FEDERAL RESERVE SYSTEM

12 CFR Part 225

Regulation Y; Docket No. R-1067

Bank Holding Companies and Change in Bank Control

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule with request for public comments.

SUMMARY: The Board of Governors of the Federal Reserve System, in consultation with the Secretary of the Treasury, solicits comment on a proposal that would govern the regulatory capital treatment of certain investments in nonfinancial companies by bank holding companies. This proposal would amend the Board's consolidated capital guidelines for bank holding companies to apply a 50 percent capital charge to all investments made, directly or indirectly, by a bank holding company in nonfinancial companies under the merchant banking authority of section 4(k)(4)(H) of the Bank Holding Company Act (BHC Act), in nonfinancial companies under the Board's Regulation K, under section 24 of the Federal Deposit Insurance Act, through small business investment companies (whether controlled by the bank holding company or by a subsidiary depository institution), or under sections 4(c)(6) or (7) of the BHC Act in less than 5 percent of the shares of a nonfinancial company.

This proposal is a supplement to an interim rule (with request for public comment) that governs merchant banking investments made by financial holding companies. That interim rule is published separately and implements, through a new Subpart J to the Board's Regulation Y, provisions of the recently enacted Gramm-Leach-Bliley Act (GLB Act) that permit financial holding companies to make investments in nonfinancial companies as part of a bona fide securities underwriting or merchant or investment banking activity. The capital proposal described below is being published for comment and, unlike the interim rule on merchant banking investments, is not being made effective on an interim basis. During the comment period, the Board and the Secretary will discuss issues raised by this proposal with the other Federal banking agencies and with other appropriate functional regulators.

Comment is invited on all aspects of the proposed rule, and the Board will revise the final rule as appropriate in response to comments received. The Board expects to complete this rulemaking on capital treatment expeditiously.

DATES: Comments must be received on the capital proposal by May 22, 2000.

ADDRESSES: Comments should refer to docket number R-1067 and should be sent to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551 (or mailed electronically to **regs.comments@federalreserve.gov)**. Comments addressed to Ms. Johnson also may be delivered to the Board's mail room between the hours of 8:45 a.m. and 5:15 p.m. and, outside of those hours, to the Board's security control room. Both the mail room and the security control room are accessible from the Eccles Building courtyard entrance, located on 20th Street between Constitution Avenue and C Street, N.W. Members of the public may inspect comments in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Scott G. Alvarez, Associate General Counsel (202/452-3583), Kieran J. Fallon, Senior Counsel (202/452-5270), or Camille M. Caesar, Senior Attorney (202/452-3513), Legal Division; Jean Nellie Liang, Chief, Capital Markets (202/452-2918), Division of Research & Statistics; Michael G. Martinson, Deputy Associate Director (202/452-3640) or James A. Embersit, Manager, Capital Markets (202/452-5249), Division of Banking Supervision and Regulation; Norah M. Barger, Assistant Director, Supervisory Policies and Procedures, Division of Banking Supervision and Regulation; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. Users of Telecommunications Device for the Deaf (TDD) only contact Janice Simms at (202) 872-4984.

SUPPLEMENTARY INFORMATION:

A. Background

Section 103(a) of the GLB Act (Pub. L. No. 106-102, 113 Stat. 1338 (1999)) added a new section 4(k)(4)(H) to the BHC Act (12 U.S.C. 1843(k)(4)(H)) that authorizes financial holding companies to acquire or control shares, assets or ownership interests of any nonfinancial company as part of a bona fide underwriting or merchant or investment banking activity (merchant banking investments).

Interviews with Securities Firms and Bank Holding Companies

In order to gather information about how firms currently reserve capital against merchant banking investments, staff of the Federal Reserve System and the Department of the Treasury conducted interviews with a number of securities firms that currently make in merchant banking investments. System staff and Treasury staff also interviewed several bank holding companies that engage in more limited types of investment activities under existing authority. The attached rule reflects information collected in these interviews and the experience of the System staff and Treasury staff in supervising the more limited types of investment activities permissible for bank holding companies.

Securities firms and bank holding companies uniformly indicated that they apply higher internal capital charges against merchant banking investments than are applied to many other types of activities. The industry practice regarding the appropriate internal measures of capital required to support merchant banking activities reflects the greater risks associated with these investments, including the volatility and illiquidity of many investments and the higher leverage often associated with companies in which such investments are made. Firms that make merchant banking investments impose internal capital charges that differ by firm and, in some cases, by type of investment. These capital charges range from 25 percent to 100 percent of the investment. Firms typically record investments initially at the lower of cost or market. Investments may be assigned an adjusted carrying value if a significant event occurs (such as an initial public offering, follow-up financing, or secondary capital raising events), subject to a discount that reflects the size of the firm's holding, the liquidity of the market for the shares held, the volatility of the market and other factors and that is applied prior to recognizing any unrealized gains on the investment.

The proposal reflects industry practices in conducting merchant banking activities. The information about industry practice collected during the interviews is discussed more fully in connection with the interim rule implementing the merchant banking investment authority.

The Board and the Secretary view this capital proposal as a precaution that is necessary to prevent the buildup within banking organizations of excessive risk from merchant banking and other investment activities. In developing this proposal, they have considered the effect of the proposal on the existing activities of bank holding companies.

The Board welcomes comments on all aspects of the proposed rule. These comments will be carefully considered before promulgation of a final rule.

B. Proposed Rule

As discussed above, many firms that make merchant banking investments and engage in other types of investment activities internally allocate capital to these investments in amounts that are higher than the amounts of capital allocated to most banking assets due to the greater risk, illiquidity and volatility of merchant banking and similar investments and the higher leverage that often is associated with portfolio companies. The internal capital allocation for these investments is generally many multiples of the current regulatory capital charge.

After consideration of the industry practice, the Board, in consultation with the Secretary, is proposing to modify the methods of calculating the risk-weighted and leverage capital ratios for bank holding companies to reflect the risk profiles of these investment activities. The Board is authorized by the BHC Act and other provisions of law to promulgate rules, including capital standards, consistent with the requirements and purposes of the BHC Act and other provisions.

Under the proposal, a bank holding company would be required to deduct from its Tier 1 regulatory capital an amount equal to 50 percent of the total carrying value, as reflected on consolidated financial statements of the bank holding company, of all merchant banking investments held by the bank holding company. The total carrying value of any merchant banking investment subject to this capital deduction is excluded from the bank holding company's assets for purposes of calculating the asset denominator of the risk-based and leverage capital ratios.[1]

The capital charge applies to all investments that would be considered to be equity of the nonfinancial company and all debt instruments that are convertible into equity. It also applies to all debt extended by a bank holding company to a nonfinancial company in which the financial holding company owns 15 percent or more of the total equity. The proposal contains exceptions for short-term secured loans for working capital purposes; for debt if at least 50 percent of the initial principal balance has been syndicated to third parties; for loans that are guaranteed by the United States government; and for extensions of credit by an insured depository institution controlled by the financial holding company that are collateralized in accordance with the requirements of section 23A of the Federal Reserve Act (12 U.S.C. 371c) and that meet the other requirements of that section.

---

[1]Some investments are booked using "available for sale" (AFS) accounting. Under this accounting treatment, unrealized gains are *not* recognized as net income and flow to a special segregated equity account that is not recognized as Tier 1 capital by the regulatory agencies. Under the current bank holding company rules, 45 percent of the gain on AFS equity securities may be included in Tier 2 capital. This proposal would continue this treatment but further require deduction from Tier 1 capital of 50 percent of the reported cost (or fair value if lower for equity securities) of merchant banking investments recorded as AFS. The reported cost or fair value of the investment would be deducted from risk-weighted and average consolidated assets.

The proposal would also apply the same capital treatment to investments held in nonfinancial companies under Regulation K, in less than 5% of the shares of any company under section 4(c)(6) or 4(c)(7) of the BHC Act, through a small business investment company (SBIC) that is controlled by the bank holding company or a subsidiary depository institution, or held by a state bank subsidiary in accordance with section 24 of the Federal Deposit Insurance Act. This capital treatment would not apply to investments that are held in a trading account in accordance with applicable accounting principles and that are part of an underwriting, market making or dealing activity.

The proposal applies this capital treatment to nonfinancial investment activities described above for several reasons. Importantly, the risks associated with these investment activities do not vary according to the authority used to conduct the activity. Thus, similar investment activities should be given the same capital treatment regardless of the source of legal authority to make the investment. Moreover, current regulatory capital treatment, which applies an 8% minimum capital charge to these investments, was developed at a time when the investment activities of banking organizations were relatively small. In recent years, some bank holding companies have greatly expanded the level of their investment activities. The proposal reflects the judgment that it is appropriate at this time, when the investment authority of banking organizations has also been greatly expanded, to revisit and revise regulatory capital treatment for all investment activities.

The Board and the Secretary view this capital proposal as a precaution that is necessary to prevent the development within banking organizations of excessive risk from merchant banking and other investment activities. In developing this proposal, they have considered the effect of the proposal on the existing activities of bank holding companies. The Board and the Secretary also note that the proposed capital treatment is similar to the approach to capital sufficiency that the Federal Deposit Insurance Corporation has adopted under section 24 of the Federal Deposit Insurance Act for investments in subsidiaries that engage in principal activities that are not permissible for a national bank.

As an initial matter, adoption of the capital proposal would *not* prevent *any* holding company from becoming or remaining a financial holding company or from taking advantage of the new powers granted under the GLB Act. The capital charge would be applied only at the holding company level on the consolidated organization. Consequently, the capital proposal would not affect the capital levels of any depository institution -- which, under the GLB Act, determine whether a company qualifies to be a financial holding company -- controlled by a bank holding company.

In addition, the Board and the Secretary have reviewed a sampling of call reports of bank holding companies engaged currently in significant investment activities, including companies that are likely to seek to become financial holding companies. This review indicates that, with virtually no exception, bank holding companies would remain well capitalized on a consolidated basis even after applying the proposed capital charge to all of the investments currently made by these companies. Moreover, nearly all of these companies would be able to increase significantly their level of investment activity and continue to be well capitalized on a consolidated basis after applying the proposed capital charge.

For these reasons, the capital proposal is not expected to have a significant effect on the level of investment activities conducted by bank holding companies. The capital proposal would, however, help to limit the potential harm to bank holding companies and depository institutions controlled by bank holding companies from the risks associated with investment activities.

The capital charge would not be applied to investments made by insurance company subsidiaries of financial holding companies held in accordance with section 4(k)(4)(I) of the BHC Act. The Board expects soon to seek comments on a proposal to de-consolidate functionally regulated insurance underwriting companies from the financial holding company for purposes of applying the Board's consolidated capital rules. The proposal would take account of the different accounting standards, business practices, and capital and supervisory regimes that apply to insurance underwriting companies.

The Board and the Secretary recognize that the new authority accorded financial holding companies under the GLB Act may raise the possibility of arbitrage between an insurance company and its financial holding company affiliates designed to avoid the capital charges proposed for merchant banking and other investments. The Board and the Secretary seek comment on whether provisions should be included in the final capital rule that would apply to investments made through an insurance company the same capital charge at the holding company level as would be applied to merchant banking and other investments if the Board finds that such arbitrage is occurring within a particular holding company. The Board and the Secretary also invite comment on whether there are other mechanisms that would prevent such arbitrage.

During the period prior to adoption of a final capital rule, financial holding companies that engage in merchant banking activities will be expected to adopt and implement internal capital and accounting policies that reflect the liquidity, market and other risks associated with the company's investment activities. An initial criterion for these internal capital and accounting policies is that they be capable of enabling the financial holding company to meet the terms of the proposed capital rule on its effective date with minimal adjustment and remain in compliance with applicable regulatory capital standards. Moreover, the Board and the Secretary do not intend to encourage behavior that is different than conservative industry practice and expect to monitor capital treatment of merchant banking activities carefully.

Comment is invited on all aspects of the capital charge, including the appropriateness of a separate capital charge for investment activities under different authorities, the amount of the charge, and whether the charge should apply to the exclusions outlined. In particular, comment is invited on how, if at all, the charge differs from the internal capital charges imposed on investment activities by firms that conduct merchant banking and other investment activities. In addition, comment is sought on whether a different approach to the capital treatment would more accurately reserve for the risks of merchant banking and other investment activities. Moreover, comment is invited on the interaction between the capital sufficiency proposal and the investment thresholds for aggregate merchant banking activities discussed in the related interim rule governing merchant banking investments.

Comment also is invited on the manner in which the capital charge is applied to debt extended to portfolio companies in which a financial holding company has made investments. In addition, comment is requested on whether other methods would be more appropriate for assuring that an organization does not use an extension of credit that functions like equity as a means of evading the capital charge.

Comment is requested on whether an exclusion from the proposed capital treatment, or a lesser capital charge, should be established for investments in less than 5 percent of the securities or assets of a nonfinancial company that is publicly held and in which there is a ready market. In addition, the Board seeks comment on whether the proposed capital treatment or a lesser capital charge should apply to merchant banking investments that do not result in a financial holding company's control of the merchant banking investment.

Regulatory Flexibility Act Analysis

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)), the Board must publish an initial regulatory flexibility analysis with this rulemaking. The rule proposes and requests comment on amendments to the Board's consolidated risk-based and Tier 1 leverage capital adequacy guidelines for bank holding companies (Part 225, Appendix A and D). These amendments would establish the regulatory capital requirements applicable to the merchant banking investments of financial holding companies and similar investment activities of bank holding companies. The proposed capital amendments generally would not apply to financial or bank holding companies with consolidated assets of less than $150 million and, thus, are not likely to have a significant economic impact on a substantial number of small entities (i.e., holding companies with less than $100 million in assets). The Board believes the proposed amendments to its capital guidelines are necessary and appropriate to ensure that bank holding companies maintain capital commensurate with the level of risks associated with their activities and that the investment activities of bank holding companies do not pose an undue risk to the safety and soundness of affiliated insured depository institutions.

The Board specifically seeks comment on the likely burden that the proposed rule will impose on bank holding companies.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 App. A.1), the Board has reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget. No collections of information pursuant to the Paperwork Reduction Act are contained in the proposed rule.

List of Subjects in 12 CFR Part 225

Administrative practice and procedure, Banks, Banking, Federal Reserve System, Holding companies, Reporting and record keeping requirements, Securities.

For the reasons set out in the preamble, the Board amends 12 CFR Part 225 as follows:

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

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

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

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

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

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

* * * * *

II. * * *

B. * * *

(v) Portfolio investments–deducted from the sum of core capital elements in the manner described below.

* * * * *

5. *Portfolio investments.* Fifty percent (50%) of the value of all portfolio investments made by the parent bank holding company or by its direct or indirect subsidiaries must be deducted from the consolidated parent banking organization's core capital components.

A portfolio investment is (1) any merchant banking investment made directly or indirectly by the bank holding company pursuant to section 4(k)(4)(H) of the Bank Holding Company (BHC) Act and subpart J of Regulation Y, and (2) any investment made directly or indirectly by the bank holding company in a nonfinancial company pursuant to section 4(c)(6) or 4(c)(7) of the BHC Act, section 211.5(b)(1)(iii) of the Board's Regulation K, or section 302(b) of the Small Business Investment Act of 1958, or in accordance with section 24 of the Federal Deposit Insurance Act.[24] A nonfinancial company is an entity that engages in any activity that has not been determined to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act.

The deduction applies to all merchant banking investments made under section 4(k)(4)(H) and all investments made in nonfinancial companies under the other authorities listed above, regardless of whether the investment is held by the bank holding company, a depository institution subsidiary of the bank holding company, or a direct or indirect subsidiary of either. For example, a portfolio investment includes any investment in a private equity fund under section 4(k)(4)(H) of the BHC Act, any nonfinancial investment made by a small business investment company (SBIC) subsidiary of the bank holding company, and any nonfinancial investment made by an Edge or Agreement Corporation subsidiary of the holding company under section 211.5(b)(1)(iii) of the Board's Regulation K.

---

[24] See U.S.C. § 1843(c)(6), (c)(7) and (k)(4)(H); 12 C.F.R. 211.5(b)(1)(iii); 15 U.S.C. § 682(b); 12 U.S.C. § 1831a.

For this purpose, an investment includes any equity instrument and any debt instrument with equity features (such as conversion rights, warrants or call options). If the bank holding company owns or controls 15 percent or more of the company's total equity, the term also includes any other debt instrument held by the bank holding company or any subsidiary, except for (i) any short-term, secured extension of credit provided for working capital purposes, (ii) any extension of credit by an insured depository institution that is collateralized in accordance with the requirements of section 23A of the Federal Reserve Act (12 U.S.C. 371c) and that meets the other requirements of that section; (iii) any extension of credit at least 50 percent of which is sold or participated out to unaffiliated persons on the same terms and conditions that applied to the initial credit, and (iv) any extension of credit that is guaranteed by the U.S. government.

This provision does not apply to investments that are held in the trading account in accordance with applicable accounting principles and that are held as part of an underwriting, market making or dealing activity.

For portfolio investments that are reported at cost, under the equity method, or at fair value with unrealized gains (or losses) included in earnings, the deduction is equal to 50 percent of the carrying value of the investment. For available-for-sale portfolio investments reported at fair value with unrealized gains (or losses) included in other comprehensive income, the amount of the deduction is equal to 50 percent of the reported cost of the investment.[25] Any unrealized gains on available-for-sale investments are not to be included in core capital, but may be included in supplementary capital to the extent permitted under section II.A.2.e of this Appendix.

For portfolio investments in a company that is consolidated for accounting purposes, the deduction is equal to 50 percent of the parent banking organization's investment in the company as determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the consolidated bank holding company's core capital in accordance with section II.B.1 of this Appendix). The company remains fully consolidated for purposes of determining the banking organization's risk-weighted assets.

---

[25] For available-for-sale equity investments where fair value is less than historical cost, the amount of the deduction is equal to 50 percent of reported fair value. The unrealized losses on such investments are deducted from core capital in accordance with section II.A.1.a of this Appendix.

The value of any portfolio investment subject to the deduction described in this paragraph that is not consolidated for accounting purposes is excluded from the bank holding company's weighted risk assets for purposes of computing the denominator of the company's risk-based capital ratio. For available-for-sale portfolio investments, this exclusion applies to the investment's reported cost or, in the case of equity investments when fair value is less than historical cost, reported fair value.

* * * * *

3. In Appendix D to part 225, the following revisions are made:
a. In section II.b., footnote 3 is revised and the fourth sentence of section II.b. is revised.

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

* * * * *

II. * * *

b. * * *[3] As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the organization's Consolidated Financial Statements (FR Y-9C Report), less goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets and purchased credit

---

[3]Tier 1 capital for banking organizations includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of Tier 1 capital.) In addition, as a general matter, Tier 1 capital excludes goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, exceed 100 percent of Tier 1 capital; nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 25 percent of Tier 1 capital; all other identifiable intangible assets; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations; and 50 percent of the value of portfolio investments. The Federal Reserve may exclude certain other investments in subsidiaries or associated companies as appropriate.

card relationships that, in the aggregate, are in excess of 25 percent of Tier 1 capital; all other identifiable intangible assets; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitations set forth in section II.B.4 of Appendix A of this part; portfolio investments; and other investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital.

By order of the Board of Governors of the Federal Reserve System, March 17, 2000.

Robert deV. Frierson
Associate Secretary of the Board