value ratio and the appropriate risk weight under § 567.6(a).

* * * * *

Qualifying residential construction loan. (1) * * *

(ii) The residence being constructed must be a 1–4 family residence sold to a home purchaser;

(iii) The lending savings association must obtain sufficient documentation from a permanent lender (which may be the construction lender) demonstrating that:

* * * * *

Tier 1 capital. The term *Tier 1 capital* means core capital as computed in accordance with § 567.5(a) of this part.

Tier 2 capital. The term *Tier 2 capital* means supplementary capital as computed in accordance with § 567.5 of this part.

* * * * *

3. Section 567.2(a)(2)(ii) is revised to read as follows:

§ 567.2 Minimum regulatory capital requirement.

(a) * * *

(2) *Leverage ratio requirement.* * * *

(ii) A savings association must satisfy this requirement with core capital as defined in § 567.5(a) of this part.

* * * * *

4. Section 567.6(a)(1)(vi) is revised to read as follows:

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

(a) * * *

(1) * * *

(vi) *Indirect ownership interests in pools of assets.* Assets representing an indirect holding of a pool of assets, e.g., mutual funds, are assigned to risk-weight categories under this section based upon the risk weight that would be assigned to the assets in the portfolio of the pool. An investment in shares of a mutual fund whose portfolio consists primarily of various securities or money market instruments that, if held separately, would be assigned to different risk-weight categories, generally is assigned to the risk-weight category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the investment objectives set forth in its prospectus. The savings association may, at its option, assign the investment on a pro rata basis to different risk-weight categories according to the investment limits in its prospectus. In no case will an investment in shares in any such fund be assigned to a total risk weight less than 20 percent. If the savings association chooses to assign investments on a pro rata basis, and the sum of the investment limits of assets in the fund's prospectus exceeds 100 percent, the savings association must assign the highest pro rata amounts of its total investment to the higher risk categories. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities will generally be disregarded in determining the risk-weight category into which the savings association's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk-weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk-weight category.

* * * * *

5. Section 567.8 is revised to read as follows:

§ 567.8 Leverage ratio.

(a) The minimum leverage capital requirement for a savings association assigned a composite rating of 1, as defined in § 516.3 of this chapter, shall consist of a ratio of core capital to adjusted total assets of 3 percent. These generally are strong associations that are not anticipating or experiencing significant growth and have well-diversified risks, including no undue interest rate risk exposure, excellent asset quality, high liquidity, and good earnings.

(b) For all savings associations not meeting the conditions set forth in paragraph (a) of this section, the minimum leverage capital requirement shall consist of a ratio of core capital to adjusted total assets of 4 percent. Higher capital ratios may be required if warranted by the particular circumstances or risk profiles of an individual savings association. In all cases, savings associations should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.

Dated: December 15, 1998.

By the Office of Thrift Supervision.

Ellen Seidman,

Director.

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BILLING CODE OCC: 4810–33–P (25%); Board: 6210–01–P (25%); FDIC: 6714–01–P (25%); OTS: 6720–01–P (25%)

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R–0948]

Risk-Based Capital Standards: Construction Loans on Presold Residential Properties; Junior Liens on 1- to 4-Family Residential Properties; and Investments in Mutual Funds

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is amending its risk-based capital standards for bank holding companies. The intended effect of this final rule is to keep the Board's bank holding company risk-based capital standards for construction loans on presold residential properties, real estate loans secured by junior liens on 1- to 4-family residential properties, and investments in mutual funds consistent with the risk-based capital standards for banks and thrifts.

EFFECTIVE DATE: This final rule is effective April 1, 1999. The Federal Reserve will not object if an institution wishes to apply the provisions of this final rule beginning with the date it is published in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT: Norah Barger, Assistant Director (202/452–2402), Barbara Bouchard, Manager (202/452–3072), T. Kirk Odegard, Financial Analyst (202/530–6225), Division of Banking Supervision and Regulation; or Mark E. Van Der Weide, Attorney (202/452–2263), Legal Division. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452–3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

I. Background

The bank and thrift regulatory agencies have recently engaged in an interagency effort to make uniform capital standards pursuant to section 303 of the Riegle Community Development and Regulatory

Improvement Act of 1994 (CDRI Act).[1] Section 303 of the CDRI Act requires the agencies to review their own regulations and written policies and to streamline those regulations where possible, and also requires the agencies to work jointly to make uniform all regulations and guidelines implementing common statutory or supervisory policies. To fulfill the CDRI Act section 303 mandate, the agencies reviewed their capital standards for banks and thrifts to identify areas where they had substantively different capital treatments or where streamlining was appropriate.

As a result of these reviews, on October 27, 1997, the agencies proposed conforming amendments to their risk-based and leverage capital standards for banks and thrifts (62 FR 55686), while the Board concurrently proposed similar amendments to the capital standards for bank holding companies (62 FR 55692). Specifically, the agencies proposed to amend the risk-based capital treatments for construction loans on presold residential properties, loans secured by junior liens on 1- to 4-family residential properties, and investments in mutual funds. In addition, the agencies proposed a streamlining revision to their leverage capital rules. While not technically mandated under section 303 of the CDRI Act, the Board decided to amend the risk-based and leverage capital standards for bank holding companies to maintain consistency with the capital standards for banks and thrifts. The interagency and Board proposals were identical with respect to risk-based capital standards, but differed with respect to leverage capital standards.

This Board final rule applies to the bank holding company risk-based capital standards the same changes that are being concurrently implemented in the risk-based capital standards for banks and thrifts.[2] The Board amended its leverage capital standard for bank holding companies effective June 30, 1998 (63 FR 30369); the leverage capital standard is not discussed further in this notice.

II. The Board's Proposal

The Board proposed to amend its risk-based capital standards for bank holding companies in three areas. First, with regard to construction loans on presold residential property, the Board proposed to conform its regulatory language to that of the FDIC. This revision would provide guidance on the characteristics of loans to builders that would be considered prudently underwritten, but would not substantively change the Board's capital treatment for such loans.[3] Second, the Board proposed to adopt the OCC's capital treatment for first and junior liens on 1- to 4-family residential properties where no institution holds an intervening lien. This would entail treating first and junior liens separately, with qualifying first liens risk-weighted at 50 percent, and nonqualifying first liens and all junior liens risk-weighted at 100 percent.[4] Finally, the Board proposed to modify its capital treatment for investments in mutual funds[5] by allowing an institution to allocate its investment in a mutual fund on a pro rata basis to various risk weight categories based on the investment limits set forth in the fund's prospectus.

III. Comments Received

The Board received 4 public comments on the risk-based capital components of the proposal (one each from a bank holding company and an industry trade group, and two from concerned individuals).[6] No commenters specifically addressed the proposed risk-based capital treatment for construction loans on presold residential property or investments in mutual funds, while three commenters opposed the proposed treatment for junior liens on 1- to 4-family residential properties. One commenter supported the entire proposal without elaboration.

Of the three commenters opposing the junior lien proposal, two opposed what they perceived to be lower capital requirements for first and junior liens to the same borrower. Both commenters indicated that lowering capital requirements would increase credit risk for institutions with high loan-to-value (LTV) loans, and one of these commenters expressed the opinion that this increased risk would negatively impact lending to low- and moderate-income borrowers. The third commenter opposed the proposal for different reasons. This commenter indicated that the proposed 100 percent risk weight for all junior liens was unreasonable because the credit risk inherent in such liens varies widely. This commenter further suggested that first and junior liens by the same lender should be treated separately because of the complexity of tracking such loans, and that junior liens individually should be eligible for either a 50 percent or 100 percent risk weight.

IV. Final Rule

After consideration of the comments received and further deliberation of the issues involved, the Board has determined to adopt a final rule that is largely consistent with the original proposal. The Board is adopting the proposed capital treatments for construction loans on presold residential property and investments in mutual funds. The Board has decided, however, to adopt a capital treatment for junior liens on 1- to 4-family residential properties that differs from the proposed treatment.

Construction Loans on Presold Residential Property

As proposed, the Board will continue to permit a qualifying residential construction loan to become eligible for the 50 percent risk category at the time the property is sold, regardless of when the institution made the loan to the builder. The Board is revising its regulatory language to conform its discussion of qualifying construction loans to that of the FDIC.

Junior Liens on 1- to 4-Family Residential Properties

Rather than implementing the proposed treatment of junior liens on 1- to 4-family residential properties, the Board is maintaining its current treatment of such liens. Where a bank holding company holds the first lien and junior lien(s) on a residential property and no other party holds an intervening lien, the loans will be viewed as a single extension of credit secured by a first lien on the underlying property for the purpose of determining the LTV ratio, as well as for risk weighting. The combined loan amount will be assigned to either the 50 percent or 100 percent risk category, depending on whether the credit satisfies the criteria for a 50 percent risk weighting. To qualify for the 50 percent risk

[1] The Board has worked with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) to fulfill the CDRI Act section 303 mandate.

[2] Amended risk-based and leverage capital standards for banks and thrifts are included in a separate interagency notice published elsewhere in today's **Federal Register**.

[3] Qualifying construction loans on presold residential property are accorded a risk weight of 50 percent when the property is sold, regardless of when the institution makes the loan to the builder.

[4] Generally, qualifying liens are liens where the underlying loan meets prudent underwriting criteria, including an appropriate loan-to-value ratio, and is considered to be performing adequately. A lien where the underlying loan is 90 days or more past due, or is in nonaccrual status, is not considered to be performing adequately.

[5] An institution's investment in a mutual fund is generally assigned entirely to the risk category that is applicable to the highest-risk asset allowed under the fund's prospectus.

[6] For more information about public opinion with respect to this final rule, see the comment summaries in the concurrent interagency final rule regarding capital standards for banks and thrifts.

category, the combined loan must be made in accordance with prudent underwriting standards, including an appropriate LTV ratio.[7] In addition, none of the combined loan may be 90 days or more past due, or be in nonaccrual status. Loans that do not meet all of these criteria must be assigned in their entirety to the 100 percent risk category.

Investments in Mutual Funds

As proposed, a bank holding company's total investment in a mutual fund should be assigned to the risk category appropriate to the highest risk-weighted asset the fund may hold in accordance with the stated investment limits set forth in its prospectus. Bank holding companies will also have the option of assigning the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus. Regardless of the risk-weighting method used, the total risk weight of a mutual fund must be no less than 20 percent. If the bank chooses to assign investments on a pro rata basis, and the sum of the investment limits of assets in the fund exceeds 100 percent, the bank must assign investments in descending order, beginning with the highest-risk assets.[8]

In addition, if a mutual fund can hold an insignificant amount of highly liquid, high-quality securities that do not qualify for a preferential risk weight, then these securities may be disregarded in determining the fund's risk weight. The prudent use of hedging instruments by a mutual fund to reduce its risk exposure will not increase the mutual fund's risk weighting. The Board also emphasizes that any activities which are speculative in nature or otherwise inconsistent with the preferential risk weighting assigned to the fund's assets could result in the fund being assigned to the 100 percent risk category.

V. Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board has determined that this final rule will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). The effect of the final rule will be to reduce regulatory burden on bank holding companies by unifying the agencies' risk-based capital treatment for presold construction loans, junior liens, and investments in mutual funds. Moreover, because the risk-based capital guidelines generally do not apply to bank holding companies with consolidated assets of less than $150 million, the final rule will not affect such companies. Accordingly, a regulatory flexibility analysis is not required.

VI. Paperwork Reduction Act

The Board has determined that the final rule does not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

VII. Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA) (Title II, Pub. L. 104–121) provides generally for agencies to report rules to Congress for review. The reporting requirement is triggered when a federal agency issues a final rule. Accordingly, the agencies filed the appropriate reports with Congress as required by SBREFA.

The Office of Management and Budget has determined that this final rule does not constitute a ''major rule'' as defined by SBREFA.

List of Subjects in 12 CFR Part 225

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

For the reasons set forth in the preamble, part 225 of chapter II of title 12 of the Code of Federal Regulations is amended as set forth below.

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

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

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

2. In appendix A to part 225, section III.*A*., footnote 24 is revised to read as follows:

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

* * * * *

III. * * *

A. * * * [24]

* * * * *

3. In appendix A to part 225, section III.*C*.3. footnote 37 is revised to read as follows:

* * * * *

III. * * *

C. * * *

3. * * * [37]

* * * * *

4. In appendix A to part 225, section III.*C*.3. is amended by adding a new sentence to the end of footnote 38 to read as follows:

* * * * *

III. * * *

C. * * *

3. * * * [38]

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[7] In this regard, bank holding companies are encouraged to adhere to the criteria established in the interagency guidelines for real estate lending. See 12 CFR part 208, subpart C.

[8] For example, assume that a fund's prospectus permits 100 percent risk-weighted assets up to 30 percent of the fund, 50 percent risk-weighted assets up to 40 percent of the fund, and 20 percent risk-weighted assets up to 60 percent of the fund. In such a case, the institution must assign 30 percent of the total investment to the 100 percent risk category, 40 percent to the 50 percent risk category, and 30 percent to the 20 percent risk category. The institution may not minimize its capital requirement by assigning 60 percent of the total investment to the 20 percent risk category and 40 percent of the total investment to the 50 percent risk category.

[24] An investment in shares of a fund whose portfolio consists primarily of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the stated investment objectives set forth in the prospectus. An organization may, at its option, assign a fund investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus. In no case will an investment in shares in any fund be assigned to a total risk weight of less than 20 percent. If an organization chooses to assign a fund investment on a pro rata basis, and the sum of the investment limits of assets in the fund's prospectus exceeds 100 percent, the organization must assign risk weights in descending order. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities generally will be disregarded when determining the risk category into which the organization's holding in the overall fund should be assigned. The prudent use of hedging instruments by a fund to reduce the risk of its assets will not increase the risk weighting of the fund investment. For example, the use of hedging instruments by a fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if a fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

[37] If a banking organization holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purposes of determining the loan-to-value ratio and assigning a risk weight.

[38] * * * Such loans to builders will be considered prudently underwritten only if the bank holding company has obtained sufficient documentation that the buyer of the home intends to purchase the home (i.e., has a legally binding written sales contract) and has the ability to obtain

Continued

By order of the Board of Governors of the Federal Reserve System, February 24, 1999.

Jennifer J. Johnson,

Secretary of the Board.

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BILLING CODE 6210–01–U

a mortgage loan sufficient to purchase the home (i.e., has a firm written commitment for permanent financing of the home upon completion).