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M E M O R A N D U M

February 4, 2002

To Our Clients and Friends

Re: Final Rule for Capital Requirements
For Nonfinancial Equity Investments

SUMMARY

The Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Federal Reserve Board have amended their capital guidelines to establish special minimum capital requirements for equity investments¹ in nonfinancial companies. These new capital requirements, which will apply to equity investments of banks and bank holding companies, impose a series of marginal capital charges on covered equity investments that increase with the level of a banking organization's overall exposure to equity investments relative to the organization's Tier 1 capital. The rule is effective April 1, 2002.

PROVISIONS

Under the rule, equity investments are subject to a Tier 1 capital charge (for both risk-based and leverage capital purposes) that increases as the banking organization's investment in equity investments increases on the assumption that exposure to risk increases as the level of equity investments increases.

¹ "Equity investment" includes the purchase, acquisition, or retention of any equity instrument (common stock, preferred stock, partnership interests, interested in limited liability companies, trust certificates and warrants and call options), any equity feature of a debt instruction and any debt instrument that is convertible into equity. The rule generally does not apply to investments in nonconvertible senior or subordinated debt.

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The capital charges that will be deducted in determining the amount of a banking organization's Tier 1 capital are:

- 8 percent on the portion of a nonfinancial equity investment portfolio that represents up to 15 percent of the organization's Tier 1 capital
- 12 percent on the portion of nonfinancial equity investment portfolio that is at least 15 percent (but less than 25 percent) of Tier 1 capital
- 25 percent on the portion of nonfinancial equity investment portfolio that exceeds 25% of Tier 1 capital.

The agencies view these capital requirements as minimum capital levels and reserve the right to impose a higher capital charge if warranted by the risks associated with a banking organization's investments.

The charges imposed by the rule apply to investments in nonfinancial companies held under the merchant bank authority granted to bank holding companies by the Gramm-Leach-Bliley Act, and by banking organizations under the portfolio investment provisions of Regulation K and under the provisions of section 4(c) of the Bank Holding Company ("BHC") Act. The charges also apply to investments made by bank holding companies or banks through small business investment companies (SBICs) or under section 24 of the Federal Deposit Insurance Act.

Exempt from these Tier 1 capital charges are individual investments made by banking organizations prior to March 13, 2000 and investments made through SBICs unless the amount of these investments exceeds 15 percent of Tier 1 capital. Also exempt from the rule are: 1) investments made in a community development corporation to promote the public welfare; 2) securities that are acquired in satisfaction of a debt previously contracted; 3) unexercised warrants acquired by a bank as additional consideration for making a loan; 4) equity investments made under section 4(k) of the BHC Act by an insurance underwriting affiliate of a financial holding company; and 5) investments made by a financial holding company under the "complementary" investment authority of section 4(k)(1)(B) of the BHC Act.

The aggregate investment review thresholds that currently apply to the merchant banking investments of financial holding companies will expire automatically on April 1, 2002.

A copy of the final rule can be found at <http://www.schwartzandballen.com/WhatsNew.htm>.

If you have any questions concerning this final rule, please call Gilbert Schwartz, Robert Ballen or Tom Fox at (202) 776-0700.