

whatever name) that involves an *irrevocable* obligation to make a payment to the customer or to a third party in the event the customer fails to repay an outstanding debt obligation or fails to perform a contractual obligation is treated, for risk-based capital purposes, as respectively, a financial guarantee standby letter of credit or a performance standby.

f. A loan commitment, on the other hand, involves an obligation (with or without a material adverse change or similar clause) of the bank to fund its customer in the normal course of business should the customer seek to draw down the commitment.

g. Sale and repurchase agreements and asset sales with recourse (to the extent not included on the balance sheet) and forward agreements also are converted at 100 percent. The risk-based capital definition of the sale of assets with recourse, including the sale of 1- to 4-family residential mortgages, is the same as the definition contained in the instructions to the commercial bank Call Report. Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of 1- to 4-family residential mortgages, are to be converted at 100 percent and assigned to the risk weight appropriate to the obligor, or if relevant, the nature of any collateral or guarantees. The terms of a transfer of assets with recourse may contractually limit the amount of the institution's liability to an amount less than the effective risk-based capital requirement for the assets being transferred with recourse. If such a transaction (including one that is reported as a financing, i.e., the assets are not removed from the balance sheet) meets the criteria for sales treatment under GAAP, the amount of total capital required is equal to the maximum amount of loss possible under the recourse provision. If the transaction is also treated as a sale for regulatory reporting purposes, then the required amount of capital may be reduced by the balance of any associated non-capital liability account established pursuant to GAAP to cover estimated probable losses under the recourse provision. So-called "loan strips" (that is, short-term advances sold under long-term commitments without direct recourse) are defined in the instructions to the commercial bank Call Report and for risk-based capital purposes as assets sold with recourse.

h. Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,⁴⁵ and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

i. Securities lent by a bank are treated in one of two ways, depending upon whether the lender is at risk of loss. If a bank, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. If, alternatively, a bank lends its own securities or, acting as agent for a

customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor, to any collateral delivered to the lending bank, or, if applicable, to the independent custodian acting on the lender's behalf. Where a bank is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the bank, the transaction is deemed to be collateralized by cash on deposit in the bank for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

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

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

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

2. In Part 225, Appendix A, section III.D.1. is revised to read as follows:

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

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III. * * *

D. * * *

1. *Items with a 100 percent conversion factor.*

a. A 100 percent conversion factor applies to direct credit substitutes, which include guarantees, or equivalent instruments, backing financial claims, such as outstanding securities, loans, and other financial liabilities, or that back off-balance sheet items that require capital under the risk-based capital framework. Direct credit substitutes include, for example, financial standby letters of credit, or other equivalent irrevocable undertakings or surety arrangements, that guarantee repayment of financial obligations such as: commercial paper, tax-exempt securities, commercial or individual loans or debt obligations, or standby or commercial letters of credit. Direct credit substitutes also include the acquisition of risk participations in bankers acceptances and standby letters of credit, since both of these transactions, in effect, constitute a guarantee by the acquiring banking organization that the underlying account party (obligor) will repay its obligation to the originating, or issuing, institution.⁴⁴ (Standby letters of credit that are performance-related are discussed below

and have a credit conversion factor of 50 percent.)

b. The full amount of a direct credit substitute is converted at 100 percent and the resulting credit equivalent amount is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor or the nature of the collateral. In the case of a direct credit substitute in which a risk participation⁴⁵ has been conveyed, the full amount is still converted at 100 percent. However, the credit equivalent amount that has been conveyed is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after giving effect to any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation. Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the portion of a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the risk category appropriate to claims guaranteed by those institutions, that is, the 20 percent risk category.⁴⁶ This approach recognizes that such conveyances replace the originating banking organization's exposure to the obligor with an exposure to the institutions acquiring the risk participations.⁴⁷

c. In the case of direct credit substitutes that take the form of a syndication, that is, where each banking organization if obligated only for its *pro rata* share of the risk and there is no recourse to the originating banking organization, each banking organization will only include its *pro rata* share of the direct credit substitute in its risk-based capital calculation.

d. Financial standby letters of credit are distinguished from loan commitments (discussed below) in that standbys are irrevocable obligations of the banking organization to pay a third-party beneficiary when a customer (account party) *fails to repay* an outstanding loan or debt instrument (direct credit substitute). Performance standby letters of credit (performance bonds) are irrevocable obligations of the banking organization to pay a third-party beneficiary when a customer (account party) *fails to perform* some other contractual non-financial obligation.

e. The distinguishing characteristic of a standby letter of credit for risk-based capital purposes is the combination of irrevocability with the fact that funding is triggered by some failure to repay or perform an obligation. Thus, any commitment (by whatever name) that involves an *irrevocable*

⁴⁵ That is, a participation in which the originating banking organization remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

⁴⁶ Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

⁴⁷ A risk participation in bankers acceptances conveyed to other institutions is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

⁴⁵ Forward forward deposits accepted are treated as interest rate contracts.

⁴⁴ Credit equivalent amounts of acquisitions of risk participations are assigned to the risk category appropriate to the account party obligor, or, if relevant, the nature of the collateral or guarantees.