

of the issuer; and (4) does not embody an obligation on the part of the issuer.

An instrument that embodies an obligation on the part of the issuer would be considered an equity exposure if the instrument meets any of the following conditions: (1) The issuer may defer indefinitely the settlement of the obligation; (2) the obligation requires, or permits at the issuer's discretion, settlement by the issuance of a fixed number of the issuer's equity interests; (3) the obligation requires, or permits at the issuer's discretion, settlement by the issuance of a variable number of the issuer's equity interests, and all things being equal, any change in the value of the obligation is attributable to, comparable to, and in the same direction as, the change in value of a fixed number of the issuer's equity shares; or (4) the holder has the option to require that the obligation be settled by issuance of the issuer's equity interests, unless the banking organization's primary Federal supervisor has opined in writing that the instrument should be treated as a debt position.

Debt obligations and other securities, derivatives, or other instruments structured with the intent of conveying the economic substance of equity ownership would be considered equity exposures for purposes of the A-IRB capital requirements. For example, options and warrants on equities and short positions in equity securities would be characterized as equity exposures. If a debt instrument is convertible into equity at the option of the holder, it would be deemed equity upon conversion. If such debt is convertible at the option of the issuer or automatically by the terms of the instrument, it would be deemed equity from inception. In addition, instruments with a return directly linked to equities would be characterized as equity exposures under most circumstances. A banking organization's primary Federal supervisor would have the discretion to allow a debt characterization of such an equity-linked instrument, however, if the instrument is directly hedged by an equity holding such that the net position does not involve material equity risk to the holder. Equity instruments that are structured with the intent of conveying the economic substance of debt holdings, or securitization exposures would not be considered equity exposures. For example, some issuances of term preferred stock may be more appropriately characterized as debt.

In all cases, the banking organization's primary Federal supervisor would have the discretion to

recharacterize debt holdings as equity exposures or equity holdings as debt or securitization exposures for regulatory capital purposes.

The Agencies encourage comment on whether the definition of an equity exposure is sufficiently clear to allow banking organizations to make an appropriate determination as to the characterization of their assets.

Materiality

As noted above, a banking organization that is required or elects to use the A-IRB approach for any credit portfolio would also generally be required to use the A-IRB approach for its equity exposures. However, if the aggregate equity holdings of a banking organization are not material in amount, the organization would not be required to use the A-IRB approach to equity exposures. For this purpose, a banking organization's equity exposures generally would be considered material if their aggregate carrying value, including holdings subject to exclusions and transitional provisions (as described below), exceeds 10 percent of the organization's Tier 1 and Tier 2 capital on average during the prior calendar year. To address concentration concerns, however, the materiality threshold would be lowered to 5 percent of the banking organization's Tier 1 and Tier 2 capital if the organization's equity portfolio consists of less than ten individual holdings. Banking organizations would risk weight at 100 percent equity exposures exempted from the A-IRB equity treatment under a materiality threshold.

Comment is sought on whether the materiality thresholds set forth above are appropriate. Exclusions from the A-IRB Equity Capital Charge

Zero and Low Risk Weight Investments

The New Accord provides that national supervisors may exclude from the A-IRB capital charge those equity exposures to entities whose debt obligations qualify for a zero risk weight under the New Accord's standardized approach for credit risk. Entities whose debt obligations qualify for a zero risk weight generally include (i) sovereigns rated AAA to AA-; (ii) the BIS; (iii) the IMF; (iv) the European Central Bank; (v) the European Community; and (vi) high-quality multilateral development banks (MDBs) with strong shareholder support.²⁷ The Agencies intend to

²⁷ These are, at present, the World Bank group comprised of the International Bank for Reconstruction and Development and the International Finance Corporation, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and

exclude from the A-IRB equity capital charge equity investments in these entities. Instead, these investments would be risk weighted at zero percent under the A-IRB approach.

In addition, the Agencies are proposing to exempt from the A-IRB equity capital charge investments in non-central government public-sector entities (PSEs) that are not traded publicly and generally are held as a condition of membership. Examples of such holdings include stock of a Federal Home Loan Bank or a Federal Reserve Bank. These investments would be risk-weighted as they would be under the general risk-based capital rules—20 percent or zero percent, respectively, in the examples.

Comment is sought on whether other types of equity investments in PSEs should be exempted from the A-IRB capital charge on equity exposures, and if so, the appropriate criteria for determining which PSEs should be exempted.

Legislated Program Equity Exposures

Under the New Accord, national supervisors may exclude from the A-IRB capital charge on equity exposures certain equity exposures made under legislated programs that involve government oversight and restrictions on the types or amounts of investments that may be made (legislated program equity exposures). Under the New Accord, a banking organization would be able to exclude from the A-IRB capital charge on equity exposures legislated program equity exposures in an amount up to 10 percent of the banking organization's Tier 1 plus Tier 2 capital.

The Agencies propose that equity investments by a banking organization in a small business investment company (SBIC) under section 302(b) of the Small Business Investment Act of 1958 would be legislated program equity exposures eligible for the exclusion from the A-IRB equity capital charge in an amount up to 10 percent of the banking organization's Tier 1 plus Tier 2 capital. A banking organization would be required to risk weight at 100 percent any amounts of legislated program equity exposures that qualify for this exclusion from the A-IRB equity capital charge.

The Agencies seek comment on what conditions might be appropriate for this partial exclusion from the A-IRB equity capital charge. Such conditions could include limitations on the size and types of

Development, the Inter-American Development Bank, the European Investment Bank, the Islamic Development Bank, the Nordic Investment Bank, the Caribbean Development Bank, and the Council of Europe Development Bank.