use \$172.

The IRS said that the new tax withholding tables are ready now and will be mailed to about five million employers by the middle of February. The revised Circular E, "Employer's Tax Guide" contains the new tables effective for wages paid after February 1992.

But some workers may see the boost in their pay checks sooner because the IRS is encouraging employers to use the new tables as soon as possible. Since many employers use commercial service bureaus to compute income tax withholding for their employees, the IRS is sending the new tables to the major commercial payroll services for them to use immediately.

Attached are examples of how the withholding changes will apply in some typical situations.

X X X

Adjustment of Wage Withholding Tables

Examples

A single worker with no dependents earns \$2,000 a month and has \$1,000 of interest income to report. The worker does not itemize deductions and claims no withholding allowances on Form W-4. Currently, \$297.29 is withheld from this worker's pay each month. Beginning in March, this will drop to \$282.92 a month. Even with a reduction in withholding of \$144 between March and the end of the year, this taxpayer will still receive a refund of \$588 when she files.

A married couple with two children files jointly. Only the husband works making \$700 a week. They do not itemize when they file and their only income is from the husband's job. Each week \$81.06 in federal tax is withheld from his pay based on the two withholding allowances he claims. Starting in March, he will see his withholding drop to \$74.42 a week. During the rest of the year, he will see \$288 more in his pay check and he and his wife will still get a refund of \$747 next year when they file.

In the example above, let's assume the husband claims five withholding allowances (for the worker, his wife, two children and an extra allowance -- called the Special Withholding Allowance -- because the spouse does not work and the worker has only one job). His weekly withholding would be \$61.15 and the couple would neither owe money or get a refund when they filed. With the reduced withholding in March, their withholding would drop to \$54.52 and they would owe \$288 when they filed. The husband can avoid this by asking his employer to withhold enough extra tax each week to maintain his current level of withholding.

Another married couple with one child also files jointly. Only the wife works earning \$2,000 per week. They don't itemize their deductions and have no other income to report on their return. The wife is paid weekly and claims three withholding allowances on her Form W-4. Under the current tables, her employer withholds income tax from her pay at the rate of \$417.40 a week. Under the adjusted withholding tables, there will be no change. Under both the current and the new tables, the couple would receive a federal tax refund of \$713 when they file. Unlike the example above, at this level of wages, there is no need for the wage earner to complete a new Form W-4 to maintain her current level of withholding.

Another married couple also with two children files jointly. Both the husband and the wife work. One spouse earns \$500 per week and the other earns \$200 per week. The couple does not itemize and has no other taxable income. The spouse earning \$500 a week claims one withholding allowance and the other claims none. Currently the couple has a total of \$77.02 withheld each week. Starting in March, this will change to \$63.75. Although the family's overwithholding will be reduced by \$575 between March and December, it will still be eligible for a refund of \$250.