[Federal Register: December 28, 1994]

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 325

RIN 3064-AB29

Capital Maintenance

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Final rule.

SUMMARY: The FDIC has decided not to proceed with its proposal to include net unrealized holding gains (losses) on available-for-sale securities in Tier 1 capital. Instead, the FDIC is adopting only technical wording changes to conform the language in its leverage and risk-based capital standards with the terminology used in Statement of Financial Accounting Standards No. 115, ``Accounting for Certain Investments in Debt and Equity Securities'' (FASB 115). For regulatory capital purposes, this FDIC final rule requires net unrealized holding losses on available-for-sale equity securities with readily determinable fair values to be deducted in determining the amount of Tier 1 capital. All other net unrealized holding gains (losses) on available-for-sale securities are excluded from the definition of Tier 1 capital. However, for purposes of the quarterly Reports of Condition and Income (Call Reports) filed by FDIC-supervised institutions, the Federal Financial Institutions Examination Council (FFIEC) requires net unrealized gains (losses) on all available-for-sale securities to be reported as a separate component of stockholders' equity, in accordance with FASB 115.

EFFECTIVE DATE: January 27, 1995.

FOR FURTHER INFORMATION CONTACT: For supervisory purposes, Stephen G. Pfeifer, Examination Specialist (202/898-8904), or Robert F. Storch, Section Chief (202/898-8906), Accounting Section, Division of Supervision; for legal issues, Cristeena G. Naser, Attorney, Legal Division (202/898-3587).

SUPPLEMENTARY INFORMATION:

I. Background

The FDIC's leverage and risk-based capital standards (12 CFR part 325--subpart A and appendix A to part 325) set forth a definition of Tier 1 capital that includes common stockholders' equity. The capital definitions (12 CFR 325.2(d) and section 1.A.1. of appendix A) further explain that common stockholders' equity includes common stock and any related surplus, undivided profits, disclosed capital reserves that represent a segregation of undivided profits, and foreign currency translation adjustments, less net unrealized losses on marketable equity securities.

In May 1993, the Financial Accounting Standards Board (FASB) issued FASB 115 which, in effect, changes the composition of stockholders' equity in financial statements prepared in accordance with generally accepted accounting principles (GAAP) by including as a separate component of equity the amount of net unrealized holding gains and losses on debt and equity securities that are deemed to be available-for-sale. The FFIEC has notified all banks that they must adopt the new FASB 115 accounting standard for purposes of their Call Reports as of January 1, 1994, or the beginning of their first fiscal year thereafter, if later. Early adoption of this standard was also permitted in Call Reports to the extent allowable under FASB 115.

Prior to the adoption of FASB 115, Call Report instructions required banks to report a separate capital component for the net unrealized loss on marketable equity securities, consistent with the provisions of Statement of Financial Accounting Standards No. 12, ``Accounting for Certain Marketable Securities'' (FASB 12). FASB 115, which supersedes FASB 12, broadens the scope of this separate component of stockholders' equity in that the FASB 115 capital component includes unrealized gains and losses on all securities that are available-for-sale (debt as well as equity), rather than just the net unrealized losses on marketable equity securities.

This new GAAP accounting standard and the conforming Call Report guidance raised the question of how the FASB 115 capital component for net unrealized holding gains and losses on available-for-sale securities should be treated for purposes of calculating the amount of an institution's regulatory capital under part 325.

II. December 1993 Proposal

In view of this FASB 115 issue, the FDIC issued a proposal (58 FR 68781, December 29, 1993) to amend its leverage and risk-based capital standards to explicitly recognize net unrealized holding gains and

losses on available-for-sale securities in determining the amount of an institution's Tier 1 capital. Accordingly, the FDIC requested specific comments on the following:

(1) Recognition of FASB 115 Capital Adjustments for Regulatory Capital Purposes. Given the provisions of section 37 of the Federal Deposit Insurance Act (FDI Act) and the other issues discussed in the proposal's preamble, should the FASB 115 capital adjustments that institutions are required to reflect for GAAP and Call Report purposes also be taken into consideration for purposes of determining an institution's Tier 1 capital under the FDIC's leverage and risk-based capital standards? If not, what regulatory capital treatment should be applied?

(2) Effect of FASB 115 Adjustments on Other Capital-Based Regulations. If the FASB 115 capital adjustments are recognized for purposes of calculating an institution's leverage and risk-based capital ratios, these adjustments may also have an effect on certain other laws and regulations that are based, in part, on regulatory capital levels, including the prompt corrective action rules (12 CFR part 325--subpart B), the risk-related insurance premium system (12 CFR part 327), the brokered deposit restrictions (12 CFR 337.6), and the restrictions on activities and investments of insured state banks (12 CFR part 362), such as the limitations in Sec. 362.3(d)(4) on the book value of certain equity investments as a percent of Tier 1 capital. If the FASB 115 capital adjustments are recognized in calculating an institution's compliance with the minimum leverage and risk-based capital standards, should these adjustments also be recognized for purposes of the other rules noted above that are based, in part, on an institution's regulatory capital levels? If not, what treatment should be used for these other regulations?

(3) Appropriateness of Recognizing FASB 115 Net Appreciation for Regulatory Capital Purposes. In determining the amount of any FASB 115 adjustment to stockholders' equity for changes in the fair value of available-for-sale securities, FASB 115 as well as the conforming Call Report guidance take into consideration all changes in the fair value of these securities, regardless of whether these changes represent net appreciation or net depreciation. Under the accounting rules that were applicable prior to the adoption of FASB 115, an institution's capital for GAAP and Call Report purposes could not be increased by the amount of any net unrealized appreciation on securities held for sale. Should the regulatory capital treatment for changes in the fair value of securities held in the FASB 115 available-for-sale category differ, depending upon whether the change represents net appreciation or net depreciation? If so, what treatment is appropriate?

III. Summary and Analysis of Comment Letters Received

The FDIC received 61 responses to its request for comment, including 41 from banks, 11 from multibank holding companies, four from financial institution trade associations, three from state banking regulators, and two from banking consultants. Nearly three-fourths of the respondents were opposed to the proposal to include net unrealized holding gains (losses) on available-for-sale securities in Tier 1 capital. Many of the 41 letters from banks were from community banks and 37 of these respondents were against the proposal. The 11 responses from multibank holding companies were generally mixed, with six appearing to favor the proposed rule and the remaining five opposed to it.

Three of the four financial institution trade associations that responded to the proposal at least cautiously supported the proposal; however, one of the associations in favor of the proposal did so partially out of a concern that, if the proposal were not adopted, an even more restrictive lower-of-cost-or-market (LOCOM) approach might be required where only net depreciation (but not net appreciation) on available-for-sale securities would be recognized for Tier 1 capital purposes. The responses from the three state banking regulators and the two banking consultants were mixed.

Common arguments raised by many of the respondents opposing the proposal included: (1) The additional capital volatility arising from marking-to-market the available-for-sale securities, which may cause banks to shorten maturities, sacrifice yield and thus realize less net income; (2) the distortive effect that the piecemeal application of market value accounting may have on a bank's financial statements, particularly when interest rates rise but offsetting changes in the value of the bank's deposit base cannot be recognized; (3) the adverse impact that these market fluctuations may have on other capital-based rules, such as prompt corrective action and risk-related insurance premiums; and (4) the potential for more banks to fail simply because of market value changes in securities that may be temporary and that may exist on available-for-sale securities which the bank does not have the current intent to sell.

The most common alternative to the FDIC's proposed treatment of the FASB 115 net unrealized gains (losses) on available-for-sale securities, which was expressed by 37 of the commenters, was to exclude the FASB 115 unrealized gains and losses from Tier 1 capital. However, if the FASB 115 adjustments were to be included in regulatory capital, 12 commenters indicated that net appreciation and depreciation on available-for-sale securities should be treated consistently (otherwise a LOCOM approach could result for regulatory capital purposes). Additionally, seven of the respondents specifically mentioned that FASB 115 net unrealized gains (losses) on available-for-sale securities should only be included in Tier 2 (or total risk-based capital) rather than in Tier 1 capital. Several respondents also indicated that, even

if these net unrealized gains (losses) are recognized for purposes of calculating supervisory capital ratios, they should be ignored in determining capital for purposes of prompt corrective action, risk-related insurance premiums, applicable lending limits, Federal Reserve Board Regulation O, and section 23A of the Federal Reserve Act.

Some of the reasons given by the minority of the commenters who favored the proposal included the following: (1) The proposal to recognize net unrealized holding gains (losses) on available-for-sale securities in Tier 1 capital is consistent with the requirements under GAAP and the Call Report instructions that these unrealized gains (losses) be recognized as a component of stockholders' equity; (2) the proposal is consistent with section 37 of the FDI Act, which generally provides that accounting principles applicable to depository institutions for regulatory reporting purposes should be no less stringent than GAAP; and (3) the proposal would minimize the reporting and systems burden that might otherwise exist if the FASB 115 capital component is treated differently for regulatory capital purposes than it is for regulatory reporting and GAAP purposes.

The FDIC has considered the comments raised by those responding to the request for comment. After carefully evaluating the merits of the proposed rule and consulting with the other federal banking agencies, the FDIC has decided not to proceed with its proposal but rather to retain the existing regulatory capital treatment. As a result, net unrealized holding losses on available-for-sale equity securities with readily determinable fair values should continue to be deducted in determining the amount of Tier 1 capital. However, all other net unrealized holding gains (losses) on available-for-sale securities will be excluded from the definition of Tier 1 capital.

In addition, for regulatory reporting (as opposed to regulatory capital) purposes, FDIC-supervised institutions will continue to reflect FASB 115 net unrealized gains (losses) on available-for-sale securities as a separate component of equity capital in the Call Reports they file with the FDIC on a quarterly basis. This reporting treatment is consistent with the provisions of section 37 of the FDI Act.

Although section 37 generally requires that accounting principles applicable to depository institutions for regulatory reporting purposes must be consistent with or no less stringent than GAAP, the FDIC believes that the requirements of section 37 do not extend to the federal banking agencies' definitions of regulatory capital. It is well established that the calculation of regulatory capital for supervisory purposes can differ from the measurement of equity capital for financial reporting purposes. For example, statutory restrictions against the recognition of goodwill for regulatory capital purposes may lead to differences between the reported amount of equity capital and the regulatory capital calculation for Tier 1 capital. Other types of

intangible assets are also subject to limitations under the agencies' regulatory capital rules. In addition, subordinated debt and the allowance for loan and lease losses are examples of items where the regulatory reporting and the regulatory capital treatments differ.

The FDIC acknowledges that unrealized gains and losses on all securities, regardless of whether they are in the held-to-maturity, available-for-sale, or trading accounts, should be taken into consideration in the overall qualitative evaluation of an institution's capital adequacy. Further, if an institution has established a securities trading account in which it buys and holds securities principally for the purpose of selling those assets in the near term, it is appropriate for such an institution to reflect the amount of any net unrealized gains (losses) on these trading account assets in both net income and the calculation of Tier 1 capital. However, for debt securities that are placed in the held-to-maturity or available-for-sale categories, the FDIC does not believe that market value fluctuations should automatically be factored into the quantitative calculations for regulatory capital, but rather these unrealized gains (losses) generally should be qualitatively considered in assessing capital adequacy.

Under the final rule, FDIC-supervised institutions will continue to reflect net unrealized holding gains (losses) on available-for-sale securities as a separate capital component for regulatory reporting purposes, consistent with the Call Report instructions issued by the FFIEC. However, because unrealized holding gains (losses) on available-for-sale securities will not be included in the determination of regulatory capital (other than for net unrealized holding losses on available-for-sale equity securities with readily determinable fair values), institutions' capital levels under the FDIC's leverage and risk-based capital standards will not be adversely affected by temporary fluctuations in the fair value of these securities that may give rise to net unrealized holding losses. Similarly, if banks have net unrealized holding gains on available-for-sale securities, these gains, which also may be temporary in nature, will be excluded from the calculation of Tier 1 capital.

The FDIC is concerned that if unrealized losses on all available-for-sale securities are deducted in the Tier 1 capital calculation, but unrealized gains are not included, an inequitable treatment would exist in that institutions would reflect the full impact of any net unrealized losses in their regulatory capital calculations without receiving the benefit of net unrealized gains.

The FDIC believes that both net appreciation and net depreciation on available-for-sale debt securities should be treated consistently for regulatory capital purposes and that it is more appropriate to exclude these unrealized gains and losses from the calculation of regulatory capital than it is to include both in Tier 1 capital,

particularly since Tier 1 capital generally is expected to be comprised of the most permanent forms of capital. In this regard, the FDIC considers it more appropriate to qualitatively evaluate the impact of these FASB 115 net unrealized gains (losses) on a case-by-case basis (e.g., in conjunction with the overall assessment of the institution's interest rate risk exposure), rather than to automatically incorporate these amounts into the quantitative calculation of Tier 1 capital.

This approach is deemed proper in view of the potential volatility in the amount of net unrealized gains (losses) on available-for-sale debt securities as interest rates change, particularly where these changes may be temporary in nature, and the effect that these unrealized gains and losses could otherwise have on an institution's capital category for purposes of the FDIC's prompt corrective action, risk-related insurance premiums, brokered deposit, and other capital-based rules if these unrealized gains (losses) were included in Tier 1 capital. In addition, because of the piecemeal application of market value accounting mandated by FASB 115, the FDIC believes it is inappropriate to explicitly recognize in regulatory capital all unrealized gains (losses) on available-for-sale securities when offsetting gains (losses) in the value of an institution's other assets and liabilities are not similarly recognized.

The FDIC, however, retains the authority to require institutions to maintain more capital than the minimums set forth in part 325.[1]