Joint Report: Differences in Accounting and Capital Standards Among the Federal Banking Agencies; Report to Congressional Committees

AGENCIES: Office of the Comptroller of the Currency (OCC), Treasury; Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision (OTS), Treasury.

ACTION: Report to the Congressional Committees.

SUMMARY: The OCC, the Board, the FDIC, and the OTS (the Agencies) have prepared this report pursuant to section 37(c) of the Federal Deposit Insurance Act. Section 37(c) requires the Agencies to jointly submit an annual report to the Committee on Financial Services of the United States House of Representatives and to the Committee on Banking, Housing, and Urban Affairs of the United States Senate describing differences between the capital and accounting standards used by the Agencies. The report must be published in the Federal Register.
FOR FURTHER INFORMATION CONTACT:


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SUPPLEMENTARY INFORMATION: The text of the report follows:

REPORT TO THE COMMITTEE ON FINANCIAL SERVICES OF THE UNITED STATES HOUSE OF REPRESENTATIVES AND TO THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS OF THE UNITED STATES SENATE REGARDING DIFFERENCES IN ACCOUNTING AND CAPITAL STANDARDS AMONG THE FEDERAL BANKING AGENCIES
Introduction

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) ("the federal banking agencies" or "the agencies") must jointly submit an annual report to the Committee on Financial Services of the U.S. House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate describing differences between the accounting and capital standards used by the agencies. The report must be published in the Federal Register.

This report, which covers differences existing as of December 31, 2006, is the fifth joint annual report on differences in accounting and capital standards to be submitted pursuant to Section 37(c) of the Federal Deposit Insurance Act (12 U.S.C. 1831n(c)), as amended. Prior to the agencies' first joint annual report, Section 37(c) required a separate report from each agency.

Since the agencies filed their first reports on accounting and capital differences in 1990, the agencies have acted in concert to harmonize their accounting and capital standards and eliminate as many differences as possible. Section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4803) also directed the agencies to work jointly to make uniform all regulations and guidelines implementing common statutory or supervisory policies. The results of these efforts must be "consistent with the principles of safety and soundness, statutory law and policy, and the
public interest.” In recent years, the agencies have revised their capital standards to address changes in credit and certain other risk exposures within the banking system and to align the amount of capital institutions are required to hold more closely with the credit risks and certain other risks to which they are exposed. These revisions have been made in a uniform manner whenever possible and practicable to minimize interagency differences.

While the differences in capital standards have diminished over time, a few differences remain. Some of the remaining capital differences are statutorily mandated. Others were significant historically but now no longer affect in a measurable way, either individually or in the aggregate, institutions supervised by the federal banking agencies. In this regard, the OTS plans to eliminate two such de minimis differences during 2007 that have been fully discussed in previous joint annual reports ((i) covered assets and (ii) pledged deposits, nonwithdrawable accounts, and certain certificates), and these differences have been excluded from this annual report.

In addition to the specific differences in capital standards noted below, the agencies may have differences in how they apply certain aspects of their rules. These differences usually arise as a result of case-specific inquiries that have only been presented to one agency. Agency staffs seek to minimize these occurrences by coordinating responses to the fullest extent reasonably practicable.
The federal banking agencies have substantially similar capital adequacy standards. These standards employ a common regulatory framework that establishes minimum leverage and risk-based capital ratios for all banking organizations (banks, bank holding companies, and savings associations). The agencies view the leverage and risk-based capital requirements as minimum standards, and most institutions are expected to operate with capital levels well above the minimums, particularly those institutions that are expanding or experiencing unusual or high levels of risk.

The OCC, the FRB, and the FDIC, under the auspices of the Federal Financial Institutions Examination Council, have developed uniform Reports of Condition and Income (Call Reports) for all insured commercial banks and state-chartered savings banks. The OTS requires each OTS-supervised savings association to file the Thrift Financial Report (TFR). The reporting standards for recognition and measurement in the Call Reports and the TFR are consistent with U.S. generally accepted accounting principles (GAAP). Thus, there are no significant differences in regulatory accounting standards for regulatory reports filed with the federal banking agencies. Only one minor difference remains between the accounting standards of the OTS and those of the other federal banking agencies, and that difference relates to push-down accounting, as more fully explained below.
Differences in Capital Standards Among the Federal Banking Agencies

Financial Subsidiaries

The Gramm-Leach-Bliley Act (GLBA) establishes the framework for financial subsidiaries of banks.\(^1\) GLBA amends the National Bank Act to permit national banks to conduct certain expanded financial activities through financial subsidiaries. Section 121(a) of the GLBA (12 U.S.C. 24a) imposes a number of conditions and requirements upon national banks that have financial subsidiaries, including specifying the treatment that applies for regulatory capital purposes. The statute requires that a national bank deduct from assets and tangible equity the aggregate amount of its equity investments in financial subsidiaries. The statute further requires that the financial subsidiary’s assets and liabilities not be consolidated with those of the parent national bank for applicable capital purposes.

State member banks may have financial subsidiaries subject to all of the same restrictions that apply to national banks.\(^2\) State nonmember banks may also have financial

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\(^1\) A national bank that has a financial subsidiary must satisfy a number of statutory requirements in addition to the capital deduction and deconsolidation requirements described in the text. The bank (and each of its depository institution affiliates) must be well capitalized and well managed. Asset size restrictions apply to the aggregate amount of assets of all of the bank’s financial subsidiaries. Certain debt rating requirements apply, depending on the size of the national bank. The national bank is required to maintain policies and procedures to protect the bank from financial and operational risks presented by the financial subsidiary. It is also required to have policies and procedures to preserve the corporate separateness of the financial subsidiary and the bank’s limited liability. Finally, transactions between the bank and its financial subsidiary generally must comply with the Federal Reserve Act’s (FRA) restrictions on affiliate transactions and the financial subsidiary is considered an affiliate of the bank for purposes of the anti-tying provisions of the Bank Holding Company Act. See 12 U.S.C. Section 5136A.

\(^2\) See 12 U.S.C. Section 335 (state member banks subject to the “same conditions and limitations” that apply to national banks that hold financial subsidiaries).
subsidiaries, but they are subject only to a subset of the statutory requirements that apply to national banks and state member banks.3 Finally, national banks, state member banks, and state nonmember banks may not establish or acquire a financial subsidiary or commence a new activity in a financial subsidiary if the bank, or any of its insured depository institution affiliates, has received a less than satisfactory rating as of its most recent examination under the Community Reinvestment Act.4

The OCC, the FDIC, and the FRB adopted final rules implementing their respective provisions of Section 121 of GLBA for national banks in March 2000, for state nonmember banks in January 2001, and for state member banks in August 2001. GLBA did not provide new authority to OTS-supervised savings associations to own, hold, or operate financial subsidiaries, as defined.

Subordinate Organizations Other Than Financial Subsidiaries

Banks supervised by the OCC, the FRB, and the FDIC generally consolidate all significant majority-owned subsidiaries other than financial subsidiaries for regulatory capital purposes. This practice assures that capital requirements are related to the

3 The applicable statutory requirements for state nonmember banks are as follows. The bank (and each of its insured depository institution affiliates) must be well capitalized. The bank must comply with the capital deduction and deconsolidation requirements. It must also satisfy the requirements for policies and procedures to protect the bank from financial and operational risks and to preserve corporate separateness and limited liability for the bank. Further, transactions between the bank and a subsidiary that would be classified as a financial subsidiary generally are subject to the affiliate transactions restrictions of the FRA. See 12 U.S.C. Section 1821w.

4 See 12 U.S.C. Section 1841(i)(2).
aggregate credit (and, where applicable, market) risks to which the banking organization is exposed. For subsidiaries other than financial subsidiaries that are not consolidated on a line-for-line basis for financial reporting purposes, joint ventures, and associated companies, the parent banking organization's investment in each such subordinate organization is, for risk-based capital purposes, deducted from capital or assigned to the 100 percent risk-weight category, depending upon the circumstances. The FRB's and the FDIC's rules also permit the banking organization to consolidate the investment on a pro rata basis in appropriate circumstances. These options for handling unconsolidated subsidiaries, joint ventures, and associated companies for purposes of determining the capital adequacy of the parent banking organization provide the agencies with the flexibility necessary to ensure that institutions maintain capital levels that are commensurate with the actual risks involved.

Under the OTS's capital regulations, a statutorily mandated distinction is drawn between subsidiaries, which generally are majority-owned, that are engaged in activities that are permissible for national banks and those that are engaged in activities "impermissible" for national banks. Where subsidiaries engage in activities that are impermissible for national banks, the OTS requires the deduction of the parent's investment in these subsidiaries from the parent's assets and capital. If a subsidiary's activities are permissible for a national bank, that subsidiary's assets are generally consolidated with those of the parent on a line-for-line basis. If a subordinate organization, other than a subsidiary, engages in impermissible activities, the OTS will generally deduct
investments in and loans to that organization.\textsuperscript{5} If such a subordinate organization engages solely in permissible activities, the OTS may, depending upon the nature and risk of the activity, either assign investments in and loans to that organization to the 100 percent risk-weight category or require full deduction of the investments and loans.

\textbf{Collateralized Transactions}

The FRB and the OCC assign a zero percent risk weight to claims collateralized by cash on deposit in the institution or by securities issued or guaranteed by the U.S. Government, U.S. Government agencies, or the central governments of other countries that are members of the Organization for Economic Cooperation and Development (OECD). The OCC and the FRB rules require the collateral to be marked to market daily and a positive margin of collateral protection to be maintained daily. The FRB requires qualifying claims to be fully collateralized, while the OCC rule permits partial collateralization.

The FDIC and the OTS assign a zero percent risk weight to claims on qualifying securities firms that are collateralized by cash on deposit in the institution or by securities issued or guaranteed by the U.S. Government, U.S. Government agencies, or other OECD central governments. The FDIC and the OTS accord a 20 percent risk weight to such claims on other parties.

\textsuperscript{5} See 12 CFR Section 559.2 for the OTS's definition of subordinate organization.
Noncumulative Perpetual Preferred Stock

Under the federal banking agencies' capital standards, noncumulative perpetual preferred stock is a component of Tier 1 capital. The capital standards of the OCC, the FRB, and the FDIC require noncumulative perpetual preferred stock to give the issuer the option to waive the payment of dividends and to provide that waived dividends neither accumulate to future periods nor represent a contingent claim on the issuer.

As a result of these requirements, if a bank supervised by the OCC, the FRB, or the FDIC issues perpetual preferred stock and is required to pay dividends in a form other than cash, e.g., stock, when cash dividends are not or cannot be paid, the bank does not have the option to waive or eliminate dividends, and the stock would not qualify as noncumulative. If an OTS-supervised savings association issues perpetual preferred stock that requires the payment of dividends in the form of stock when cash dividends are not paid, the stock may, subject to supervisory approval, qualify as noncumulative.

Equity Securities of Government-Sponsored Enterprises

The FRB, the FDIC, and the OTS apply a 100 percent risk weight to equity securities of government-sponsored enterprises (GSEs), other than the 20 percent risk weighting of Federal Home Loan Bank stock held by banking organizations as a condition of membership. The OCC applies a 20 percent risk weight to all GSE equity securities.
Limitation on Subordinated Debt and Limited-Life Preferred Stock

The OCC, the FRB, and the FDIC limit the amount of subordinated debt and intermediate-term preferred stock that may be treated as part of Tier 2 capital to 50 percent of Tier 1 capital. The OTS does not prescribe such a restriction. The OTS does, however, limit the amount of Tier 2 capital to 100 percent of Tier 1 capital, as do the other agencies.

In addition, for banking organizations supervised by the OCC, the FRB, and the FDIC, at the beginning of each of the last five years of the life of a subordinated debt or limited-life preferred stock instrument, the amount that is eligible for inclusion in Tier 2 capital is reduced by 20 percent of the original amount of that instrument (net of redemptions). The OTS provides thrifts the option of using either the discounting approach used by the other federal banking agencies, or an approach which, during the last seven years of the instrument’s life, allows for the full inclusion of all such instruments, provided that the aggregate amount of such instruments maturing in any one year does not exceed 20 percent of the thrift’s total capital.

Tangible Capital Requirement

Savings associations supervised by the OTS, by statute, must satisfy a 1.5 percent minimum tangible capital requirement. Other subsequent statutory and regulatory changes, however, imposed higher capital standards rendering it unlikely, if not
impossible, for the 1.5 percent tangible capital requirement to function as a meaningful regulatory trigger. This statutory tangible capital requirement does not apply to institutions supervised by the OCC, the FRB, or the FDIC.

**Market Risk Rules**

In 1996, the OCC, the FRB, and the FDIC adopted rules requiring banks and bank holding companies with significant exposure to market risk to measure and maintain capital to support that risk. The OTS did not adopt a market risk rule because no OTS-supervised savings association engaged in the threshold level of trading activity addressed by the other agencies’ rules. As the nature of many savings associations’ activities has changed since 1996, market risk has become an increasingly more significant risk factor to consider in the capital management process. Accordingly, the OTS has joined the other agencies in proposing a revised market risk rule.6

**Differences in Accounting Standards Among the Federal Banking Agencies**

**Push-Down Accounting**

Push-down accounting is the establishment of a new accounting basis for a depository institution in its separate financial statements as a result of the institution becoming substantially wholly owned. Under push-down accounting, when a depository institution is acquired in a purchase, yet retains its separate corporate existence, the assets and

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6 71 FR 55958 (September 25, 2006).
liabilities of the acquired institution are restated to their fair values as of the acquisition date. These values, including any goodwill, are reflected in the separate financial statements of the acquired institution, as well as in any consolidated financial statements of the institution’s parent.

The OCC, the FRB, and the FDIC require the use of push-down accounting for regulatory reporting purposes when an institution’s voting stock becomes at least 95 percent owned by an investor or a group of investors acting collaboratively. This approach is generally consistent with accounting interpretations issued by the staff of the Securities and Exchange Commission. The OTS requires the use of push-down accounting when an institution’s voting stock becomes at least 90 percent owned by an investor or investor group.
Dated: 4-9-07.

John C. Dugan,
Comptroller of the Currency.
[THIS SIGNATURE PAGE PERTAINS TO THE JOINT REPORT: DIFFERENCES IN ACCOUNTING AND CAPITAL STANDARDS AMONG THE FEDERAL BANKING AND THRIFT AGENCIES; REPORT TO CONGRESSIONAL COMMITTEES]

By order of the Board of Governors of the Federal Reserve System, April 9, 2007.

[Signature]

Jennifer J. Johnson,
Secretary of the Board.
[THIS SIGNATURE PAGE PERTAINS TO THE JOINT REPORT: DIFFERENCES IN ACCOUNTING AND CAPITAL STANDARDS AMONG THE FEDERAL BANKING AND THRIFT AGENCIES; REPORT TO CONGRESSIONAL COMMITTEES]

Dated at Washington, D.C., this 11th day of April, 2007.

FEDERAL DEPOSIT INSURANCE CORPORATION.

[Signature]

Robert E. Feldman
Executive Secretary.

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DATED: April 16, 2007

By the Office of Thrift Supervision.

John M. Reich,
Director.

Billing Codes
OCC: 4810-33-P 1/4
Board: 6210-01-P 1/4
FDIC: 6714-01-P 1/4
OTS: 6720-01-P 1/4