are not permitted to invest in equity securities, nor are they generally permitted to engage in real estate investment or development activities. To the extent that commercial banks are permitted to hold equity securities (for example, in connection with debts previously contracted), the three banking agencies generally assign such investments to the 100 percent risk category for risk-based capital purposes.

Under the three banking agencies' rules, the agencies may, on a case-by-case basis, deduct equity investments from the parent bank's capital or make other adjustments, if necessary, to assess an appropriate capital charge above the minimum requirement. The banking agencies' treatment of investments in subsidiaries is discussed below.

The OTS risk-based capital standards require that thrift institutions deduct certain equity investments from capital over a phase-in period, which ended on July 1, 1994, as explained more fully below in the section on subsidiaries.

FSLIC/FDIC-covered assets (assets subject to guarantee arrangements by the FSLIC or FDIC)

The three banking agencies generally place these assets in the 20 percent risk category, the same category to which claims on depository institutions and government-sponsored agencies are assigned.

The OTS places these assets in the zero percent risk category.

Repossessed assets and assets more than 90 days past due

The three banking agencies require that foreclosed real estate be written down to fair value (see Section Two of this report, "Specific Valuation Allowances for, and Charge-Offs of, Troubled Real Estate Loans not in Foreclosure" for further details) with the resulting asset assigned to the 100 percent risk category. The write-down effectively results in a reduction of capital. Assets 90 days or more past due, including 1- to 4-family residential mortgages, are assigned to the 100 percent risk category. If and when such assets are eventually charged off, capital is effectively adjusted for any resulting

Consistent with the Basle Accord, the 100 percent risk category is the highest risk category under the risk-based capital guidelines of the three banking agencies. As noted above, however, the bank risk-based capital standards represent minimum ratios.

Organizations with high levels of risk, including a significant volume of nonperforming or past due assets, are expected to maintain capital ratios

above minimum levels. Thus, the riskbased capital framework of the banking agencies provides the flexibility to require higher levels of capital against assets of this type.

The OTS risk-based capital framework assigns a 200 percent risk weight to repossessed assets (generally referred to as real estate owned or REO) and assets more than 90 days past due. An exception exists for 1- to 4-family residential mortgages more than 90 days past due, which are assigned to the 100 percent risk category. The OTS intends to change the risk weight for all REO to 100 percent in conjunction with recent changes in the accounting for REO.

Limitation on subordinated debt and limited-life preferred stock

Consistent with the Basle Accord, the three banking agencies limit the amount of subordinated debt and limited-life preferred stock that may be included in Tier 2 capital. This limit, in effect, states that these components together may not exceed 50 percent of Tier 1 capital. In addition, maturing capital instruments must be discounted by 20 percent in each of the last five years prior to maturity.

Neither subordinated debt nor limited-life preferred stock is a permanent source of funds, and subordinated debt cannot absorb losses while the bank continues to operate as a going-concern. On the other hand, both capital components can provide a cushion of protection to the FDIC insurance fund. Thus, the 50 percent limitation permits the inclusion of some subordinated debt in capital, while assuring that permanent stockholders' equity capital remains the predominant element in bank regulatory capital.

The OTS has no limitation on the total amount of limited-life preferred stock or maturing capital instruments that may be included within Tier 2 capital. In addition, the OTS allows thrifts the option of: (1) Discounting maturing capital instruments issued on or after November 7, 1989, by 20 percent a year over the last 5 years of their term—the approach required by the banking agencies; or (2) including the full amount of such instruments provided that the amount maturing in any of the next seven years does not exceed 20 percent of the thrift's total capital.

## Subsidiaries

Consistent with the Basle Accord and long-standing supervisory practices, the three banking agencies generally consolidate all significant majority-owned subsidiaries of the parent organization for capital purposes. This

consolidation assures that the capital requirements are related to all of the risks to which the banking organization is exposed.

As with most other bank subsidiaries, banking and finance subsidiaries generally are consolidated for regulatory capital purposes. However, in cases where banking and finance subsidiaries are not consolidated, the Federal Reserve, consistent with the Basle Accord, generally deducts investments in such subsidiaries in determining the adequacy of the parent bank's capital.

The Federal Reserve's risk-based capital guidelines provide a degree of flexibility in the capital treatment of unconsolidated subsidiaries (other than banking and finance subsidiaries) and investments in joint ventures and associated companies. For example, the Federal Reserve may deduct investments in such subsidiaries from an organization's capital, may apply an appropriate risk-weighted capital charge against the proportionate share of the assets of the entity, may require a lineby-line consolidation of the entity, or otherwise may require that the parent organization maintain a level of capital above the minimum standard that is sufficient to compensate for any risks associated with the investment.

The guidelines also permit the deduction of investments in subsidiaries that, while consolidated for accounting purposes, are not consolidated for certain specified supervisory or regulatory purposes. For example, the Federal Reserve deducts investments in, and unsecured advances to, Section 20 securities subsidiaries from the parent bank holding company's capital. The FDIC accords similar treatment to securities subsidiaries of state nonmember banks established pursuant to Section 337.4 of the FDIC regulations.

Similarly, in accordance with Section 325.5(f) of the FDIC regulations, a state nonmember bank must deduct investments in, and extensions of credit to, certain mortgage banking subsidiaries in computing the parent bank's capital. (The Federal Reserve does not have a similar requirement with regard to mortgage banking subsidiaries. The OCC does not have requirements dealing specifically with the capital treatment of either mortgage banking or securities subsidiaries. The OCC, however, does reserve the right to require a national bank, on a case-bycase basis, to deduct from capital investments in, and extensions of credit to, any nonbanking subsidiary.)

The deduction of investments in subsidiaries from the parent's capital is designed to ensure that the capital supporting the subsidiary is not also