



FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT
AND CHIEF OPERATING OFFICER

March 11, 1988

DALLAS, TEXAS 75222

Circular 88-22

TO: The Chief Executive Officer of
all financial institutions in the
Eleventh Federal Reserve District

SUBJECT

**Request for public comment on revised risk-based capital guidelines
proposal**

DETAILS

The Board of Governors of the Federal Reserve System has requested public comment on a revised proposal to establish risk-based capital guidelines for U.S. banking organizations. This proposal is based upon a risk-based capital framework developed jointly during the past year by the Basle Committee on Banking Regulations and Supervisory Practices. The Basle Committee includes supervisory authorities from 12 major industrial countries.

This proposal represents a major step in coordinating with regulatory authorities of other countries establishment of appropriate capital standards for banking organizations, in accordance with the International Lending Supervision Act of 1983.

A document detailing this issue is available upon request. If you would like to receive a copy, please contact the Public Affairs Department at (214) 651-6289. Comments should be received by May 13, 1988.

ATTACHMENTS

The Board's press release which summarizes the text of the proposal is attached.

MORE INFORMATION

For further information, please contact W. Arthur Tribble of the Supervision and Regulation Department at (214) 744-7447.

Sincerely yours,

For additional copies of any circular please contact the Public Affairs Department at (214) 651-6289. Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank (800) 442-7140 (intrastate) and (800) 527-9200 (interstate).



For immediate release

March 1, 1988

The Federal Reserve Board today requested comment on a revised risk-based capital guidelines proposal for U.S. banking organizations. The proposal is based upon a framework developed by the Basle Committee on Banking Regulations and Supervisory Practices. The Basle Committee includes supervisory authorities from 12 major industrial countries.

The revised proposal for U.S. banking organizations was developed in conjunction with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

Comments should be received by the Board on this matter by May 13, 1988.

The proposal is designed to achieve important goals long sought by the Board:

- Establish a uniform capital framework, applicable to all federally supervised banking organizations, that is more sensitive to risk factors, including off-balance-sheet exposures;
- Encourage international banking organizations to strengthen their capital positions; and,
- Reduce a source of competitive inequality arising from differences in supervisory requirements among nations.

The joint interagency preamble to the Federal Register Notice and the Federal Reserve's proposed guidelines for state member banks and bank holding companies are attached.

DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY
12 CFR PART 3
[DOCKET NO. 88-5]

FEDERAL RESERVE SYSTEM
12 CFR PART 225, APPENDIX B
[REGULATION Y; DOCKET NO. R-0628]

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR PART 325, APPENDIX A

CAPITAL; RISK-BASED CAPITAL GUIDELINES

AGENCIES: Office of the Comptroller of the Currency, Department of Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation.

ACTION: Notice of Proposed Guidelines.

SUMMARY: Since the early 1980s, the Board of Governors of the Federal Reserve System ("Board"), the Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("Office" or "OCC") (collectively, "the Federal banking agencies" or "Agencies") have employed minimum supervisory ratios of primary and total capital to total assets in assessing the capital adequacy of national and state-chartered banks and bank holding companies (collectively, "banking organizations").

While these ratios of capital to total assets have served as a useful tool for assessing capital adequacy, the Federal banking agencies believe that there is a need for a measure that is more sensitive to the risk profiles of individual banking organizations. As a result, the Federal banking agencies first proposed in early 1986 the adoption of a risk-based capital measure that took explicit account of broad differences in risks among a banking organization's assets and off-balance sheet items. Based, in part, on comments received in response to that earlier proposal, the Federal banking agencies, in conjunction with the Bank of England, published a revised risk-based capital proposal in early 1987, which would have established risk-based capital standards applicable to banking organizations in the United States and the United Kingdom ("U.S./U.K. proposal" or "measure"). Implementation of the U.S./U.K. proposal was deferred to enlist the participation of additional countries in the risk-based capital agreement.

The Federal banking agencies are now seeking public comment on a revised risk-based capital proposal in lieu of the U.S./U.K. measure. The current proposal is based upon a risk-based capital framework developed jointly during the past year by supervisory authorities from 12 major industrial countries. Adoption of this proposal would achieve important goals long sought by the Agencies. First, it would establish a

uniform risk-based capital framework, applicable to all federally-supervised banking organizations, that is more sensitive to credit risk factors, including off-balance sheet exposures. Second, it would encourage international banking organizations to strengthen their capital positions. Finally, it would mitigate a source of competitive inequality arising from differences in national supervisory requirements.

This proposal represents a major step in the process of coordinating with regulatory authorities of other countries to establish appropriate capital standards for banking organizations, in accordance with the International Lending Supervision Act of 1983 ("ILSA"), 12 U.S.C. 3901 et seq.

DATE: Comments must be submitted on or before May 13, 1988.

ADDRESSES: Comments should be sent to the appropriate Federal banking agency at the following addresses:

OCC: Comments should be sent to Docket No. 88-5, Communications Division, Office of the Comptroller of the Currency, 490 L'Enfant Plaza East, S.W., Washington, D.C. 20219, Attention: Lynette Carter. Telephone (202) 447-1800. Comments will be available for inspection and photocopying at the same address.

Board: Comments should refer to Docket No. R-0628, and should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551, or should be delivered to the Office of the Secretary, Room 2223, Eccles Building, 20th and Constitution Avenue, N.W., between the hours of 9:00 a.m. and 5:00 p.m. weekdays. Comments may be inspected in Room 1119, Eccles Building, between 9:00 a.m. and 5:00 p.m. weekdays.

FDIC: Comments should be sent to Hoyle L. Robinson, Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429, or delivered to Room 6108 at the same address between the hours of 9:00 a.m. and 5:00 p.m. on business days.

FOR FURTHER INFORMATION CONTACT:

OCC: Ed Irmiler, Associate Director, Economic and Policy Analysis Division, (202/447-1924); Larry Senter, National Bank Examiner, Commercial Activities Division, (202/447-1164); C. Stewart Goddin, Senior International Economic Advisor, Multinational and Regional Bank Division, (202/447-1747); Sanford Brown, Attorney, Legal Advisory Services Division, (202/447-1880), Office of Comptroller of the Currency, 490 L'Enfant Plaza East, S.W., Washington, D.C. 20219.

Board: Richard Spillenkothen, Deputy Associate Director (202/452-2594), Anthony G. Cornyn, Assistant Director (202/452-3354), Stephen M. Lovette, Manager (202/452-3622), Rhoger Pugh, Manager (202/728-5883), Norah Barger, Financial Analyst (202/452-2402), or Kelly S. Shaw, Financial Analyst (202/452-3054), Division of Banking Supervision and Regulation, Board of Governors; or J. Virgil Mattingly, Deputy General Counsel (202/452-3430), or Michael J. O'Rourke, Senior Attorney (202/452-3288), Legal Division, Board of Governors; or Andrew Spindler, Vice President (212/720-5846), Betsy B. White, Vice President (212/720-5874), Donald E. Schmid, Manager (212/720-6611), or Jeffrey Bardos, Bank Supervision Specialist (212/720-7962), Federal Reserve Bank of New York. For the hearing impaired only, Telecommunication Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3544).

FDIC: Stephen G. Pfeifer, Examination Specialist (202/898-6894) or Robert F. Mialovich, Associate Director (202/898-6918) Division of Bank Supervision; or Claude A. Rollin, Attorney, Legal Division (202/898-3985). Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.

I. SUPPLEMENTARY INFORMATION AND BACKGROUND

The Purpose of the Risk-Based Capital Proposal

In 1986, the Federal banking agencies issued for public comment a risk-based capital proposal applicable to U.S. banks and bank holding companies. The principal objectives of this early proposal, as well as subsequent proposals, were: 1) to develop more systematic procedures for factoring on- and off-balance sheet risks into supervisory assessments of capital adequacy; and 2) to foster coordination among supervisory authorities from major industrial countries, many of which employ risk-sensitive capital measures.

The risk-based capital proposal was consistent with one of the major goals of the International Lending Supervision Act of 1983, which was to strengthen the bank regulatory framework by encouraging greater coordination among regulatory authorities in different countries. In addition to enhancing the Federal banking agencies' authority to establish and enforce minimum levels of capital for U.S. banking organizations, this Act instructed the Federal banking agencies to work with governments, central banks, and regulatory authorities of other major countries to maintain and, where necessary, strengthen the capital positions of banking institutions involved in international lending.

In 1987, the Federal banking agencies, in conjunction with the Bank of England, issued a revised risk-based capital proposal ("U.S./U.K. proposal" or "measure") that would apply to U.S. and U.K. banking organizations.¹ Like the 1986 proposal, a principal objective of the U.S./U.K. measure was to promote the convergence of supervisory policies on capital adequacy assessments among countries with major banking centers. In issuing the proposal, U.S. and U.K. supervisory authorities expressed the hope that it would provide a reasonable basis for working with other countries to achieve a more consistent international framework for assessing capital adequacy.

The Federal banking agencies deferred action on the U.S./U.K. proposal in order to participate in the development of a more broadly-based capital framework that would be applicable to international banking organizations from the major industrial countries. The revised capital proposal described in this Notice of Proposed Guidelines is based upon a risk-based capital

¹On March 18, 1987, the Board, together with the Bank of England, also issued a proposal to incorporate counterparty credit risks stemming from interest rate and foreign exchange rate contracts into the proposed U.S./U.K. risk-based capital measure.

framework ("Basle capital framework") developed by the Basle Committee on Banking Regulations and Supervisory Practices ("Basle Supervisors' Committee").² Officials from each of the Federal banking agencies are members of the Basle Supervisors' Committee and have played an active role in the development of the Basle capital framework.³ This framework was endorsed by the Group of Ten central bank governors and recommended to each of the countries represented on the Basle Supervisors' Committee as a basis for seeking comment on a risk-based capital adequacy measure applicable to international banking organizations in the major industrial countries.

The risk-based capital guidelines described in Sections II through V of this joint Notice constitute a proposal for applying the Basle capital framework to U.S. banking organizations. The text of each Federal banking agency's proposed guidelines is attached to this Notice. The guidelines for national banks were developed by the OCC, the guidelines for state-chartered non-member banks by the FDIC, and the guidelines for state member banks and bank holding companies by the Federal Reserve. The Federal banking agencies are seeking comment on these risk-based capital guidelines which supersede the U.S./U.K. proposal.

The current proposal achieves the principal objectives the Agencies have sought in connection with their previous proposals. In particular, the proposal establishes a systematic analytical framework that: (1) makes regulatory capital requirements more sensitive to differences in risk profiles among banking organizations; (2) takes off-balance sheet exposures into explicit account in assessing capital adequacy; and (3) minimizes disincentives to holding liquid, low-risk assets.

The development of a risk-based framework in conjunction with supervisory officials from other industrial countries acknowledges the growing internationalization of major banking and financial markets throughout the world. The harmonization and strengthening of capital standards worldwide should contribute to a more stable and resilient international

²The Basle Supervisors' Committee consists of representatives of the central banks and supervisory authorities from the Group of Ten countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, United States), Switzerland, and Luxembourg.

³The Basle capital framework is described in a consultative paper prepared by the Basle Supervisors' Committee and issued jointly by the Federal banking agencies on December 10, 1987. A copy of the paper and the joint press release are available upon request from the Federal banking agencies.

banking system and help mitigate a source of competitive inequality for international banks stemming from differences in national supervisory requirements.

In addition to international banks, the Federal banking agencies are proposing to extend the application of the risk-based capital framework to all other U.S. banking organizations, regardless of size. Although the Agencies recognize the need to minimize the additional reporting and bookkeeping burden that the risk-based capital framework may impose on small banks, the underlying rationale behind the use of a risk-based capital approach applies to small domestic banking institutions as well as large international banking organizations.

This proposal consists of a definition of capital, a system for assigning assets and off-balance sheet items to risk categories, and a schedule for establishing minimum supervisory standards. The current proposal also provides for transitional arrangements and a phase-in period to facilitate adoption and implementation of the measure. Each of these areas is described in greater detail in Sections II through V below. Following is a brief overview of the Basle capital framework and a discussion of how the proposal, as it applies to U.S. banking organizations, relates to previous proposals.

Overview of the Basle Capital Framework

The framework, as already noted, comprises four broad aspects:

- 1) A common international definition of core or Tier 1 capital (consisting of common stockholders' equity), and a "menu" of internationally-accepted non-common equity items for supplementing core capital (supplementary or Tier 2 capital components). The proposal affords national supervisors a degree of latitude, within prescribed parameters, for determining which supplementary components will qualify as capital.
- 2) A general framework for assigning assets and off-balance sheet items to five broad risk categories (0, 10, 20, 50 and 100 percent) and procedures for calculating a risk-based capital ratio.
- 3) A schedule for achieving a minimum risk-based capital ratio by the end of 1990 of 7.25 percent, (of which at least 3.25 percentage points should be in the form of common stockholders' equity) and, by the end of 1992, 8.0 percent (of which at least 4.0 percentage points should be in the form of common stockholders' equity).

- 4) Transitional arrangements and a phase-in period (running through the end of 1992) permitting banking organizations to include some supplementary items in core capital on a temporary basis and providing time to bring their capital positions into full conformity with the risk-based capital definitions and minimum supervisory standards.

In setting out a system for measuring and assessing capital adequacy, the Basle capital framework does not mandate a completely uniform structure to be employed by all countries. Rather, the framework attempts to recognize and accommodate, within prescribed limits, unique features of individual countries arising from differences in basic accounting procedures, in the structure and evolution of banking and financial markets, and in fundamental supervisory methodologies and techniques. While not eliminating these differences, the Basle capital framework nonetheless represents a significant step toward the adoption of more consistent international procedures for measuring and evaluating capital adequacy in relation to a broadly-accepted international norm.

The Basle capital framework focuses principally on broad categories of credit risk, although it does provide latitude to national supervisory authorities to take into account interest rate risk associated with certain assets in assigning them to risk categories. The measure does not, however, take account of other factors that can affect an organization's financial condition, such as overall interest rate exposure; liquidity, funding and market risks; the quality and level of earnings; investment or loan portfolio concentrations; the quality of loans and investments; the effectiveness of loan and investment policies; and management's overall ability to monitor and control other financial and operating risks. A final assessment of capital adequacy must take account of each of these considerations, including, in particular, the level and severity of problem and classified assets. Thus, the risk-based capital ratio is but one element in the assessment of capital adequacy, and the final supervisory judgment on an organization's capital adequacy may differ significantly from conclusions that might be drawn solely from the absolute level of the organization's risk-based capital ratio.

The definitions and provisions of the Basle capital framework, including the definitions of supplementary capital components, the provisions for assigning assets to risk categories, and the interim and final ratio standards, would establish minimum supervisory guidelines and standards. Supervisory authorities in each country would be responsible for determining how the risk-based framework would apply to organizations in that country, including whether considerations of safety and soundness or other factors, such as national accounting procedures, justify departures from the Basle

framework. Such departures could involve the establishment of definitional guidelines or capital standards that are higher or more restrictive than those incorporated in the proposed Basle capital framework.

Relationship of the Current Proposal to the Previous Proposal

The current risk-based capital measure, based upon the Basle capital framework, is similar to the previous U.S./U.K. proposal in a number of respects.

First, the general nature and construction of the current proposal broadly parallel the U.S./U.K. measure. The current proposal takes the form of supervisory guidelines rather than a formal regulation. Under the current proposal, an organization's risk-based capital ratio would continue to be determined by dividing its capital base by the sum of its weighted risk assets. The proposal defines capital to include core components, generally on an unlimited basis, and other supplementary elements, subject to certain prudential limitations. Weighted risk assets are determined by assigning assets and credit equivalent amounts of off-balance sheet items to one of five risk categories (0, 10, 20, 50 and 100 percent), based primarily upon broad judgments of relative credit risk. (An illustration of how the proposed ratio would be calculated is contained in Table I.)

Second, with the exception of some important differences noted below, the general treatment accorded many assets and off-balance sheet items in the current proposal is broadly similar to that of the U.S./U.K. proposal. As under that earlier proposal, all short-term claims on banks, both foreign and domestic, would be given identical low-risk treatment in recognition of the role of interbank funding markets as an important source of liquidity. With respect to sovereign transfer risk, the proposal generally opts for limiting low-risk treatment to domestic central governments. Claims by U.S. banking organizations on any foreign government involving an element of transfer risk, without distinguishing among countries, would be placed in the standard (100 percent) risk category.

Third, like the U.S./U.K. measure, this proposal also recognizes that the calculation of a risk-based capital ratio is but one step in the evaluation of an organization's overall capital adequacy. Many other factors and risk considerations must be taken into account before a final judgment on an organization's capital adequacy can be rendered. In this regard, the current risk-based capital proposal provides that, initially, the Federal banking agencies will continue to utilize their existing ratios of primary and total capital to total assets (leverage ratios).

Fourth, as was contemplated but not specified in the U.S./U.K. measure, the current proposal establishes a schedule

for achieving a minimum ratio of capital (as defined in the proposal) to weighted risk assets. Banking organizations, under the revised proposal, would generally be encouraged to operate above the minimum risk-based ratio.

Fifth, the Federal banking agencies intend to apply the proposed minimum risk-based capital measure to all banking organizations that they supervise.⁴ As discussed in greater detail in Section V below, however, initial implementation efforts would generally be directed toward large international organizations. Moreover, steps would be taken to minimize any additional reporting or recordkeeping burden associated with adoption of the risk-based capital standard, especially for smaller institutions.

Sixth, the revised proposal incorporates explicit procedures for factoring off-balance sheet risks into the risk-based capital framework. As in the U.S./U.K. proposal, the current proposal first applies credit conversion factors to the face value, or notional principal, amounts of off-balance sheet exposures and then assigns the resulting credit equivalent amounts to the appropriate risk category in a manner generally similar to balance sheet assets. With respect to the treatment of counterparty credit risks associated with interest rate and foreign exchange rate contracts, the current proposal (as it applies to U.S. banking organizations) adopts a simplified version of the approach taken in the U.S./U.K. proposal.

The current risk-based capital proposal differs in some respects from the U.S./U.K. measure, as well as from existing capital policies. These differences have resulted primarily from further consideration of key issues in light of discussions with banking supervisors in other countries and comments received in response to earlier risk-based capital proposals. Following is a brief review of the principal differences between the current risk-based capital proposal and the earlier U.S./U.K. measure.

First, while the current proposal, like the U.S./U.K. measure, defines the capital structure to comprise two basic components (core and supplementary capital), the current proposal provides that, after the transition period, core capital is to be comprised solely of common stockholders' equity (including retained earnings) and minority interest in the common equity

⁴The risk-based capital guidelines would apply to bank holding companies with less than \$150 million in consolidated assets on a bank-only basis unless: (1) the holding company or any nonbank subsidiary is engaged directly or indirectly in any nonbank activity involving significant leverage or (2) the holding company or any nonbank subsidiary has outstanding debt held by the general public.

accounts of consolidated subsidiaries.⁵ This is in contrast to the Federal banking agencies' present definition of primary capital which includes both common and perpetual preferred stock, the allowance for loan and lease losses, and mandatory convertible debt instruments. The current proposal also differs from the U.S./U.K. proposal which included the allowance for loan and lease losses (general loan loss reserves in the U.K.) in base capital along with common stockholders' equity.

The requirement that core capital (Tier 1) should ultimately be made up exclusively of common stockholders' equity is not meant to suggest that other elements of capital, such as perpetual preferred stock, mandatory convertible securities, the allowance for loan and lease losses, and subordinated debt do not impart important strengths to an organization's capital position. Indeed, these items continue to be included in capital, under appropriate conditions, within the supplementary components. Rather, the predominant role afforded common stockholders' equity reflects the fact that this element provides maximum strength and flexibility to a banking organization experiencing losses or other financial pressures. For this reason, international supervisors reached a consensus that a minimum level of common stockholders' equity should serve as the foundation of a bank's capital base.

A second difference relates to the treatment of the allowance for loan and lease losses as a component of capital. The Basle framework assigns general loan loss reserves -- defined as reserves not attributed to, or earmarked for, specific assets and not representing a reduction in the value of particular assets -- to supplementary elements of capital (Tier 2). It also phases in a limitation on valuation reserves⁶ (that is, loan loss reserves that represent valuation adjustments for groups of assets or latent but unidentified losses inherent in the balance sheet). After the transition period, these reserves, as an element of capital, may constitute no more than 1.25 percent of weighted risk assets within the supplementary components.

In practice, it is very difficult to distinguish between the portion of loan loss reserves that is freely available to absorb future losses within the portfolio and the portion that, in reality, may reflect present or imminent losses,

⁵During the transition period, as described in greater detail in Section V below, non-common equity components may be included in core capital under certain conditions that call for their phaseout into supplementary capital over time.

⁶Both the U.S./U.K. measure and the Basle capital framework exclude from capital allocated reserves representing identified losses on specific assets.

perhaps in amounts as yet unquantified, on existing problem or troubled loans. Thus, the Federal banking agencies propose to limit the inclusion of the allowance for loan and lease losses, as an element of capital, to no more than 1.25 percent of⁷ weighted risk assets within the supplementary components.

This limitation represents an effort to balance the present supervisory policy of including the allowance for loan losses in regulatory capital with the need to minimize the possibility that reserves reflecting a high level of problem loans will play a prominent role in an organization's capital base. The effect of the limitation is to bring the proportion of regulatory capital that may consist of the allowance for loan losses more broadly into line with the percentage role it played in bank capital generally in the years prior to 1987. The Federal banking agencies will continue to work together, and with banking authorities in other countries, to ensure over time that only reserves that are freely available to absorb future losses qualify for inclusion in regulatory capital.

A third major difference from the U.S./U.K. proposal relates to the treatment of certain intangible assets. While the current risk-based proposal, like the U.S./U.K. measure, provides for the deduction of goodwill from capital⁸, other identifiable intangible assets, such as purchased mortgage servicing rights, would not necessarily be deducted in calculating the risk-based capital ratio. Rather, these identifiable intangibles would be treated in accordance with each Federal banking agency's policies and practices as set forth in their respective proposed guidelines.

⁷Consistent with the Basle capital framework, the Federal banking agencies are also proposing an interim limitation on the allowance for loan losses in capital. By the end of 1990, the allowance for loan losses, as an element of capital, would be limited to 1.5 percent of weighted risk assets within Tier 2. No limit is being proposed on the role of loan loss reserves in capital for the initial phase of the transition period.

⁸Each of the Federal banking agencies may "grandfather" goodwill in certain institutions under their individual jurisdiction in accordance with terms and conditions spelled out in their respective proposed guidelines.

⁹Under current regulatory policy, the Federal Reserve generally evaluates identifiable intangible assets on a case-by-case basis and makes appropriate adjustments when the level or recorded value of these intangibles is inconsistent with the organization's overall financial condition. The only form of identifiable intangible assets currently permitted for state

(Footnote Continued)

Fourth, another significant change in the current proposal is the role for straight term subordinated debt, which was not included in the U.S./U.K. capital definition and which plays only a very limited role in the Federal banking agencies' current definition of total capital. Subordinated debt at the bank level helps to protect both depositors and the Federal deposit insurance fund. At the holding company level, subordinated debt provides a cushion to senior creditors, thereby tending to promote funding stability. Issuance of subordinated debt in prudent amounts can also enhance the role of market forces in disciplining the affairs of banking organizations. Under the current risk-based proposal, term subordinated debt, together with intermediate-term limited-life preferred stock, may be included in supplementary capital up to an amount equal to 50 percent of core capital.

Fifth, the risk-weighting framework of the revised proposal, as applied to U.S. banking organizations, provides for a number of changes from the U.S./U.K. proposal. In particular, under the revised proposal, the major changes include:

- Securities issued by the U.S. Government or its Agencies (defined as agencies whose obligations are explicitly guaranteed by the U.S. Government) with remaining maturities of 91 days or less will be assigned to the zero percent risk category, rather than to the 10 percent category.
- All other U.S. Government and Agency obligations will be assigned to the 10 percent risk category, rather than assigning securities with maturities of under one year to the 10 percent category and securities with maturities of over one year to the next higher risk category. (Portions of loans and other assets guaranteed by the U.S. Government or its Agencies, or portions of loans collateralized by cash or U.S. Government or Agency debt, will also be assigned to the 10 percent risk category).
- The weight of the category for short-term interbank claims has been reduced from 25 to 20 percent, reducing, at the same time, the risk weight for other assets assigned to this category. In addition, this category also now includes long-term claims on domestic, but not foreign, depository institutions.
- The risk weight for securities issued by U.S.

(Footnote Continued)

non-member and national banks by the FDIC and OCC, respectively, are purchased mortgage servicing rights, with other intangibles considered for inclusion only on a case-by-case basis.

Government-sponsored Agencies (defined as agencies established by the U.S. Congress to serve public purposes and whose debt obligations are not explicitly guaranteed by the U.S. Government) and general obligations of U.S. local governments (defined as debt explicitly backed by the full faith and credit of the taxing authority of U.S. states, counties, or municipalities) has been reduced from 50 percent to 20 percent.

- The effective risk weight for short-term commitments has been reduced to 0 percent, and unused retail credit card lines unconditionally cancellable by the bank at any time have been defined to be short-term commitments.
- The credit conversion factor for short-term, self-liquidating trade-related contingencies, such as commercial letters of credit, has been reduced from 50 percent to 20 percent.
- Portions of assets guaranteed by, or backed by the full faith and credit of, domestic depository institutions will be assigned to the risk category of the guarantor (20 percent).
- The procedures for determining capital requirements for interest rate swaps and foreign exchange contracts have been simplified and the capital requirements have been reduced.
- The assignment of claims on foreign banks to risk categories is based upon original rather than remaining maturity. (In addition, like the U.S./U.K. proposal, the assignment of commitments to risk categories is also based upon original maturity.)

In general, most of the changes made to the proposed risk asset framework result in lower effective risk weightings. These changes were made in light of public comments received on previous proposals and to facilitate international convergence by bringing the Federal banking agencies' risk-based capital proposal into alignment with the Basle capital framework.

Finally, the current proposal sets an explicit schedule for achieving a minimum level of capital to weighted risk assets by the end of the transition period. The proposal establishes an interim target risk-based ratio by the end of 1990 of 7.25 percent (of which 3.25 percentage points must be in the form of common stockholders' equity) and a minimum standard by the end of 1992 of 8 percent (of which at least one-half, or 4 percentage points, must be in the form of common stockholders' equity). While the current proposal establishes no initial standard, banking organizations with ratios below the interim and final

supervisory minimums are generally expected to avoid further reductions in their capital positions and should adopt plans and take steps to bring their capital positions into compliance with the risk-based minimums as soon as reasonably possible.

II. PROPOSED DEFINITION OF CAPITAL

In accordance with the Basle capital framework, the Federal banking agencies propose a risk-based capital ratio that relates an institution's qualifying capital base (the numerator of the ratio) to its weighted risk assets (the denominator). An institution's qualifying capital base consists of two types of capital elements: "core capital elements" (Tier 1) and "supplementary capital elements" (Tier 2). These capital elements and the various limits, restrictions, and deductions to which they are subject are discussed below.

The Components of Qualifying Capital

1. Core capital elements (Tier 1).

Core capital elements consist of:

- common stockholders' equity (common stockholders' equity includes common stock, surplus, and retained earnings, including disclosed capital reserves that represent an appropriation of retained earnings);
- minority interest in the common stockholders' equity accounts of consolidated subsidiaries; and,
- supplementary capital elements (during a transitional period only and subject to limitations set forth below in Section V under "Transition and Implementing Arrangements").

At least 50 percent of the total qualifying capital base (Tier 1 plus Tier 2) of a banking organization must consist of core capital (Tier 1). Core capital is defined as the sum of core capital elements minus goodwill and other disallowed intangible assets. A detailed discussion of each Agency's treatment of goodwill and other intangibles is contained in the respective Agency's proposed risk-based capital guidelines. Arrangements for calculating the risk-based capital ratio during the transitional period are discussed in Section V below.

2. Supplementary capital elements (Tier 2).

A portion of an institution's qualifying capital base may consist of supplementary capital elements. Supplementary capital elements include:

- allowance for loan and lease losses (subject to

limitations discussed below);

- perpetual and long-term preferred stock (original maturity of at least 20 years);
- hybrid capital instruments, including perpetual debt and mandatory convertible securities; and,
- subordinated debt and intermediate-term preferred stock (original average maturity of seven years or more).

The maximum amount of supplementary components that may be treated as capital for regulatory purposes would be limited to 100 percent of core capital. In addition, the combined amount of subordinated debt and intermediate-term preferred stock that may be treated as capital for regulatory purposes would be limited to 50 percent of core capital. Amounts in excess of these limits may, of course, be issued and, while not included in the ratio calculation, would be taken into account in the overall assessment of an organization's funding and capital adequacy.

The Basle capital framework also provides for the inclusion of "revaluation reserves" as an element of supplementary capital at the discretion of national supervisory authorities.¹⁰ These items, as well as the other components of supplementary capital, are discussed in greater detail below.

Allowance for loan and lease losses. Allowances for loan and lease losses that have been established through a charge against earnings to absorb future losses on loans or lease financing receivables are included within the meaning of general reserves, which the Basle capital framework assigns to Tier 2. Allowances for loan and lease losses exclude "allocated transfer

¹⁰The Basle capital framework also provides for the inclusion of "undisclosed reserves" in Tier 2. As defined in the Basle Agreement, undisclosed reserves represent accumulated after-tax retained earnings that are not disclosed on the balance sheet of a bank. Apart from the fact that these reserves are not disclosed publicly, they are essentially of the same quality and character as retained earnings, and, to be included in capital, such reserves must be accepted by the banking organization's home supervisor. Although such undisclosed reserves are common in some countries, under generally accepted accounting principles and long-standing supervisory practice, these types of reserves are not recognized for banks and bank holding companies in the United States. Foreign banking organizations seeking to make acquisitions or conduct business in the United States would be expected to disclose publicly at least the degree of reliance on such reserves in meeting supervisory capital requirements.

risk reserves." Allocated transfer risk reserves are reserves that have been established in accordance with Section 905(a) of the International Lending Supervision Act of 1983 against certain assets whose value has been found by the U.S. supervisory authorities to have been significantly impaired by protracted transfer risk problems. Allowances for loan and lease losses also exclude reserves against identified losses or earmarked for a specified asset.

As noted above, it is not always possible to distinguish clearly between loan loss reserves that are freely available to absorb future losses within the portfolio and the portion that, in reality, may reflect present or imminent losses on existing problem or troubled loans. For this reason, the Federal banking agencies, consistent with the Basle capital framework, propose a phasedown during the transition period of the extent to which allowances for loan and lease losses may be included in an institution's capital base. Initially no limit will apply to these allowances. However, at the end of 1990, allowances for loan and lease losses, as a component of capital, may constitute no more than 1.5 percent of weighted risk assets and, at the end of 1992 and thereafter, no more than 1.25 percent of risk weighted assets.

Perpetual and long-term preferred stock. Perpetual preferred stock is defined as preferred stock without a fixed maturity date and that cannot be redeemed at the option of the holder. Long-term preferred stock includes limited-life preferred stock with an original maturity of 20 years or more. These preferred stock instruments would qualify for inclusion in capital provided that they can absorb losses while the issuer operates as a going concern (a fundamental characteristic of equity capital) and provided the issuer has the option to defer preferred dividends if dividends on common stock are eliminated. Given these conditions and the perpetual or long-term nature of the instruments, there is no limit on the amount of these instruments that may be included within Tier 2 capital.

Hybrid capital instruments. Hybrid capital instruments include long-term debt instruments that generally meet the requirements set forth below:

- 1) The instrument must be unsecured; fully paid-up; and subordinated to general creditors and, if issued by a bank, also to depositors.
- 2) The instrument must not be redeemable at the option of the holder prior to maturity, except with the prior approval of the banking organization's primary Federal regulator.
- 3) The instrument must be available to participate in losses while the issuer is operating as a going concern. (Straight term subordinated debt would not

meet this requirement). To satisfy this requirement, the instrument must convert to common stock or perpetual or long-term preferred stock in the event that the sum of the retained earnings and capital surplus accounts of the issuer shows a negative balance.

- 4) The instrument must provide the option for the issuer to defer interest payments if: a) the issuer does not report a profit in the preceding annual period (defined as combined profits for the most recent four quarters) and b) the issuer eliminates cash dividends on common and preferred stock. (This provision is intended to provide the issuer with the option of mitigating the burden associated with interest payments during a period of severe financial stress.)

In addition to hybrid capital instruments meeting the above conditions, mandatory convertible securities that meet the current criteria for such instruments specified by the banking organization's primary Federal regulatory authority¹¹ or that have been previously approved as capital would also be treated as qualifying hybrid capital instruments under the proposal. During the transition period, the Federal banking agencies will review the criteria for mandatory convertible securities in light of the definitions contained in the Basle capital framework. As a result of this review, the agencies may modify the mandatory convertible criteria as part of their overall effort to implement the risk-based capital framework.

There is no limit on the amount of hybrid capital instruments and mandatory convertible securities that may be included within Tier 2 capital.

Subordinated debt and intermediate-term preferred stock. The aggregate amount of subordinated debt and intermediate-term preferred stock that may be treated as capital for risk-based capital purposes is limited to 50 percent of core capital. Subordinated debt and intermediate-term preferred stock must have an original average maturity of at least seven years to qualify as supplementary capital.¹² In the case of subordinated

¹¹Criteria for instruments issued by state member banks and bank holding companies are set forth in 12 C.F.R. Part 225, Appendix A; those for national banks are set forth in 12 C.F.R. 3.100 (e)(5); and those for state non-member banks are set forth in 12 C.F.R. 325.2(e).

¹²Unsecured debt issued by bank holding companies prior to
(Footnote Continued)

debt, the instrument must be unsecured and must clearly state on its face that it is not a deposit and is not insured by the Federal Deposit Insurance Corporation. To qualify as capital in banks, debt must be subordinated to depositors and general creditors; in bank holding companies, debt must be subordinated in right of payment to all senior indebtedness of the issuer.

Discount of supplementary capital instruments.

As a limited-life capital instrument approaches maturity it begins to take on characteristics of a short-term obligation and becomes less like a component of capital. For this reason, the outstanding amount of term subordinated debt and long- and intermediate-term limited-life preferred stock eligible for inclusion in Tier 2 would be adjusted downward, or discounted, as it approaches maturity. All such instruments would be discounted by reducing the outstanding amount of the capital instrument that would count as supplementary capital by a fifth of the original amount (less redemptions) each year during the instrument's last five years before maturity. Such instruments, therefore, would have no capital value when they have a maturity of less than a year.

Revaluation reserves. Revaluation reserves include "formal revaluation reserves" and "latent revaluation reserves." Formal revaluation reserves are created through a formal adjustment, or restatement, of the amount at which fixed assets are recorded on the balance sheet to reflect a change in the market value of the assets. Such reserves are recognized as capital in some countries, notably Great Britain, where banks are permitted periodically to revalue their own premises. Latent revaluation reserves are hidden values (that is, values that are not formally recorded on the balance sheet) that reflect unrealized capital appreciation on long-term holdings of equity securities. These reserves are defined as the difference between the current market value of the securities and the carrying value of the securities based on historic cost. In some countries, notably Japan, such revaluation reserves are substantial.

In the United States, banking organizations for the most part follow generally accepted accounting principles (GAAP) when preparing their financial statements, and GAAP generally does not permit the use of market-value accounting. Consistent with this approach, the Federal banking agencies have not included unrealized asset values in capital ratio calculations, although such values have long been taken into account in

(Footnote Continued)

March 12, 1988, and qualifying as capital at the time of issuance, would continue to qualify as capital under the risk-based framework, subject to the 50 percent of core capital limitation. Bank holding company term debt issued after this date must be subordinated in order to qualify as capital.

assessing an organization's overall financial health. In addition to the fact that U.S. accounting procedures have not traditionally recognized revaluation reserves, the uncertainty and volatility that may be associated with the market values of securities and buildings may be viewed as inconsistent with the emphasis on capital as a reliable and determinable source of strength when an organization is experiencing financial adversity.

In light of these considerations, the equivalent of revaluation reserves for U.S. banking organizations will not be formally recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all banking organizations are encouraged to disclose publicly their equivalent of premises and equity revaluation reserves, and such values will be taken into account as additional factors in assessing overall capital adequacy and financial condition. For example, other things being equal, organizations with significant and reliable revaluation reserves may be permitted to operate closer to the minimum risk-based capital ratio than organizations without such unrealized gains.

Deductions from capital and other adjustments.

Certain assets would be deducted from a banking organization's capital base for the purpose¹³ of calculating the numerator of the risk-based capital ratio.¹³ These assets include:

- 1) Goodwill and other disallowed intangibles -- deducted from Tier 1;
- 2) Capital investments in unconsolidated banking and finance subsidiaries and, on a case-by-case basis, other subsidiaries or associated companies at the discretion of the supervisory authority -- deducted from the sum of Tier 1 and Tier 2; and
- 3) Reciprocal holdings of capital instruments of banking organizations -- deducted from the sum of Tier 1 and Tier 2.

Goodwill and other intangible assets. Goodwill is an intangible asset that represents the excess of the purchase price over the fair market value of net assets acquired in acquisitions accounted for under the purchase method of accounting. Because

¹³ Any deductions made against capital in computing the numerator of the ratio would also be deducted from the appropriate asset categories in computing the denominator of the ratio.

banks generally may not include goodwill in regulatory capital under current supervisory policies, all goodwill in banks will be deducted from Tier 1 capital immediately.¹⁴

Under current policies, bank holding company goodwill is not deducted automatically from capital for general supervisory purposes. Thus, goodwill acquired by holding companies prior to March 12, 1988, would be "grandfathered" during the transition period (until the end of 1992). Any goodwill acquired after March 12, 1988, and all goodwill (including previously grandfathered goodwill) would be deducted from Tier 1 capital after 1992.

The Federal banking agencies' policies regarding other identifiable intangible assets are discussed in detail in the Agencies' respective proposed risk-based capital guidelines.

As a general rule, the Federal banking agencies believe that banking organizations should maintain strong tangible core capital bases in relation to weighted risk assets. Banking organizations that seek to expand significantly, either through internal growth or acquisition, will be expected to maintain capital positions that are above minimum supervisory levels, or otherwise acceptable to their primary Federal regulator, without undue reliance on intangible assets.

Investments in certain subsidiaries. Any equity or debt capital investments in banking or finance subsidiaries that are not consolidated under regulatory reporting requirements¹⁵ would be deducted from an organization's total capital base (i.e., the sum of core capital and supplementary capital elements).¹⁶ For this purpose, a subsidiary generally is defined as any banking or finance company in which the reporting institution holds more than 50 percent of the outstanding common stock. The assets of unconsolidated subsidiaries are not fully reflected in a banking organization's consolidated total assets.

¹⁴Goodwill acquired by banks in connection with supervisory mergers would continue to be included in capital for risk-based capital purposes under terms and conditions established by the banking organization's primary Federal regulator. Other previously permitted goodwill would not be deducted from Tier 1 capital until year end 1992.

¹⁵The requirements for consolidation are spelled out in the instructions to the bank Consolidated Reports of Condition and Income and the Consolidated Bank Holding Company FR Y-9 Report.

¹⁶An exception to this deduction would be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith.

Such assets may be viewed as the equivalent of off-balance sheet exposures since the operations of an unconsolidated subsidiary could expose the parent organization and its consolidated subsidiaries to considerable risk. For this reason, it is appropriate to view the capital invested in these entities as primarily supporting the risks inherent in these off-balance sheet assets, and not generally available to support risks or additional leverage elsewhere in the organization.

As a general rule, U.S. banking organizations do not have unconsolidated subsidiaries engaged in banking or finance since generally accepted accounting principles normally require the consolidation of such entities. Aside from these entities, the deduction of equity and debt capital investments from the banking organization's capital may at some future date be applied in the case of other subsidiaries, such as securities affiliates, if such action were necessary to facilitate functional regulation of financial service subsidiaries. This approach may also be applied, on a case-by-case basis, to certain consolidated subsidiaries for the purpose of determining whether the banking organization meets the capital standard without reliance on the capital invested in these subsidiaries. Finally, the Federal banking agencies may, at a later date, seek public comment on the extension of this approach to all subsidiaries engaged in certain specified activities for the purpose of assessing the banking organization's consolidated capital position, exclusive of the capital supporting these activities. In general, when investments in a subsidiary are deducted from a banking organization's capital, the subsidiary's assets will also be excluded from the assets of the banking organization in order to assess the latter's capital adequacy.

The Federal banking agencies had contemplated deducting from capital investments in all other unconsolidated subsidiaries (such as those engaged in businesses other than banking or finance) as well as investments in joint ventures and associated companies, since the rationale set forth above is also applicable to these entities.¹⁷ Although the Agencies continue to believe that unconsolidated subsidiaries and associated companies may pose special risks for banking organizations, they have decided not to automatically deduct such investments from capital at this time. Instead, the Agencies intend to monitor the level and nature of such investments for individual banking organizations and, on a case-by-case basis, may deduct such investments from capital or apply an appropriate risk-weighted capital charge

¹⁷Under regulatory reporting procedures, associated companies and joint ventures are generally defined as companies in which the banking organization owns 20 to 50 percent of the voting stock.

against the organization's percentage share of the assets of these entities.

Reciprocal holdings of bank capital instruments.

Reciprocal holdings of capital securities (i.e., capital instruments that qualify as Tier 1 or Tier 2 capital) would be deducted from the organizations' total capital bases for the purpose of determining the numerator of the risk-based capital ratio. Reciprocal holdings are cross-holdings or other formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other's capital instruments. Generally, as this definition implies, deductions would be limited to intentional cross holdings.

The Federal banking agencies also considered whether to deduct non-reciprocal holdings of capital securities issued by other banking organizations on the grounds that the purchase by one banking organization of capital securities issued by another organization does not represent additional capital to the banking system. In addition, such purchases may increase the interdependency of banking institutions generally and thus increase the possibility that problems could be transmitted from one banking institution to another. At present, the Agencies are not proposing to deduct non-reciprocal holdings of such capital instruments. Rather, the Agencies intend to monitor non-reciprocal holdings of other banking organizations' capital securities and to provide information on such holdings to the Basle Supervisors' Committee as called for under the Basle capital framework.

Table II summarizes the definition of capital for risk-based capital purposes.

III. RISK WEIGHTS FOR ASSETS AND OFF BALANCE SHEET ITEMS

Weighted risk assets are determined by assigning assets and off-balance sheet credit equivalent amounts to one of five broad risk categories based principally on the degree of credit risk associated with the obligor. The five risk categories are 0, 10, 20, 50, and 100 percent -- the latter representing the standard risk category which contains most loans to private sector entities. Table III summarizes the assignment of assets to risk categories.

In determining weighted risk assets, the only forms of collateral that are formally recognized by the risk asset framework are cash on deposit in the lending institution; securities issued by, or guaranteed by, the U.S. Government or its agencies; and securities issued by, or guaranteed by, U.S. Government-sponsored agencies. (See definitions below.) The only guarantees that are recognized are guarantees, or guarantee-type instruments, of the U.S. Government or its agencies, U.S. Government-sponsored agencies, domestic state and

local governments, and domestic depository institutions. While not formally factored into the ratio, the existence of other forms of collateral or guarantees would be taken into account in making an overall assessment of the risks inherent in an organization's loan portfolio. Maturity is generally not a factor in assigning items to risk categories with the exceptions of securities issued by the U.S. Government or its agencies, claims on foreign banks, commitments, and interest rate swaps and foreign exchange contracts -- all of which are discussed in greater detail below.

The remainder of this section explains in greater detail the assignment of assets and off-balance sheet items to risk categories.

Risk Weights for Balance Sheet Assets

Category 1 - Zero percent. This category includes cash (domestic and foreign) owned and held in all offices of a bank or in transit; claims on, and balances due from, Federal Reserve Banks; and, in light of their near-cash characteristics, securities issued by the U.S. Government or its agencies (direct obligations) with a remaining maturity of 91 days or less.¹⁸ Any foreign currency held by banks should be converted into U.S. dollar equivalents at current exchange rates. Deposit reserves and other balances at Federal Reserve Banks are included in Category 1, but Federal Reserve Bank stock is assigned to Category 2, and carries a weight of 10 percent.

Category 2 - 10 percent. This category includes securities issued by the U.S. Government or its agencies with a remaining maturity of over 91 days and all other claims (including leases) on the U.S. Government or its agencies.¹⁹ While these obligations bear no credit risk, this treatment is generally consistent with the latitude afforded by the Basle capital framework to recognize some degree of market and interest rate risk. In addition, all securities and loans guaranteed by the U.S. Government or its agencies (including portions of such assets guaranteed) are also included in this category. Only that

¹⁸For this purpose, a U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the U.S. Government.

¹⁹Examples of U.S. Government agencies include the Government National Mortgage Association (GNMA), the Small Business Administration (SBA), the Veterans Administration, the Federal Housing Administration, the Export-Import Bank (Exim Bank), and the Overseas Private Investment Corporation (OPIC).

portion of the loan that is guaranteed by a U.S. Government agency is to be included in this category; the remainder is to be assigned to the risk category otherwise appropriate to the obligor.

Category 2 also includes portions of all loans and other assets that are collateralized by securities issued by, or guaranteed by, the U.S. Government or its agencies or by cash on deposit in the lending institution. The degree or extent of collateral backing is based upon the current market value of the underlying collateral. Those portions of claims not secured by recognized collateral would be assigned to the risk category otherwise appropriate to the obligor.

The book value of paid-in stock of a Federal Reserve Bank is also assigned to Category 2.

Category 3 - 20 percent. The principal items in this category include short-term (original maturity of one year or less) claims on domestic depository institutions²⁰ and foreign banks²¹, including foreign central banks; cash items in process of collection; long-term (original maturity of more than one year) claims on domestic depository institutions;²² and the portions of claims guaranteed by, or backed by the full faith and

²⁰Domestic depository institutions are defined to include branches (foreign and domestic) of banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. To be included in this category, depository institutions must be federally-insured. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, international banking facilities of domestic banks, and U.S.-chartered depository institutions owned by foreigners. However, this definition excludes both branches and agencies of foreign banks located in the U.S. and bank holding companies.

²¹Foreign banks are defined as institutions that are organized under the laws of a foreign country; engage in the business of banking; are recognized as banks by the bank supervisory or monetary authorities of the country of their organization or principal banking operations; receive deposits to a substantial extent in the regular course of business; and have the power to accept demand deposits. Foreign banks include U.S. branches and agencies of foreign banks.

²²Claims on foreign banks with an original maturity exceeding one year and claims on bank holding companies are assigned to Category 5, which carries a weight of 100 percent.

credit of, domestic depository institutions. This category also includes claims on, or portions of claims guaranteed by, U.S. Government-sponsored agencies and portions of claims collateralized by securities issued by, or guaranteed by, U.S. Government-sponsored agencies.²³ (The degree of collateralization in this regard is based upon the market value of the underlying collateral.) In addition, this category includes general obligation claims on, or portions of claims guaranteed by the full faith and credit of, U.S. state and local governments. Finally, local currency claims on foreign central governments to the extent the bank has local currency liabilities in the foreign country;²⁴ and claims on official multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or a contributing member are also assigned to Category 3.²⁵

Claims on banks and depository institutions consist of balances due from such institutions, including demand deposits and other transaction accounts, savings deposits, and time certificates of deposit; and federal funds sold and securities purchased under agreements to resell for which a depository

²³For this purpose, U.S. Government-sponsored agencies are defined as agencies originally established or chartered by the U.S. Government to serve public purposes specified by the U.S. Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government. Examples of such agencies include the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), the Farm Credit System, the Federal Home Loan Bank System, and the Student Loan Marketing Association.

²⁴A foreign central government is defined to include departments, ministries, and agencies of the central government. It does not include state, provincial, or local governments; commercial enterprises owned by the central government; or private agencies sponsored by the central government. In addition, claims on foreign central governments do not include claims on non-central government entities that are guaranteed by the foreign central government.

²⁵Claims on official multilateral lending institutions or regional development institutions include securities issued by international and regional organizations to which the U.S. belongs. Claims on such institutions include loans to the International Monetary Fund, the International Bank for Reconstruction and Development (World Bank), the Bank for International Settlements, the Inter-American Development Bank, and the African Development Bank, and bankers acceptances for which the account party is one of these multilateral or regional institutions.

institution is the counterparty. To the extent that federal funds and resale agreements are collateralized by U.S. Government or agency securities, they are to be included in Category 2, which carries a weight of 10 percent.

Among other items considered to be claims on depository institutions are loans to such institutions, including overdrafts and term federal funds; holdings of the institution's own discounted acceptances for which the account party is a depository institution; holdings of bankers acceptances of other banks; and securities issued by depository institutions, except those that qualify as capital (which are to be excluded from this category and included in Category 5).

Category 3 also includes those portions of loans or other assets guaranteed by, or backed by the full faith and credit of, a domestic depository institution²⁶, such as commercial paper or tax-exempt securities backed by a standby letter of credit. Risk participations in bankers acceptances and standby letters of credit conveyed to other domestic depository institutions are equivalent to financial guarantee-type instruments issued by such institutions. Accordingly, portions of customers' liabilities to the bank on outstanding acceptances guaranteed through risk participations conveyed to other domestic depository institutions are to be netted from the outstanding exposure to the underlying account party and included in Category 3. Likewise, the credit equivalent amount of standby letters of credit conveyed to other domestic depository institutions in the form of risk participations is to be netted from²⁷ the exposure to the account party and assigned to this category. If the guarantee matures or expires and the asset or off-balance sheet exposure is still outstanding, the guaranteed portion of the asset or off-balance sheet exposure is to be reassigned to the risk category appropriate to the underlying obligor.

General obligations of states and political subdivisions of the U.S. include loans, leases, and securities such as notes, bonds, and debentures (including tax warrants and tax-anticipation notes). Because such general obligation claims

²⁶The Basle capital framework does not recognize guarantees issued by foreign banks or depository institutions. The treatment of guarantees by the issuing bank in the form of standby letters of credit or acquisitions of risk participations is discussed below in the off-balance sheet section.

²⁷This treatment would also apply to participations in commitments conveyed to other domestic depository institutions if the conveying bank remains obligated to the customer for the full amount of the commitment in the event the participating institution fails to fund its portion of the commitment.

are secured by the full faith and credit of the local taxing authority, they are assigned to a lower risk weight category than revenue bonds issued by U.S. state or local governments, which are repayable with revenues from the specific projects financed. Public purpose revenue (non-general obligation) bonds for which the underlying obligor is the state or local governmental authority are assigned to Category 4, which has a risk weight of 50 percent. Revenue bonds for which the underlying obligor is a private entity are assigned to Category 5, which has a risk weight of 100 percent.

The Basle capital framework provides flexibility to national supervisory authorities in assigning risk weights to claims on the domestic public sector (e.g., Government-sponsored agencies and state and local governmental units) because risk characteristics of these claims vary from country to country. The assignment of claims on U.S. Government-sponsored agencies and general obligation claims on U.S. state and local governments to this category, rather than to the 10 percent category, reflects the fact that while such claims generally involve low risks, they are not identical to claims that carry the explicit full faith and credit guarantee of the U.S. Government.

Category 4: 50 percent. This category includes revenue bonds or similar obligations, including loans and leases, that are obligations of U.S. state or local governments, but for which the government entity is committed to repay the debt with revenues from the facilities financed, rather than from general tax funds.

Category 5: 100 percent. All assets not classified in the categories above are assigned to this category, which comprises standard risk assets. This category includes the bulk of the assets typically found in a loan portfolio.

Category 5 consists of all claims on foreign banks with an original maturity exceeding one year, all non-local currency claims on foreign governments, and local currency claims on a foreign central government that exceed local currency liabilities held by the bank in the foreign country. Thus, this category includes all claims on foreign governments that entail an element of transfer risk. This category also includes all claims on foreign and domestic private sector obligors not included in the categories above; claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding involving standard risk claims (that is, claims assigned to the 100 percent category);²⁸ investments in fixed

²⁸Customer liabilities on acceptances outstanding involving claims in other than the 100 percent category, such as claims on
(Footnote Continued)

assets, premises, and other real estate owned; investments in unconsolidated companies, joint ventures or associated companies that have not been deducted from capital; instruments that qualify as capital issued by other banking organizations; and common and preferred stock of corporations, including stock acquired for debts previously contracted. Also included in this category are industrial development bonds and similar obligations issued by U.S. state or local governments for the benefit of a private party or enterprise where that party or enterprise, not the government, is committed to pay the principal and interest.

Finally, this category includes commercial and individual mortgage loans, including loans secured by 1-4 family residential mortgages. While the Basle capital framework provides for the assignment of the latter to the 50 percent category, the Federal banking agencies, consistent with past risk-based capital proposals, intend to give these assets a weight of 100 percent. The Federal banking agencies, as a matter of general policy, have long sought to avoid the appearance or reality of regulatory credit allocation among private sector borrowers in formulating their capital adequacy programs. Thus, the agencies will continue the policy of not singling out particular sectors or segments of the private economy on an ex ante basis for the purpose of according special low-risk capital treatment. The agencies believe that decisions on allocating credit among private sector borrowers are better left to bank management. However, for the purpose of supervisory comparisons among major international banking organizations, the Federal banking agencies will take account of, and, where appropriate, adjust for holdings of residential mortgage loans by U.S. banking organizations.

Treatment of Off-Balance Sheet Items

Risk weights for all off-balance sheet items are determined by a two-step process. First, the notional principal, or face value, amount of the off-balance sheet item is generally multiplied by a credit conversion factor to arrive at a balance sheet "credit equivalent amount". Then the credit equivalent amount is assigned, like any balance sheet asset, to the appropriate risk category, according to the obligor, or, if relevant, the guarantor or the nature of the collateral. Table IV summarizes the treatment of off-balance sheet obligations.

Items with a 100 Percent Conversion Factor. Direct credit substitutes are any irrevocable off-balance sheet obligations in which a bank has essentially the same credit risk

(Footnote Continued)

domestic banks, would be assigned to the risk category appropriate to the identity of the obligor or the other relevant characteristics of the claim.

as if it had made a direct loan to the obligor or account party.²⁹ Direct credit substitutes include guarantees, or guarantee-type instruments, backing financial claims, such as outstanding securities, loans and other financial liabilities. Thus, direct credit substitutes include standby letters of credit, or other equivalent irrevocable obligations or surety arrangements, that back or guarantee repayment of commercial paper, tax-exempt securities, commercial or individual loans or debt obligations, commercial letters of credit, or other off-balance sheet exposures that require capital backing under the risk-based capital framework. (Standby letters of credit that are performance-related are discussed below and have a credit conversion factor of 50 percent.)

Direct credit substitutes are converted at 100 percent and the resulting credit equivalent amount is then assigned to the appropriate risk category like any other asset. For example, standby letters of credit backing outstanding commercial paper issued by a private firm, or backing tax-exempt public purpose municipal revenue bonds, would be assigned to the 100 percent and 50 percent categories, respectively. The credit equivalent amount of risk participations conveyed to other domestic depository³⁰ institutions would be assigned to the 20 percent category.

²⁹The focus in this context is on credit risk. For example, if Bank A guarantees, or equivalently backs, a loan from Bank B (beneficiary) to Bank A's customer (account party) and the customer defaults, then Bank A must pay Bank B and Bank A ends up with a problem loan to its customer -- the same result as would have occurred if Bank A had made a direct loan to its customer. It is recognized that, while financial guarantee-type instruments involve credit risks similar to direct loans, providing financing through such instruments does not entail funding risks unless the standby is drawn down. The treatment of financial guarantee-type instruments and equivalent standby letters of credit in a manner similar to direct loans is consistent with the fact that such exposures generally are covered by statutory limits on loans to a single borrower, warrant the same credit review and approval process as traditional loans, and are treated and analyzed like loans by bank supervisors.

³⁰This refers to participations in which the originating bank remains liable to the beneficiary for the full amount of the standby if the participating depository institution fails to perform under the guarantee. Those participations that are syndicated out, that is, where each depository institution is responsible only for its pro-rata share of the risk and there is no recourse to the originating bank, would be excluded entirely from the originating bank's weighted risk assets.

Standby letters of credit are distinguished from loan commitments (discussed below) in that standbys are irrevocable obligations of the bank to pay a third-party beneficiary when the bank's customer (account party) fails to repay an outstanding loan or debt instrument (direct credit substitute) or fails to perform some other contractual obligation (performance bond). A loan commitment, on the other hand, involves an obligation (irrevocable or revocable under certain terms) of the bank to fund its customer in the normal course of business should the customer seek to draw down the commitment. The distinguishing characteristic of a standby letter of credit for risk-based capital purposes is, therefore, the combination of irrevocability with the notion that funding is triggered by some failure to perform an obligation. Thus, any commitment (by 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 would be treated, for risk-based capital purposes, as respectively, a financial guarantee-type standby letter of credit or a performance standby.

The acquisition of risk participations in bankers acceptances and participations in financial guarantee-type standby letters of credit or other direct credit substitutes also involve assuming risks that are analogous to direct loans to the account parties or obligors. Participations acquired by a bank in bankers acceptances and direct credit substitutes (including standby letters of credit) are converted at 100 percent and assigned to the appropriate risk weight category depending upon the identity of the account party or obligor.

Sale and repurchase agreements and asset sales with recourse, if not already included on the balance sheet, are treated in the same way as direct credit substitutes. The risk-based capital definition of the sale of assets with recourse, including the sale of one-to-four family residential mortgages, is the same as the definition contained in the instructions to the bank Consolidated Reports of Condition and Income (Call Report).³¹

³¹In regulatory reports and under GAAP, bank holding companies are permitted to treat some asset sales with recourse as "true" sales, even though similar transactions by banks must be reported as borrowings on the bank call report. For risk-based capital purposes, however, such assets sold with recourse and reported as "true" sales by bank holding companies would be converted at 100 percent and assigned to the risk category appropriate to the underlying obligor, provided the transactions met the definition of assets sold with recourse contained in the bank Report of Condition.

For U.S.-chartered banks, assets sold subject to an agreement to repurchase, or for which any risk of loss is retained, are generally required to remain on the balance sheet of the "selling" bank and the proceeds of the "sale" are recorded as a borrowing in accordance with the Call Report instructions. Such assets retained on the balance sheet are to be assigned to a risk weight category appropriate to the obligor, guarantor, or collateral. So-called "loan strips" (i.e., short-term advances sold under long-term commitments) sold without direct recourse are accorded the same treatment as assets sold with recourse.

Forward agreements are legally binding agreements (contractual obligations) to purchase assets with certain drawdown at a specified future date. These obligations include forward purchases, forward deposits, and partly-paid shares and securities; they do not include commitments to make residential mortgage loans. On the date a bank enters into such an agreement, it should convert the principal amount of the assets to be purchased at 100 percent and then assign this amount to the risk category appropriate to the obligor or guarantor of the item, or the nature of the collateral.

Items with a 50 Percent Conversion Factor.

Transaction-related contingencies include bid bonds, performance bonds, performance standby letters of credit, warranties, and standby letters of credit related to particular transactions. These instruments are different from financial guarantee-type standby letters of credit in that performance standbys generally represent obligations backing the performance of nonfinancial or commercial contracts or undertakings. To the extent permitted by law or regulation, performance standby letters of credit include arrangements backing, among other things, contractors' and suppliers' performance, labor and materials contracts, and construction bids. These instruments generally involve guaranteeing the account party's obligation to deliver a service or product in the conduct of its day-to-day business.

Unused commitments with an original maturity exceeding one year, including underwriting commitments, and commercial and consumer credit commitments also are to be converted at 50 percent. Original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which the following two conditions hold: 1) the bank can, at its option, unconditionally (without cause) cancel the commitment, and 2) the bank actually reviews the ³²facility to determine whether or not it should be extended. Commitments

³²Facilities that are unconditionally (without cause) cancellable at any time by the bank are not deemed to be commitments, provided the bank makes a separate credit decision before each drawing under the facility.

with an original maturity of one year or less are deemed to involve low risk and, therefore, are not assessed a capital charge (that is, they are assigned a 0 percent credit conversion factor). Such short-term commitments are defined to include unused lines of credit on retail credit cards that can be unconditionally cancelled by the bank at any time. However, commitments with an original maturity of over one year to extend loans under home equity or mortgage lines would be converted at 50 percent and then assigned to the 100 percent risk weight category.

For the purpose of calculating the risk-based capital ratio, commitments are defined as any arrangements between a banking organization and its customer that legally obligate the banking organization to extend credit to the customer in the form of loans or leases, the purchase of loans or securities, or participation in loans and leases. They also include such undertakings as overdraft facilities, revolving credit, or similar transactions. Normally, commitments involve a written contract or agreement, a commitment fee, or some other form of consideration. Commitments are included in weighted risk assets regardless of whether they contain "material adverse change" clauses or other provisions that are intended to relieve the bank of its funding obligation under certain conditions.

Commitments with material adverse change clauses are included because such commitments are nonetheless binding and may involve risk if a bank funds the commitment before the customer's condition deteriorates, or before the deterioration is recognized. Moreover, while the Federal banking agencies do not wish to discourage the use of material adverse change clauses, some court decisions suggest that the presence of a material adverse change clause cannot necessarily be relied on in all cases to relieve a bank of its obligations pursuant to a commitment.

In the case of commitments structured as syndications, the risk-based capital framework includes only the banking organization's proportional share of such commitments. After conversion at 50 percent, participations in commitments conveyed to other domestic banks, but in which the originating bank retains the full obligation to the borrower if the participating bank fails to perform, would be assigned to the 20 percent risk category. This treatment is analogous to risk participations in standby letters of credit.

Only the unused portion of commitments are treated as off-balance sheet items. Amounts that are already drawn and outstanding under a commitment appear on the balance sheet and such amounts, therefore, are not also to be included as commitments for purposes of computing the risk asset ratio.

Revolving underwriting facilities (RUFs) and note issuance facilities (NIFs) also are to be converted at 50

percent. These are arrangements under which a borrower can issue on a revolving basis short-term paper in its own name but for which the underwriting banks have a legally binding commitment either to purchase any notes the borrower is unable to sell by the roll-over date or to advance funds to the borrower. The original maturity of the commitment typically is five to seven years, while the paper most frequently is issued for maturities of three or six months. For bank issuers, the paper usually takes the form of short-term certificates of deposit; for non-bank borrowers, it usually takes the form of promissory notes (commonly known as Euro-notes). For the purpose of calculating the risk-based capital ratio, similar arrangements such as note purchase facilities and Euro-note facilities are to be treated in the same manner as RUFs and NIFs.

Items with a 20 Percent Conversion Factor. Short-term, self-liquidating trade-related contingencies which arise from the movement of goods include commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

Items with a Zero Percent Conversion Factor. These include unused commitments with an original maturity of one year or less. Original maturity, as noted above, is the earliest date after the commitment is made that a bank: 1) can, at its option, unconditionally (without cause) cancel the commitment and 2) actually reviews the facility to determine whether or not it should be extended. Facilities that, at the bank's option, are unconditionally cancellable at any time are not considered to be commitments, provided that the bank makes a separate credit decision before each drawdown under the facility. Unused retail credit card lines are deemed to be short-term commitments if the bank has the unconditional option to cancel the card at any time.

Interest Rate and Foreign Exchange Rate Contracts

Risk weights for interest rate and exchange rate contracts are determined by a two-step process. First, the notional principal amount of the item is converted into a balance sheet equivalent measure which approximates the amount of credit exposure involved. Second, the resulting credit equivalent amount is assigned to the appropriate risk asset category, based primarily on the identity of the obligor (counterparty), or, where relevant, on the nature of the guarantee or the underlying collateral.

Risk Analysis. The treatment of interest rate, foreign exchange rate, and related contracts takes account of the fact that the credit risks associated with these contracts is generally not equal to the notional value of the contracts. Rather, the cost to a banking organization of counterparty default on an interest rate or exchange rate contract is the cost of replacing the cash flows specified by the contract. At the time a contract is initiated, it can be replaced at little or no

cost because interest rates or exchange rates embodied in the contract reflect those prevailing in the market. But as time passes and market rates change, the value of the cash flows that the banking organization is entitled to receive from the counterparty under the contract terms often will exceed the value of the cash flows it is obligated to pay. If the counterparty were to default in such a circumstance, the banking organization would have to pay a premium to replace, or reestablish, the cash flows specified by the original contract.

A fundamental premise underlying the treatment of off-balance sheet exposures in the risk-based capital framework is that capital support is required not only for current exposure to losses, but also for potential future increases in that exposure. Accordingly, U.S. banking organizations will be required to utilize the current exposure method, as set forth in the Basle capital framework, to determine the capital necessary to support their interest rate and exchange rate contract portfolios. This method requires banking organizations to calculate the credit equivalent amount by: 1) determining the current replacement cost of contracts having positive value on the reporting date, by marking them to market, and 2) adding to that amount an estimate (the "add-on") of the potential increase in credit exposure over the remaining life of all contracts by multiplying the notional value of all contracts by the conversion factors prescribed below.³³

³³ Despite the wide range of different instruments in the market, the methodology used for assessing the credit risk on all of the contracts is the same. The analysis consists of examining the behavior of matched pairs of swaps under different volatility assumptions. A matched pair is a pair of contracts with identical terms, for which the banking organization is the buyer of one of the contracts and the seller of the other. The analysis assumes that estimates based on matched pairs provide a more accurate representation of credit exposure on a portfolio of interest rate and exchange rate contracts than estimates based on single contracts. Because banking organizations often act as intermediaries between end-users of contracts, a large share of their portfolios often consist of matched -- or nearly matched -- pairs. The volatility analysis was conducted by the staffs of the Bank of England and the U.S. Federal bank supervisory authorities. This analysis involved estimating the volatility of interest rates and exchange rates. The analysis produced probability distributions of potential replacement costs over the remaining life of matched pairs of contracts. Potential exposure was then defined in terms of confidence limits for (percentiles of) these distributions. This analysis provided the basis for the "adds-ons" included in the Basle capital framework.

Scope. Credit equivalent amounts would be computed for the following:

I. Interest Rate Contracts

- A. Single currency interest rate swaps.
- B. Basis swaps.
- C. Forward rate agreements.
- D. Interest rate options purchased.
- E. Any other instrument that gives rise to similar credit risks.

II. Exchange Rate Contracts

- A. Cross-currency interest rate swaps.
- B. Forward foreign exchange contracts.
- C. Currency options purchased.
- D. Any other instrument that gives rise to similar credit risks.

Over-the-counter options purchased would be treated in exactly the same way as the other interest rate and exchange rate contracts. That is, the credit equivalent amount would be the sum of the marked-to-market replacement cost and the "add-on" amount for potential future exposure.

Exceptions. Exchange rate contracts with an original maturity of seven days or less would be excluded. Also, instruments traded on exchanges that require daily payment of variation margin would be excluded.

Calculation of Credit Equivalent Amounts. Credit equivalent amounts would be calculated for contracts of the types described under Scope above. To calculate the credit equivalent amount of its off-balance sheet interest rate and exchange rate instruments, a bank would sum:

- 1) the current exposure, that is, the mark-to-market value (positive values only) of their contracts, and
- 2) an estimate of the potential future increases to credit exposure over the remaining life of the instruments.

Examples of the calculation of credit equivalent amounts for these instruments are contained in Table V.

Current Exposure. Current exposure is simply the mark-to-market value of a contract on the reporting date, if positive. The mark-to-market value is the amount the banking organization would have to pay to replace the net payment stream specified by the contract if the counterparty were to default.

Negative mark-to-market values would not be taken into account in the calculation of credit equivalent amounts. The mark-to-market value would include the value of interest that has accrued but has not been received. Mark-to-market values would be measured in dollars, regardless of the currency or currencies specified in the contracts.

Potential Future Exposure. Potential future exposure represents the additional exposure that may arise over the remaining life of the contract as a result of fluctuations in interest rates or exchange rates. Such changes may increase the market value of the contract in the future and, therefore, increase the cost of replacing it if the counterparty subsequently defaults. Thus, these contracts entail a commitment by the banking organization to assume additional credit exposure in the future. This commitment requires capital support beyond what is necessary to support the current exposure on the reporting date. Potential exposure on a contract is determined by multiplying the notional principal amount of the contract, including contracts with negative mark-to-market value, by one of the following credit conversion factors, as appropriate:

<u>Remaining Maturity</u>	<u>Interest Rate Contracts</u>	<u>Exchange Rate Contracts</u>
Less than one year	-0-	1.0%
One year and over	0.5%	5.0%

Because exchange rate contracts involve an exchange of principal upon maturity and exchange rates are generally more volatile than interest rates, higher conversion factors are proposed for foreign exchange instruments than for interest rate contracts.

No potential credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

Application of Credit Equivalent Amounts within the Overall Risk Framework. Table V provides examples of how credit equivalent amounts for several types of interest rate and foreign exchange rate contracts would be calculated. In each case, three pieces of information are needed to calculate the credit equivalent amount: the current mark-to-market value, the notional principal, and the remaining maturity of the contract.

Once the credit equivalent amount for interest rate and exchange rate instruments has been determined, that amount will be weighted within the overall framework according to the category of the counterparty, and, in some cases, to the nature of any underlying collateral or guarantees. In accordance with the Basle capital framework, the maximum weight applied to the credit equivalent amount would be 50 percent. However, the Federal

banking agencies intend to monitor the quality of credits in the interest rate and exchange rate markets and, in the future, would consider, if appropriate, assigning credit equivalent amounts for contracts involving standard risk obligors to the 100 percent risk category, as is the case with other off-balance-sheet instruments.

Accounting. In certain cases, credit exposures arising from the interest rate and exchange rate instruments covered by this proposal may already be reflected, in part, on the balance sheet. For example, U.S. banking organizations generally record current counterparty credit exposures (mark-to-market values) on forward foreign exchange contracts on the balance sheet. In addition, some U.S. banking organizations also include certain counterparty credit exposures that arise from interest rate swaps and options purchased on the balance sheet.

To avoid double counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the types of instruments covered by this proposal may need to be excluded from balance sheet assets in calculating banking organizations' total weighted risk asset ratios. The Federal banking agencies will address this issue in designing reporting systems.

Collateral. The existence of collateral is recognized in assigning credit equivalent amounts for these contracts to risk categories under the same conditions and limitations as discussed above for on-balance sheet claims.

Netting. In accordance with the terms of the Basle capital framework, netting of swaps and similar contracts will not be recognized at this time. While the Federal banking agencies encourage any reasonable arrangements designed to reduce the risks inherent in these transactions, the Basle Supervisors' Committee felt that the legal issues posed by netting arrangements require further consideration.

Relationship to Prior Proposals. The "add-ons" contained in the Basle capital framework differ in several respects from the corresponding calculation for potential future exposure incorporated in the U.S./U.K. proposal.³⁴ These changes

³⁴The fact that in-the-money interest rate contracts tend to entail less potential future exposure relative to other contracts is implicitly recognized in the Basle framework. In addition, in this framework, lower confidence levels are employed, and, in the underlying technical analysis, potential future exposures are discounted. Finally, the maximum weight assigned to credit equivalent amounts for standard risk obligors under the Basle framework is 50 percent, rather than 100 percent.

reflect in part recognition of comments received on the U.S./U.K. proposal, and have the effect of reducing the capital requirements contained in that earlier measure.

The proposed method of calculating the potential exposure under the Basle framework is significantly less complex than that recommended in the U.S./U.K. proposal. In simplifying the methodology, assumptions about the pattern of banks' portfolios (including the rates at which contracts have been entered into and their average maturity) have been introduced that have involved a loss of some precision relative to the U.S./U.K. measure. However, the Federal banking agencies believe that the current formula for calculating the credit equivalent amount for interest rate and exchange rate contracts represents an acceptable balance between the need to capture the risks associated with these instruments and the need to avoid unnecessary complexity.

IV. TARGET RATIO STANDARD

After the transition period (by the end of 1992), all banking organizations would be expected to meet a minimum ratio of total capital to weighted risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of core capital (Tier 1).

The maximum amount of supplementary capital elements that could qualify as Tier 2 capital would be limited to the total amount of core capital. Within Tier 2, the maximum amount of allowance for loan and lease losses that would qualify as capital would be limited to 1.25 percent of weighted risk assets. In addition, the combined maximum amount of subordinated debt and intermediate-term preferred stock that would qualify as Tier 2 capital would be limited to 50 percent of Tier 1 capital.

Total capital is calculated by adding core, or Tier 1, capital (defined to exclude goodwill and disallowed intangibles) to supplementary, or Tier 2, capital (limited to 100 percent of core capital) and then deducting from this sum any capital investments in unconsolidated banking and finance subsidiaries, reciprocal holdings of banking organization capital securities, or other items at the direction of the supervisory authority.

A transition period has been provided to give banking organizations time to bring their capital positions into conformity with the risk-based standards and definitions. The transition period would end December 31, 1992. Banking organizations not currently meeting the 8 percent minimum would be expected to undertake a sustained effort to meet that standard by year-end 1992.

V. TRANSITION AND IMPLEMENTING ARRANGEMENTS

Transition Arrangements

The proposed transition period is designed to facilitate smooth adjustment and phasing in of the risk-based capital measure and the minimum ratio standard within a wide variety of supervisory systems. The transition period would begin on the date that the proposed risk-based capital framework becomes effective and end on December 31, 1992. In addition, there will be an interim target ratio to be met by the end of 1990.

Initial period to the end of 1990. From the beginning of the transition period until the end of 1990, no formal risk-based capital standard or minimum level will be set. As noted above, the Federal banking agencies would expect any organization that has a risk-based ratio of less than 8 percent to move in the direction of that target during the transition period and meet the target by the end of 1992. Banking organizations with ratios of 8 percent or lower should not make adjustments to their risk profiles or undertake growth plans that would lower their ratios.

As indicated, the Basle capital framework establishes no initial standard. However, for the purpose of calculating the ratio during the initial period, the Basle capital framework allows the core capital of an organization to include some supplementary capital elements. Specifically, a maximum of 25 percent of core capital (before any deduction of goodwill and other disallowed intangibles) may consist of supplementary capital elements, with the remainder consisting of common stockholders' equity (including retained earnings). By year-end 1990, banking organizations would be expected to reduce the amount of supplementary capital included in core capital to no more than 10 percent of core capital.

For bank holding companies, any goodwill acquired before March 12, 1988, would be grandfathered until the end of 1992. Goodwill acquired by holding companies after this date, and all goodwill on holding company books after 1992, would be deducted from Tier 1 capital components to arrive at core capital.

Initially, the allowance for loan and lease losses may be included in a banking organization's supplementary capital without limit. However, by the end of 1990, such reserves counted in supplementary capital may not exceed 1.5 percent of weighted risk assets.

Existing primary and total capital-to-total assets (leverage) ratios would continue to be employed during this initial period. The Federal banking agencies will, prior to

year-end 1990, consider whether a leverage ratio will continue to be employed in conjunction with the implementation of the risk-based standard. If a leverage ratio is employed after 1990, the Agencies may, after appropriate consideration, adopt for leverage ratio purposes the Tier 1 and Tier 2 capital definitions contained in the risk-based capital guidelines.

Year-end 1990 through year-end 1992. During this interval, banking organizations would be expected to meet a minimum total capital to weighted risk asset ratio of 7.25 percent, at least one-half of which should be in the form of core capital. During this period, up to 10 percent of an organization's core capital (before any deduction of goodwill and disallowed intangibles) may consist of supplementary capital elements. Thus, the interim target ratio implies a minimum ratio of core capital to weighted risk assets of 3.6 percent (one-half of 7.25) and a minimum common stockholders' equity to weighted risk assets ratio of 3.25 percent (nine-tenths of the core capital ratio). Any organization not meeting the minimum supervisory ratios would be expected to develop and discuss with its supervisory authority a plan setting forth how the organization intends to reach them.

By the end of 1992, an organization's required core capital must consist solely of common stockholders' equity.

During this period, the maximum amount of allowance for loan and lease losses that may qualify as supplementary capital will be limited to 1.5 percent of weighted risk assets (that is, 1.5 percentage points of the required 7.25 percent), declining to 1.25 percent by year-end 1992. Amounts in excess of these limits may, of course, be maintained, but would not be included in an organization's total capital base. (The Federal banking agencies, however, will continue to require banking organizations to maintain reserves at levels sufficient to cover losses inherent in their loan portfolios.)

A summary of important aspects of the transitional arrangements is contained in Table VI.

Application and Implementation of the Risk-Based Capital Measure

The Basle capital framework recommends that the risk-based standard be applied to international banks but recognizes that each national supervisory authority may wish to apply the framework to a broader class of commercial banking organizations. Since the condition or stability of any institution is affected by its level of off-balance sheet exposure or the risk composition of its asset portfolio, the risk-based capital proposal outlined above provides a systematic analytical framework that is equally relevant for large and small institutions.

For these reasons, the Federal banking agencies intend to apply the risk-based capital measure, including the minimum supervisory ratio guidelines, to all banking organizations on a consolidated basis, regardless of size.³⁵ This will include an assessment of risk-based capital ratios during examinations and reviews of supervisory applications. In implementing the risk-based ratio, the banking agencies will apply the framework in a flexible manner, giving banking organizations a reasonable amount of time to develop the systems and procedures necessary to calculate the risk-based ratio.

While the risk-based standard will be applied to banking organizations of all sizes, the principal impact of the measure will generally fall on large banking institutions and those with significant off-balance sheet exposures. Aside from the calculation of the risk-based ratio during on-site examinations, the off-site supervisory data collection and monitoring effort associated with the risk-based standard could focus on one of the following three options:

1. All banking organizations;
2. Banking organizations with either i) consolidated assets in excess of some threshold amount, such as \$150 million, \$1 billion, or \$10 billion, or ii) off-balance sheet exposure (after adjustment based upon prescribed credit conversion factors) in excess of 20 percent of common stockholders' equity; or
3. Banking organizations with consolidated assets in excess of \$20 billion.

Given the objectives of the banking agencies and the Basle capital framework, it would appear necessary to modify the supervisory reporting forms for, at least, the large banking organizations, such as those with consolidated assets in excess of \$1 billion, and for those with significant off-balance sheet exposure. However, the Federal banking agencies are seeking public comment on which of the three options above should serve as the primary focus of the supervisory data collection and monitoring effort.

During the transition period, the Federal banking agencies will modify appropriate supervisory reporting forms,

³⁵Bank holding companies with less than \$150 million in consolidated assets would generally be exempt from the calculation and analysis of risk-based ratios on a consolidated holding company basis under the same terms and conditions as provided in the Federal Reserve's current Guidelines.

primarily for the larger institutions, to bring regulatory reporting requirements generally into line with the major provisions of the risk-based capital measure. In doing this, the Agencies will endeavor to lessen the impact on recordkeeping and reporting burden by phasing in any new reporting requirements, by allowing sufficient time to modify internal recordkeeping and reporting systems, and, under appropriate conditions, by employing de minimis exceptions or other arrangements designed to minimize data collection. The latter may be particularly appropriate for smaller banking organizations or those with minimal off-balance sheet exposures. All banking organizations, however, will be expected to develop over time internal recordkeeping and control systems sufficient to allow supervisory officials and examiners to evaluate the organizations' capital positions in a manner generally consistent with the risk-based capital framework.

As noted above, this proposal, consistent with the Basle capital framework, establishes no initial minimum risk-based ratio and provides for a transition period, running through the end of 1992, during which banking organizations are expected to bring their capital positions into compliance with the prescribed framework. As discussed above, the proposed ratio does not take explicit account of all factors affecting an organization's risk profile, such as asset concentrations, overall interest-rate exposure, asset quality problems or other financial or operating weaknesses. For this reason, banking organizations will generally be encouraged to operate above the minimum risk-based capital ratio, and, as is currently the case, the Federal banking agencies may establish a specific target ratio for an individual company that is above the minimum.

The transition arrangements, including the length of the transition period, are designed to provide banking organizations with a degree of flexibility in complying with the risk-based framework. In particular, these arrangements will minimize the possibility that banking organizations would be forced to take steps that could be disruptive or inconsistent with prevailing conditions in the capital markets. While the proposal provides for a phase-in period, banking organizations, as already noted, are encouraged to bring their capital positions into compliance with minimum supervisory benchmarks as soon as reasonably possible.

Banking organizations will be able to comply with the risk-based capital guidelines in several ways, some of which do not require raising new external capital. For example, an organization can moderate growth or increase earnings retention. More importantly, however, within a risk-sensitive capital standard, an organization can raise its capital ratio by reducing its overall risk profile. This can be done by reducing off-balance sheet exposure or by placing proportionately greater emphasis on those activities that carry lower risk weights.

Relationship to Existing Capital Guidelines

The Federal banking agencies will maintain their existing minimum primary and total capital-to-total assets ratios of 5.5 and 6.0 percent, respectively, until the end of 1990 -- unless revisions to these leverage ratios are made prior to this date. This is appropriate because there is a need for some total leverage guideline, especially during the initial phase of the risk-based transition period, when no minimum risk-based ratio would be in effect. In addition, maintenance of capital-to-total assets standards will provide an important element of continuity during the implementation of the risk-based framework.

By year-end 1990, the Federal banking agencies will review the merits of continuing to employ an overall leverage constraint in tandem with the risk-based capital ratio. In particular, the agencies will consider whether the existing capital-to-total assets ratios should be reduced or eliminated. If the agencies conclude that a total leverage constraint should be maintained, the definition of capital for leverage purposes may, after appropriate consideration, be aligned with the risk-based capital definitions.

Operation of a leverage guideline in parallel with a risk-based capital measure may be appropriate because certain risks associated with high leverage, such as interest rate exposure and the possible depreciation in the market value of certain assets, are not fully factored into the risk-based standard. Under a risk-based standard by itself, a banking organization with a preponderance of assets in the 20, 10, or zero percent risk categories (such as U.S. Government securities) would be subject to only a very minimal constraint on total leverage -- or, at least in theory, to no leverage constraint at all, if all assets were held in the form of instruments assigned to the zero percent risk category. Therefore, in the absence of capital-to-total assets guidelines, or other prudential limits on total borrowing in relation to capital, banking³⁶ organizations could assume an unwarranted degree of leverage.

³⁶If a leverage ratio is adopted in conjunction with the risk-based capital measure, banking organizations could, with the permission of their supervisory authority, be allowed to operate with capital-to-total assets ratios below the minimum. Such organizations would have to be in compliance with the risk-based standard and relatively free of risks not captured by the risk-based measure.

Issues for Specific Comment

The Federal banking agencies seek comments on all aspects of the proposed risk-based capital proposal. In addition, however, the agencies invite comments on the following specific issues:

1. The proposed risk-based framework assigns claims on foreign banks and commitments to risk categories based, in part, on their original maturity. The Federal banking agencies recognize that, for this purpose, a case can be made to utilize remaining, rather than original, maturity. Would remaining maturity be a better criterion to use in assigning bank claims and commitments to risk categories?

2. From an analytical standpoint and to avoid possible "window dressing", the preferred approach to calculating capital ratios would generally be to utilize average, rather than period-end, figures -- at least for most of the items upon which the ratio is based. However, the determination of average balance sheet figures may involve additional recordkeeping burden for institutions. Should the ratio be calculated from average figures? For which items used in calculating the ratio are average figures most important? How can the burden involved in determining average figures be minimized?

3. While the risk-based standard will be applied to banking organizations of all sizes, its principal impact will generally fall on large banking institutions and those with significant off-balance sheet exposures. Aside from the calculation of the risk-based ratio during on-site examinations, the off-site supervisory data collection and monitoring effort associated with the risk-based framework could focus on one of the following three classes of organizations:

1. All banking organizations;
2. Banking organizations with either i) consolidated assets in excess of some threshold amount, such as \$150 million, \$1 billion, or \$10 billion, or ii) off-balance sheet exposure (after adjustment based upon prescribed credit conversion factors) in excess of 20 percent of common stockholders' equity; or
3. Banking organizations with consolidated assets in excess of \$20 billion.

Given the objectives of the Federal banking agencies and the Basle capital framework, it would appear necessary to modify the supervisory reporting forms for, at least, the large banking organizations, such as those with consolidated assets in excess of \$1 billion, and for those with significant off-balance sheet exposure. However, the Federal banking agencies seek

public comment on which of the three options above should serve as the primary focus of the supervisory data collection and monitoring effort.

4. The Basle capital framework generally assigns the credit equivalent amount of interest rate and foreign exchange contracts involving standard risk obligors to the 50 percent, rather than 100 percent, risk category. This is based upon the argument that obligors in these markets tend to be of high quality. The Federal banking agencies seek comments on the merits of this contention, and whether they are sufficient to warrant the proposed treatment.

5. Under the proposed risk-based capital framework, the amount of intermediate-term preferred stock and subordinated term debt that can be included in supplementary capital is limited to 50 percent of core capital. Limited-life preferred stock with an original maturity of at least 20 years may be counted as supplementary capital without limit. Is this distinction between intermediate-term and long-term preferred stock appropriate? Does the distinction offer banking organizations viable and useful options for maintaining minimum risk-based capital requirements?

6. The proposal assigns claims (excluding obligations with a remaining maturity of 91 days or less) on the U.S. Treasury and U.S. Government agencies to the 10 per cent category, while claims on U.S. Government-sponsored agencies are placed in the 20 percent category. Under the earlier U.S./U.K. proposal, claims on Government-sponsored agencies were placed in the 50 percent risk category. The distinction between claims on the U.S. Treasury and claims on Government-sponsored agencies is based upon the fact that the latter lack the explicit full faith and credit guarantee of the U.S. Government. In light of the absence of such a guarantee and the proposed treatment of U.S. Treasury obligations, what is the most appropriate treatment of debt issued or guaranteed by U.S. Government-sponsored agencies?

Table I

Sample Calculation of Risk-Based Capital Ratio

Example of a bank with \$6,000 in total capital and the following assets and off-balance sheet items:

Balance Sheet Assets

Cash	\$10,000
Long-term U.S. Government securities	20,000
Balances at domestic banks	5,000
Loans to private corporations	<u>65,000</u>
Total Balance Sheet Assets	\$100,000

Off-Balance Sheet Items

Standby letters of credit ("SLCs") backing general obligation debt issues of U.S. municipalities ("GOs")	\$10,000
Long-term commitments to private corporations	<u>20,000</u>
Total Off-Balance Sheet Items	\$30,000

This bank's total capital to total assets ratio would be:

$$(\$6,000/\$100,000) = 6.00\%.$$

Table I
(continued)

To compute the bank's weighted risk assets:

1. Compute the credit equivalent amount of each off-balance sheet ("OBS") item.

<u>OBS Item</u>	<u>Face Value</u>		<u>Conversion Factor</u>		<u>Credit Equivalent Amount</u>
SLCs backing municipal GOs	\$10,000	x	1.00	=	\$10,000
Long-term commitments to private corporations	\$20,000	x	0.50	=	\$10,000

2. Multiply each balance sheet asset and the credit equivalent amount of each OBS item by the appropriate risk weight.

0% Category

Cash	\$10,000	x	0	=	\$0
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10% Category

Long-term U.S. Government securities	\$20,000	x	0.10	=	\$2,000
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20% Category

Balances at domestic banks	\$5,000				
Credit equivalent amounts of SLCs backing GOs of U.S. municipalities	10,000				
	<u>\$15,000</u>	x	0.20	=	\$3,000

50% Category

No items

100% Category

Loans to private corporations	\$65,000				
Credit equivalent amounts of long-term commitments to private corporations	10,000				
	<u>\$75,000</u>	x	1.00	=	<u>\$75,000</u>

Total Risk-Weighted Assets					\$80,000
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This bank's risk-based capital ratio would be:

$$(\$6,000/\$80,000) = 7.50\%$$

Table II
Definition of Qualifying Capital

<u>Components</u>	<u>Minimum Requirements and Limitations After Transition Period</u>
<u>Core Capital (Tier 1)</u>	Must equal or exceed 4% of weighted risk assets
Common stockholders' equity	No limit
Minority interest in common equity accounts of consolidated subsidiaries	No limit
Less: Goodwill and other disallowed intangibles*	
<u>Supplementary Capital (Tier 2)</u>	Total of Tier 2 is limited to 100% of Tier 1**
Allowance for loan and lease losses	Limited to 1.25% of weighted risk assets**
Perpetual and long-term preferred stock (original maturity 20 yrs. or more)	No limit within Tier 2, long-term preferred is amortized for capital purposes as it approaches maturity.
Hybrid capital instruments (including perpetual debt and mandatory convertible securities)	No limit within Tier 2

*Goodwill on books of bank holding companies before March 12, 1988, would be "grandfathered" for transition period. All goodwill and disallowed intangibles in banks, except previously grandfathered intangibles or goodwill approved in supervisory mergers, would be deducted immediately as under current policies. (See each Agency's proposed guidelines for a more thorough discussion of goodwill and other intangibles). All deductions are for capital adequacy purposes only; deductions would not affect accounting treatment.

**Amounts in excess of limitations are permitted but do not qualify as capital.

TABLE II (continued)

Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 7 years or more)	Subordinated debt and intermediate-term preferred stock are limited to 50% of Tier 1**; amortized for capital purposes as they approach maturity
Revaluation reserves (equity and building)	Not included; regulators would encourage banks to disclose; would evaluate on case-by-case basis for international comparisons; and would take into account in making overall assessment of capital.
<u>Deductions (from sum of Tier 1 and Tier 2)</u>	
Investments in unconsolidated banking and finance subsidiaries	
Reciprocal holdings of bank issued capital securities	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority	On case-by-case basis or as matter of policy after formal rulemaking
<u>Total Capital (Tier 1 + Tier 2 - Deductions)</u>	Must equal or exceed 8% of weighted risk assets

**Amounts in excess of limitations are permitted but do not qualify as capital.

Table III

Summary of Risk Weights and Risk Categories

Category 1: Zero percent

1. Cash (domestic and foreign)
2. Balances due from, and claims on, Federal Reserve Banks.
3. Securities (direct obligations) issued by the U.S. Government or its agencies* with a remaining maturity of 91 days or less.

Category 2: 10 percent

1. Securities issued by the U.S. Government or its agencies* with remaining maturities of over 91 days and all other claims (loans and leases) on the U.S. Government or its agencies*.
2. Securities and other claims guaranteed by the U.S. Government or its agencies (including portions of claims guaranteed).
3. Portions of loans and other assets collateralized** by securities issued by, or guaranteed by, the U.S. Government or its agencies, or by cash on deposit in the lending institution.
4. Federal Reserve Bank stock.

Category 3: 20 percent

1. All claims (long- and short-term) on domestic depository institutions.
2. Claims on foreign banks with an original maturity of one year or less.
3. Claims guaranteed by, or backed by the full faith and credit of, domestic depository institutions.

*For the purpose of calculating the risk-based capital ratio, a U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the U.S. Government.

**Degree of collateralization is determined by current market value.

Table III (continued)

4. Local currency claims on foreign central governments to the extent the bank has local currency liabilities in the foreign country.
5. Cash items in the process of collection.
6. Securities and other claims on, or guaranteed by, U.S. Government-sponsored agencies (including portions of claims guaranteed).***
7. Portions of loans and other assets collateralized**** by securities issued by, or guaranteed by, U.S. Government-sponsored agencies.
8. General obligation claims on, and claims guaranteed by, U.S. state and local governments that are secured by the full faith and credit of the state or local taxing authority (including portions of claims guaranteed).
9. Claims on official multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or a contributing member.

Category 4: 50 Percent

1. Revenue bonds or similar obligations, including loans and leases, that are obligations of U.S. state or local governments, but for which the government entity is committed to repay the debt only out of revenues from the facilities financed.
2. Credit equivalent amounts of interest rate and foreign exchange rate related contracts, except for those assigned to a lower risk category.

Category 5: 100 Percent

1. All other claims on private obligors.

***For the purpose of calculating the risk-based capital ratio, a U.S. Government-sponsored agency is defined as an agency originally established or chartered to serve public purposes specified by the U.S. Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government.

****Degree of collateralization is determined by current market value.

Table III (continued)

2. Claims on foreign banks with an original maturity exceeding one year.
3. Claims on foreign central governments that are not included in item 4 of Category 3.
4. Obligations issued by state or local governments (including industrial development authorities and similar entities) repayable solely by a private party or enterprise.
5. Premises, plant, and equipment; other fixed assets; and other real estate owned.
6. Investments in any unconsolidated subsidiaries, joint ventures, or associated companies -- if not deducted from capital.
7. Instruments issued by other banking organizations that qualify as capital.
8. All other assets (including claims on commercial firms owned by the public sector).

Table IV

Credit Conversion Factors for Off-Balance Sheet Items

100 Percent Conversion Factor

1. Direct credit substitutes (general guarantees of indebtedness and guarantee-type instruments, including standby letters of credit serving as financial guarantees for, or supporting, loans and securities).
2. Acquisitions of risk participations in bankers acceptances and participations in direct credit substitutes (e.g., standby letters of credit).
3. Sale and repurchase agreements and asset sales with recourse, if not already included on the balance sheet.
4. Forward agreements (that is, contractual obligations) to purchase assets, including financing facilities with certain drawdown.

50 Percent Conversion Factor

1. Transaction-related contingencies (e.g., bid bonds, performance bonds, warranties, and standby letters of credit related to a particular transaction).
2. Unused commitments with an original maturity exceeding one year, including underwriting commitments and commercial credit lines.
3. Revolving underwriting facilities (RUFs), note issuance facilities (NIFs) and other similar arrangements.

20 Percent Conversion Factor

1. Short-term, self-liquidating trade-related contingences, including commercial letters of credit.

Zero Percent Conversion Factor

1. Unused commitments with an original maturity of one year or less or which are unconditionally cancellable at any time.

Table IV (Continued)

Credit Conversion for Interest Rate and Foreign Exchange Contracts

The total replacement cost of contracts (obtained by summing the positive mark-to-market values of contracts) would be added to a measure of future potential increases in credit exposure. This future potential exposure measure would be calculated by multiplying the total notional value of contracts by one of the following credit conversion factors, as appropriate:

<u>Remaining Maturity</u>	<u>Interest Rate Contracts</u>	<u>Exchange Rate Contracts</u>
Less than one year	0	1.0%
One year and over	0.5%	5.0%

No potential exposure would be calculated for single currency floating/floating interest rate contracts; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value. Exchange rate contracts with an original maturity of seven days or less would be excluded. Also, instruments traded on exchanges that require daily payment of variation margin would be excluded.

Calculation of Credit Equivalent Amounts
Interest Rate and Foreign Exchange Rate Related Transactions

Type of Contract (remaining maturity)	POTENTIAL EXPOSURE			+	CURRENT EXPOSURE		=	CREDIT EQUIVALENT AMOUNT (dollars)
	Notional Principal (dollars) (1)	x	Potential Exposure Conversion Factor (2)	=	Potential Exposure (dollars) (3)	Replacement Cost (4) ^{1/}	Current Exposure (dollars) ^{2/} (5)	
(1) 120-day forward foreign exchange	5,000,000		.01		50,000	100,000	100,000	150,000
(2) 120-day forward foreign exchange	6,000,000		.01		60,000	-120,000	-0-	60,000
(3) 3-year single- currency fixed/ floating interest rate swap	10,000,000		.005		50,000	200,000	200,000	250,000
(4) 3-year single- currency fixed/ floating interest rate swap	10,000,000		.005		50,000	-250,000	-0-	50,000
(5) 7-year cross- currency floating/ floating interest rate swap	20,000,000		.05		1,000,000	-1,300,000	-0-	1,000,000
TOTAL	\$51,000,000							\$1,510,000

^{1/}These numbers are purely for illustration.

^{2/}The larger of zero or a positive mark-to-market value.

TABLE VI

	<u>Transitional Arrangements</u>		<u>Final Arrangement</u>
	Initial	Year-End 1990	Year-End 1992
1. Minimum standard of total capital to weighted risk assets	None	7.25%	8.0%
2. Definition of tier 1 capital	Common equity <u>plus</u> supplementary elements ^{1/} <u>less</u> goodwill and other disallowed _{2/} intangibles.	Common equity <u>plus</u> supplementary elements ^{3/} <u>less</u> goodwill and other disallowed _{2/} intangibles.	Common equity <u>less</u> goodwill and other disallowed intangibles
3. Minimum standard of tier 1 capital to weighted risk assets	None	3.625%	4.0%
4. Minimum standard of common stockholders' equity to weighted risk assets	None	3.25%	4.0%
5. Limitations on supplementary capital elements			
a. Allowance for loan and lease losses	No limit within supplementary capital	1.5% of weighted risk assets	1.25% of weighted risk assets
b. Subordinated debt and intermediate term preferred stock	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1
c. Total qualifying supplementary capital	May not exceed tier 1 capital	May not exceed tier 1 capital	May not exceed tier 1 capital
6. Definition total capital	Tier 1 <u>plus</u> tier 2 <u>less</u> : - reciprocal holdings of banking organization capital instruments - investments in unconsolidated banking and finance subsidiaries	Tier 1 <u>plus</u> tier 2 <u>less</u> : - reciprocal holdings of banking organization capital instruments - investments in unconsolidated banking and finance subsidiaries	Tier 1 <u>plus</u> tier 2 <u>less</u> : - reciprocal holdings of banking organization capital instruments - investments in unconsolidated banking and finance subsidiaries

^{1/} Up to 25% of Tier 1 (before deduction of goodwill and other disallowed intangibles) may consist of supplementary elements.

^{2/} See the Notice of Proposed Guidelines and the actual text of the proposed guidelines for discussion of relevant definitions and grandfathering arrangements for goodwill.

^{3/} Up to 10% of Tier 1 (before deduction of goodwill and other disallowed intangibles) may consist of supplementary elements.

Regulatory Flexibility Act Analysis

While all commercial banks would presumably be required to make some revisions to their reporting procedures to permit supervisory monitoring of risk-based capital ratios, the Federal banking agencies do not believe that adoption of this proposal would have a significant economic impact on a substantial number of small business entities, in this case small banking organizations, in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). In addition, this proposal would generally not apply to bank holding companies with consolidated assets less than \$150 million.

This proposal is designed primarily to take account of those practices, such as the increased use of off-balance sheet risk and the decline in the holdings of low-risk, liquid assets, which have been engaged in primarily by certain larger banking organizations. Moreover, rather than requiring all banking organizations to raise additional capital, this proposal is directed at institutions whose capital positions are less than fully adequate in relation to their risk profiles.

Executive Order 12291

The Comptroller of the Currency certifies that the proposal, if adopted, would not constitute a "major rule" and, therefore, does not require the preparation of a preliminary regulatory impact analysis.

List of Subjects

12 CFR Part 3

National banks, Capital, Risk.

Comporting Changes to Part 3

If this proposal is adopted, it will, when the Comptroller's guidelines become effective, necessitate certain changes to the existing capital maintenance provisions of 12 CFR Part 3. Specifically, it is anticipated that, at least, portions of sections 3.2, 3.3, 3.4, 3.6, 3.7 and 3.100 will require changes so as to be consistent with this proposal.

12 CFR Part 225

Banks, Banking, Capital adequacy, Federal Reserve system, Holding companies, Reporting requirements, State member banks.

12 CFR Part 325

Bank deposit insurance; Banks, banking; Federal Deposit

Insurance Corporation; Capital adequacy; State
nonmember banks.

Part 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

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

Authority: 12 U.S.C. 1817(j)(13), 1818, 1843(c)(8), 1844(b), 3106, 3108, 3907, 3909.

2. The Board proposes to amend Appendix A to Part 225 by adding at the end of the title to Appendix A: "Leverage Measure".

3. The Board proposes to amend the Appendices to Part 225 by redesignating the current Appendix B as Appendix C and adding a new Appendix B to read as follows:

APPENDIX B -- Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks: Risk-Based Measure

I. OVERVIEW

The Board of Governors of the Federal Reserve System has adopted a risk-based capital measure as part of the System's Capital Adequacy Guidelines. (Supervisory leverage ratios relating primary and total capital to total assets are outlined in Appendix A of these Guidelines.) The risk-based capital measure is based upon a framework developed jointly by supervisory authorities from 12 major industrial countries ("the Basle Supervisors' Committee"). This Basle capital framework was recommended by the Group of Ten Central Bank Governors as the basis for implementing a generally consistent international approach to assessing capital adequacy.

The principal objectives of the risk-based measure are to: (i) make regulatory capital requirements more sensitive to differences in risk profiles among banking organizations; (ii) take off-balance sheet exposures into account in assessing capital adequacy; (iii) minimize disincentives to holding liquid, low-risk assets; and (iv) achieve a greater degree of consistency in the assessment of the capital adequacy of major banking organizations throughout the world.

The risk-based capital measure comprises a definition of capital and a system for calculating weighted risk assets by assigning assets and off-balance sheet items to risk categories. An institution's risk-based capital ratio is calculated by dividing its qualifying capital base (the numerator of the ratio) by its weighted risk assets (the denominator). The definition of qualifying capital is outlined below in Section II, and the procedures for calculating weighted risk assets are

discussed in Section III. Table I illustrates a sample calculation of weighted risk assets and the risk-based capital ratio. The risk-based guidelines also establish a schedule for achieving a minimum supervisory standard for the ratio of capital to weighted risk assets and provide for transitional arrangements during a phase-in period to facilitate adoption and implementation of the measure. These standards and transitional arrangements are set forth in Section IV.

The risk-based guidelines apply to all state member banks and to bank holding companies with consolidated assets of \$150 million or more. Bank holding companies with less than \$150 million in consolidated assets would generally be exempt from the calculation and analysis of risk-based ratios on a consolidated basis under the same terms and conditions as described in Appendix A (leverage measure) of the Capital Adequacy Guidelines.

The risk-based guidelines are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. Generally, banking organizations are expected to operate above the minimum risk-based standard. Those institutions with high or inordinate levels of risk should hold capital commensurate with their levels of risk.

The risk-based capital ratio focuses principally on broad categories of credit risk, although it does take one limited aspect of interest rate and market risk (maturity) into account in assigning certain assets to risk categories. The risk-based ratio (like the leverage measure) does not, however, take account of other factors that can affect an organization's financial condition. These factors include: overall interest rate exposure; liquidity, funding and market risks; the quality and level of earnings; investment or loan portfolio concentrations; the quality of loans and investments; the effectiveness of loan and investment policies; and management's overall ability to monitor and control other financial and operating risks.

In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of each of these other factors, including, in particular, the level and severity of problem and classified assets. For this reason, the final supervisory judgment on an organization's capital adequacy may differ significantly from conclusions that might be drawn solely from the absolute level of the organization's risk-based (or leverage-based) capital ratio.

II. DEFINITION OF CAPITAL FOR THE RISK-BASED CAPITAL RATIO

An institution's qualifying capital base consists of two types of capital elements: "core capital elements" (Tier 1) and "supplementary capital elements" (Tier 2). These capital elements and the various limits, restrictions, and deductions to which they are subject are discussed below and are set forth in Table II.

A. The Components of Qualifying Capital

1. Core capital elements (Tier 1).

Core capital elements consist of:

- common stockholders' equity (common stockholders' equity includes common stock, surplus, and retained earnings, including disclosed capital reserves that represent an appropriation of retained earnings, net of treasury stock, and including foreign currency translation adjustments);
- minority interest in the common stockholders' equity accounts of consolidated subsidiaries; and
- supplementary capital elements (during the transition period only, and subject to certain limitations set forth in Section IV below).

At least 50 percent of the qualifying capital base of a bank holding company or state member bank must consist of core capital. For bank holding companies, core capital is defined, during the transition period (that is, through year-end 1992), as the sum of core capital elements minus any goodwill acquired on or after March 12, 1988. (During the transition period, bank holding company goodwill booked before March 12, 1988, would be "grandfathered", that is, would not be deducted from core capital during the transition period.) State member banks generally are prohibited from including goodwill in regulatory capital; thus, all bank goodwill is to be deducted immediately from state member bank core capital without any grandfather arrangements.¹ After the transition period (that is, after year-end 1992), all bank holding company goodwill will be deducted from the sum of the core capital elements for purposes

¹An exception will continue to be made for goodwill acquired by state member banks in supervisory mergers with troubled or failed banks in which the Federal Reserve has given the bank permission to count goodwill for capital purposes.

of determining core capital and calculating the risk-based capital ratio.

2. Supplementary capital elements (Tier 2).

A portion of an institution's qualifying capital base may consist of supplementary capital elements. Supplementary capital elements include:

- allowances for loan and lease losses (subject to limitations discussed below);
- perpetual and long-term preferred stock (original maturity of at least 20 years);
- hybrid capital instruments, including perpetual debt and mandatory convertible securities; and
- term subordinated debt and intermediate-term preferred stock (original average maturity of seven years or more).

The maximum amount of supplementary elements that may be treated as regulatory capital will be limited to 100 percent of core capital (after any deductions of goodwill). In addition, the combined amount of term subordinated debt and intermediate-term preferred stock that may be treated as supplementary capital for regulatory purposes will be limited to 50 percent of core capital. Amounts in excess of these limits may be issued and, while not included in the ratio calculation, will be taken

²The Basle capital framework also provides for the inclusion of "undisclosed reserves" in Tier 2. As defined in the framework, undisclosed reserves represent accumulated after-tax retained earnings that are not disclosed on the balance sheet of a bank. Apart from the fact that these reserves are not disclosed publicly, they are essentially of the same quality and character as retained earnings and, to be included in capital, such reserves must be accepted by the banking organization's home supervisor. Although such undisclosed reserves are common in some countries, under generally accepted accounting principles and long-standing supervisory practice, these types of reserves are not recognized for banks and bank holding companies in the United States. Foreign banking organizations seeking to make acquisitions or conduct business in the United States would be expected to disclose publicly at least the degree of reliance on such reserves in meeting supervisory capital requirements.

into account in the overall assessment of an organization's funding and financial condition.

Redemptions of Tier 2 capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Consequently, an organization should consult with the Federal Reserve before redeeming perpetual preferred stock or before redeeming any other Tier 2 capital instrument prior to maturity.

The components of supplementary capital are discussed in greater detail below.

a. Allowance for loan and lease losses. Allowances for loan and lease losses are reserves that have been established through a charge against earnings to absorb future losses on loans or lease financing receivables. Allowances for loan and lease losses exclude "allocated transfer risk reserves,"³ and reserves created against identified losses or earmarked for a specific asset.

The risk-based capital guidelines provide a phasedown during the transition period of the extent to which the allowance for loan and lease losses may be included in an institution's capital base. Initially, no limit will apply to these reserves. However, by year-end 1990, the allowance for loan and lease losses, as a component of capital, may constitute no more than 1.5 percent of an institution's weighted risk assets and, at the end of the transition period and thereafter, no more than 1.25 percent of weighted risk assets.⁴

b. Perpetual and long-term preferred stock. Perpetual preferred stock is defined as preferred stock without a fixed maturity date and that cannot be redeemed at the option of the holder. Long-term preferred stock includes limited-life

³Allocated transfer risk reserves are reserves that have been established in accordance with Section 905(a) of the International Lending Supervision Act of 1983 against certain assets whose value has been found by the U.S. supervisory authorities to have been significantly impaired by protracted transfer risk problems.

⁴The amount of the allowance for loan and lease losses that may be included in capital is based on a percentage of gross risk weighted assets. A banking organization may deduct reserves for loan and lease losses in excess of the amount permitted to be included in capital, as well as allocated transfer risk reserves, from the gross sum of weighted risk assets and use the resulting net sum of weighted risk assets in computing the denominator of the risk-based capital ratio.

preferred stock with an original maturity of 20 years or more. (If the holder has a right to redeem the instrument prior to the original stated maturity, maturity would be defined for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing banking organization.) When long-term preferred stock has a remaining maturity of less than seven years, it should be treated for capital purposes as intermediate-term preferred stock and subject to the 50 percent of core capital limitation described below.

Perpetual preferred stock and long-term limited-life preferred stock would qualify for inclusion in capital provided that they can absorb losses while the issuer operates as a going concern (a fundamental characteristic of equity capital) and provided the issuer has the option to defer or reduce preferred dividends if dividends on common stock are eliminated or reduced. Given these conditions and the perpetual or long-term nature of the instruments, there is no limit on the amount of these instruments that may be included within Tier 2 capital.

c. Hybrid capital instruments. Hybrid capital instruments include long-term debt instruments that generally meet the requirements set forth below:

1) The instrument must be unsecured; fully paid-up; and subordinated to general creditors and, if issued by a bank, also to depositors.

2) The instrument must not be redeemable at the option of the holder prior to maturity, except with the prior approval of the Federal Reserve. (Consistent with the Board's criteria for perpetual debt and mandatory convertible securities, this requirement implies that holders of such instruments may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.)

3) The instrument must be available to participate in losses while the issuer is operating as a going concern. (Straight term subordinated debt would not meet this requirement.) To satisfy this requirement, the instrument must convert to common or perpetual or long-term preferred stock in the event that the sum of retained earnings and capital surplus accounts of the issuer show a negative balance.

4) The instrument must provide the option for the issuer to defer interest payments if: a) the issuer does not report a profit in the preceding annual period (defined as combined profits for the most recent four quarters); and b) the issuer eliminates cash dividends on common and preferred stock.

Perpetual debt and mandatory convertible securities that meet the criteria set forth in 12 CFR Part 225, Appendix A, will qualify as hybrid capital instruments for state member banks and bank holding companies. During the transition period, the Federal Reserve will review the criteria for mandatory convertible securities in light of the definitions contained in the Basle capital framework. As a result of this review, the Board may modify the mandatory convertible criteria as part of its overall program for implementing the risk-based capital ratio.

There is no limit on the amount of hybrid capital instruments that may be included within Tier 2 capital.

d. Subordinated debt and intermediate-term preferred stock. The aggregate amount of term subordinated debt (excluding mandatory convertible debt) and intermediate-term preferred stock that may be treated as capital for risk-based capital purposes is limited to 50 percent of core capital. Subordinated debt and intermediate-term preferred stock must have an original average maturity⁵ of at least seven years to qualify as supplementary capital. (If the holder has the option to redeem the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing banking organization.) In the case of subordinated debt, the instrument must be unsecured and must clearly state on its face that it is not a deposit and is not insured by a Federal agency. To qualify as capital in banks, debt must be subordinated to depositors and general creditors; in bank holding companies, debt must be subordinated in right of payment to all senior indebtedness of the issuer. Consistent with current regulatory requirements, if a state member bank wishes to redeem subordinated debt before the stated maturity, it should receive prior approval of the Federal Reserve.

e. Discount of supplementary capital instruments. As a limited-life capital instrument approaches maturity, it begins to take on characteristics of a short-term obligation and becomes less like a component of capital. For this reason, the outstanding amount of term subordinated debt and limited-life preferred stock eligible for inclusion in Tier 2 would be

⁵Unsecured term debt issued by bank holding companies prior to March 12, 1988, and qualifying as secondary capital at the time of issuance would continue to qualify as capital under the risk-based framework, subject to the 50 percent of core capital limitation. Bank holding company term debt issued on or after March 12, 1988, must be subordinated in order to qualify as capital.

adjusted downward, or discounted, as these instruments approach maturity. All such instruments would be discounted by reducing the outstanding amount of the capital instrument that would count as supplementary capital by a fifth of the original amount, less redemptions, each year during the instrument's last five years before maturity. Such instruments, or portions of such instruments, therefore, would have no capital value when they have a maturity of less than one year.

f. Revaluation reserves. The Basle capital framework addresses the role in capital of revaluation reserves with respect to bank premises and long-term holdings of equity securities. When recognized, these reserves result from the restatement of asset carrying values to reflect current market values. In the United States, banks and bank holding companies, for the most part, follow generally accepted accounting principles (GAAP) when preparing their financial statements, and GAAP generally does not permit the use of market-value accounting. For this and other reasons the Federal Reserve has generally not included unrealized asset values in capital ratio calculations, although it has long taken such values into account in assessing the overall financial strength of a banking organization.

The equivalent of revaluation reserves for state member banks and bank holding companies will not be formally recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all banking organizations are encouraged to disclose their equivalent of premises and equity revaluation reserves, and such values will be taken into account as additional factors in assessing overall capital adequacy and financial condition. For example, in the absence of any notable supervisory, financial, or operating problems, organizations with significant and reliable revaluation reserves may be permitted to operate closer to minimum supervisory capital ratios than organizations without such values.

B. Deductions from Capital and Other Adjustments.

Certain assets are to be deducted from an organization's capital base for the purpose of calculating the numerator of the risk-based capital ratio.⁶ These assets include:

- 1) Goodwill -- deducted from Tier 1 -- (See

⁶Any assets deducted from capital in computing the numerator of the ratio would not be included in weighted risk assets in computing the denominator of the ratio.

discussion below of limited grandfathering of bank holding company goodwill during the transition period);

- 2) Investments in unconsolidated banking and finance subsidiaries and, on a case-by-case basis, investments in other subsidiaries or associated companies at the discretion of the Federal Reserve -- deducted from the sum of Tier 1 and Tier 2; and
- 3) Reciprocal holdings of capital instruments of banking organizations -- deducted from the sum of Tier 1 and Tier 2.

1. Goodwill and other intangible assets. Goodwill is an intangible asset that represents the excess of the purchase price over the fair market value of net assets acquired in acquisitions accounted for under the purchase method of accounting.

a. Bank holding company goodwill. Any goodwill carried on the balance sheet of a bank holding company after December 31, 1992, should be deducted from the sum of core capital elements in determining Tier 1 capital. In addition, bank holding company goodwill acquired as a result of a merger or acquisition that is consummated on or after March 12, 1988, also will be deducted. For bank holding companies, any goodwill in existence before March 12, 1988, would be "grandfathered" during the transition period and would not be deducted from Tier 1 until December 31, 1992.

b. State member bank goodwill. Since state member banks generally may not include goodwill in regulatory capital under current supervisory policies, all goodwill in state member banks will be deducted from Tier 1 capital immediately.

c. Other intangible assets. The Federal Reserve is not proposing, as a matter of general policy, to deduct any other intangible assets from the capital of state member banks and bank holding companies at this time. The Federal Reserve, however, will continue to monitor closely the level and quality of other intangible assets -- including purchased mortgage servicing rights, leaseholds, and core deposit value -- and take

⁷An exception to this rule would be made for those state member banks that have acquired goodwill in connection with supervisory mergers with problem or failed banks and that have been permitted to include such goodwill in capital under current policy. Consistent with this approach, such state member banks would be allowed to continue to include goodwill in capital for risk-based capital purposes.

them into account in assessing the capital adequacy of banking institutions. As with any other asset, banking organizations should review periodically the carrying value of intangible assets and make appropriate adjustments in carrying values or related amortization periods.

As a general rule, the Board believes that banking organizations should maintain strong tangible core capital bases in relation to weighted risk assets. While all intangible assets will be monitored, intangible assets (other than goodwill) that exceed 25 percent of core (Tier 1) capital will be subject to particularly close scrutiny. In addition, the Board will, on a case-by-case basis, continue to consider the level of an individual organization's tangible capital ratio (after deducting all intangible assets), together with the quality and value of the organization's intangible assets, in making an overall assessment of capital adequacy. Moreover, the Board intends to continue its policy of requiring banking organizations experiencing substantial growth internally and by acquisition to maintain strong capital positions that are substantially above minimum supervisory levels, without significant reliance on intangible assets.

2. Investments in certain subsidiaries.

a. Unconsolidated banking or finance subsidiaries.

Any equity or debt capital investments in banking or finance subsidiaries⁸ that are not consolidated under regulatory reporting requirements are to be deducted from an organization's total capital base, that is, from the sum of core capital and supplementary capital elements.⁹ Inasmuch as the assets of unconsolidated subsidiaries are not fully reflected in a banking organization's consolidated total assets, such assets may be viewed as the equivalent of off-balance sheet exposures since the operations of an unconsolidated subsidiary could expose the parent organization and its affiliates to considerable risk. For this reason, it is appropriate to view the capital invested in these unconsolidated entities as primarily supporting the risks inherent in these off-balance sheet assets, and not

⁸For this purpose, a subsidiary generally is defined as any banking or finance company in which the reporting institution holds more than 50 percent of the outstanding common stock.

⁹An exception to this deduction would be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith. The requirements for consolidation are spelled out in the instructions to the commercial bank Consolidated Reports of Condition and Income (Call Report) and the Consolidated Financial Statements for Bank Holding Companies (Y-9C Report).

generally available to support risks or additional leverage elsewhere in the organization.

b. Other subsidiaries. The deduction of equity and debt capital investments from the banking organization's capital may also be applied in the case of other subsidiaries, such as securities affiliates, that, while consolidated for accounting purposes, are not deemed to be consolidated for certain other purposes, such as to facilitate functional regulation of financial or other subsidiaries.

The Federal Reserve will not automatically deduct investments in other unconsolidated subsidiaries (such as those engaged in commercial activities) or investments in joint ventures and associated companies.¹⁰ Nonetheless, the capital invested in these entities, like investments in unconsolidated banking and finance subsidiaries, supports assets not consolidated with the rest of the banking organization's activities and, therefore, may not be generally available to support additional leverage in the banking organization. Moreover, experience has shown that banking organizations stand behind the losses of affiliated institutions, such as joint ventures and associated companies, in order to protect the reputation of the organization as a whole. In some cases, this has led to losses that have exceeded the investments in such organizations.

For this reason, the Federal Reserve will monitor the level and nature of such investments for individual banking organizations and, on a case-by-case basis, may deduct such investments from capital, apply an appropriate risk-weighted capital charge against the organization's proportionate share of the assets of its associated companies, or otherwise require the organization to operate with a risk-based capital ratio above the minimum.

In considering the appropriateness of such adjustments or actions, the Federal Reserve will take into account whether:

- 1) The subsidiary, joint venture, or associated company has a name similar to the banking organization;
- 2) The banking organization has significant

¹⁰The definition of such entities is contained in the instructions to the commercial bank Consolidated Reports of Condition and Income and the Consolidated Financial Statements for Bank Holding Companies. Under regulatory reporting procedures, associated companies and joint ventures generally are defined as companies in which the banking organization owns 20 to 50 percent of the voting stock.

influence over the financial or managerial policies or operations of the affiliated company;

- 3) The banking organization is the largest investor in the affiliated company; or
- 4) Other circumstances prevail that appear to tie closely the activities of the affiliated company to the investing banking organization.

The Federal Reserve may, on a case-by-case basis, also deduct from capital debt and equity investments in certain consolidated subsidiaries in order to determine if the banking organization meets minimum supervisory capital requirements without reliance on the capital invested in the subsidiaries. In addition, the Board may, at some future date, seek public comment on the extension of this approach to all subsidiaries engaged in certain activities for the purpose of assessing the banking organization's consolidated capital position.

In general, when investments in a subsidiary are deducted from a banking organization's capital, the subsidiary's assets will also be excluded from the assets of the banking organization in order to assess the latter's capital adequacy.

3. Reciprocal holdings of bank capital instruments. Reciprocal holdings of banking organizations' capital instruments (that is, instruments that qualify as Tier 1 or Tier 2 capital) are to be deducted from an organization's total capital base for the purpose of determining the numerator of the risk-based capital ratio. Reciprocal holdings are cross-holdings resulting from formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other's capital instruments. Generally, as this discussion implies, deductions would be limited to intentional cross-holdings. At present, the Board does not intend to require banking organizations to deduct non-reciprocal holdings of such capital instruments.¹¹ The Board, however, intends to monitor non-reciprocal holdings of other banking organizations' capital instruments and to provide information on such holdings to the Basle Supervisors' Committee, as called for under the Basle capital framework.

¹¹ Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's Policy Statement on Nonvoting Equity Investments, 12 CFR 225.143. In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital.

III. PROCEDURES FOR COMPUTING WEIGHTED RISK ASSETS AND OFF-BALANCE SHEET ITEMS USED IN THE RISK-BASED CAPITAL RATIO.

A. Procedures

Balance sheet assets and credit equivalent amounts of off-balance sheet items of state member banks and bank holding companies are assigned to one of five broad risk categories. The aggregate dollar value of the amount in each category is then multiplied by the weight assigned to that category. The resulting weighted values from each of the five risk categories are added together and this sum is the weighted risk assets total that comprises the denominator of the risk-based capital ratio. Table I provides a sample calculation of this ratio.

Risk weights for all off-balance sheet items are determined by a two-step process. First, the "credit equivalent amount" of an off-balance sheet item is determined, in most cases, by multiplying the off-balance sheet item by a credit conversion factor. Second, the credit equivalent amount generally is assigned, like any balance sheet asset, to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral.

B. Collateral, Guarantees, and Other Considerations

In determining the risk classification of various assets, the only forms of collateral that are formally recognized by the risk-based capital framework are cash on deposit in the lending institution; securities issued by, or guaranteed by, the U.S. Government or its agencies; and securities issued by, or guaranteed by, U.S. Government-sponsored agencies. The extent to which recognized securities may act as collateral is determined by their current market value. If a claim is partially collateralized, that is, the amount of cash or the market value of the securities serving as collateral is less than the face amount of a balance sheet asset or the credit equivalent amount of an off-balance sheet item, then the portion of the claim that is not collateralized is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor. The portion that is collateralized is assigned to the risk category that is associated with the collateral. For example, to the extent that an asset is collateralized by U.S. Government securities, it would be placed in the 10 percent risk category (regardless of the maturity of those securities). A claim secured by two types of collateral that the risk-based capital framework recognizes but places in different risk categories, such as cash and U.S. Government-sponsored agency securities, should be apportioned between the two risk categories according to the amounts of each of the two types of collateral securing the claim.

Guarantees of the U.S. Government and its agencies, U.S. Government-sponsored agencies, domestic state and local governments, and domestic depository institutions are also recognized. While not formally factored into the ratio, the existence of other forms of collateral or guarantees would be taken into account in evaluating the risks inherent in an organization's loan portfolio -- which, in turn, would affect the overall supervisory assessment of the organization's capital adequacy. Maturity is generally not a factor in assigning items to risk categories with the exceptions of securities (direct obligations) of the U.S. Government or its agencies, claims on foreign banks, commitments, and interest rate and foreign exchange rate contracts.

Table III contains a listing of the risk categories, a summary of the types of assets to be included in each category and the weight assigned to each category, that is, 0 percent, 10 percent, 20 percent, 50 percent and 100 percent. A brief explanation of the components of each category follows.

C. Risk Weights

1. Category I: Zero Percent. This category includes cash (domestic and foreign) owned and held in all offices of a bank or in transit; claims on, and balances due from, Federal Reserve Banks; and, in light of their near-cash characteristics, direct securities issued by the U.S. Government or its agencies (excluding any short-term loans guaranteed by the U.S. Government or collateralized by short-term Government debt) with a remaining maturity of 91 days or less.¹²

2. Category II: 10 Percent. This category includes direct securities issued by the U.S. Government or its agencies with a remaining maturity of over 91 days; all other claims (including leases) on the U.S. Government or its agencies; all securities and portions of loans guaranteed by the U.S. Government or its agencies; and claims (including repurchase agreements) collateralized by cash on deposit in the lending institution or by securities issued by, or guaranteed by, the U.S. Government or its agencies.

¹²For this purpose, a U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the U.S. Government. These include the Government National Mortgage Association (GNMA), the Veterans Administration (VA), the Federal Housing Administration (FHA), the Export-Import Bank (Exim Bank), the Overseas Private Investment Corporation (OPIC), the Commodity Credit Corporation (CCC), and the Small Business Administration (SBA).

3. Category III: 20 Percent. This category includes short-term claims (including demand deposits¹³) on domestic depository institutions¹³ and foreign banks¹⁴ (including foreign central banks); cash items in the process of collection, both foreign and domestic; local currency claims on foreign central governments to the extent that a bank has local currency liabilities booked in the foreign country; long-term (original maturity of more than one year) claims on domestic depository institutions¹⁵; and portions of loans¹⁶ or other claims guaranteed by domestic depository institutions.¹⁶

This category also includes claims on, or portions of claims guaranteed by, U.S. Government-sponsored agencies¹⁷ and

¹³Domestic depository institutions are defined to include branches (foreign and domestic) of federally-insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, and international banking facilities of domestic banks. U.S. chartered depository institutions owned by foreigners are also included in the definition; however, branches and agencies of foreign banks located in the U.S. and bank holding companies are excluded.

¹⁴Foreign banks are defined as institutions that are organized under the laws of a foreign country; engage in the business of banking; are recognized as banks by the bank supervisory or monetary authorities of the country of their organization or principal banking operations; receive deposits to a substantial extent in the regular course of business; and have the power to accept demand deposits. Claims on foreign banks include claims on the U.S. branches and agencies of foreign banks.

¹⁵Claims on foreign banks with an original maturity exceeding one year and all claims on bank holding companies are assigned to Category V, which carries a weight of 100 percent.

¹⁶These include risk participations in bankers acceptances and in any standby letters of credit, as well as participations in commitments conveyed to other domestic banks.

¹⁷For this purpose, U.S. Government-sponsored agencies are defined as agencies originally established or chartered by the Federal government to serve public purposes specified by the U.S. Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government.

(Footnote Continued)

portions of claims collateralized by securities issued by, or guaranteed by, U.S. Government-sponsored agencies. Claims on multilateral lending institutions or regional development banks in which the U.S. Government is a shareholder or contributing member, as well as general obligation claims on, or portions of claims guaranteed by, the full faith and credit of states or other political subdivisions of the United States, are also assigned to this category.

4. Category IV: 50 percent. This category includes revenue (non-general obligation) bonds or similar obligations, including loans and leases, that are obligations of states or other political subdivisions of the United States, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds.

Also included in this category are credit equivalent amounts of interest rate and foreign exchange rate contracts involving standard risk obligors, not backed by collateral or guarantees that would allow them to be placed in lower risk weight categories, as noted below in the discussion of interest rate and foreign exchange rate contracts.

5. Category V: 100 Percent. All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category. Such assets include long-term claims (over one year) on foreign banks, as well as all non-local currency claims on foreign governments and local currency claims on a foreign central government that exceed local currency liabilities held by the bank in the foreign country, that is, all claims on foreign governments that entail some degree of transfer risk.

This category also includes all claims on foreign and domestic private sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding involving standard risk claims¹⁸;

(Footnote Continued)

These agencies include the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), the Farm Credit System, the Federal Home Loan Bank System, and the Student Loan Marketing Association (SLMA).

¹⁸Customer liabilities on acceptances outstanding involving non-standard risk claims, such as claims on domestic depository
(Footnote Continued)

investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; and commercial and consumer loans, including all residential mortgage loans (except those assigned to lower risk categories due to recognized guarantees or collateral). The following assets also are to be converted at 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures or associated companies; instruments that qualify as capital issued by other banking organizations; and any intangibles, including grandfathered goodwill. Also included in this category are industrial development bonds and similar obligations issued under auspices of states or political subdivisions of the United States for the benefit of a private party or enterprise where that party or enterprise, not the government, is obligated to pay the principal and interest.

D. Off-Balance Sheet Items

The face amount of an off-balance sheet item is generally multiplied by a credit conversion factor and the resulting credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral. Table IV sets forth the conversion factors for various types of off-balance sheet items.

1. Items With a 100 Percent Conversion Factor. 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 backing off-balance sheet items that require capital under the risk-based capital framework. For example, these direct credit substitutes include standby letters of credit, other equivalent irrevocable obligations, or surety arrangements, that guarantee repayment of commercial paper, tax-exempt securities, commercial or individual loans, debt obligations, or commercial letters of credit. They 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 institution that the underlying account party (obligor)

(Footnote Continued)

institutions, are to be assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to domestic depository institutions should be assigned to the 20 percent risk category appropriate to claims guaranteed by domestic depository institutions.

will repay its obligation to the originating, or issuing, institution. (Standby letters of credit that are performance-related are discussed below and have a credit conversion factor of 50 percent.)

In the case of direct credit substitutes that are participated out in the form of a syndication (that is, where each bank is responsible only for its pro rata share of the risk and there is no recourse to the originating bank), participated portions would be excluded entirely from the originating bank's weighted risk assets.¹⁹ A banking organization that has conveyed risk participations¹⁹ in a direct credit substitute, such as a standby letter of credit, to a third party should convert the full amount of the direct credit substitute at 100 percent without deducting the risk participations conveyed. Then, those portions of the credit equivalent amount of the direct credit substitute that have been conveyed as risk participations to domestic depository institutions should be assigned to the risk category appropriate to claims guaranteed by domestic depository institutions, that is, 20 percent, rather than to the category appropriate to the account party obligor. This treatment is accorded to these conveyances because they replace, to the extent of the participation or conveyance, the originating bank's exposure to the account party obligor with an exposure to a domestic depository institution. A bank acquiring a risk participation in such a direct credit substitute or bankers acceptance should convert the amount of the acquisition at 100 percent and then assign the credit equivalent amount to the risk weight category appropriate to the account party obligor.

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) or fails to perform some other contractual obligation (performance bond). A loan commitment, on the other hand, involves an obligation (with or without a material adverse change clause) of the banking organization to fund its customer in the normal course of business should the customer seek to draw down the commitment.

The distinguishing characteristic of a standby letter of credit for risk-based capital purposes is the combination of irrevocability with the notion that funding is triggered by some

¹⁹That is, participations in which the originating banking institution 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.

failure to repay or perform an obligation. Thus, any commitment (by 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 would be treated for risk-based capital purposes as, respectively, a financial guarantee standby letter of credit or a performance standby.

Sale and repurchase agreements and asset sales with recourse, if not already included on the balance sheet, as well as forward agreements, also are to be converted at 100 percent.

The risk-based capital definition of the sale of assets with recourse, including the sale of one-to-four family residential mortgages, is the same as the definition contained in the instructions to the commercial bank Consolidated Reports of Condition and Income. So-called "loan strips" (that is, short-term advances sold under long-term commitments) sold without direct recourse are accorded the same treatment as assets sold with recourse. Forward agreements are legally binding agreements (contractual obligations) to purchase assets with certain drawdown at a specified future date. These obligations include forward purchases, forward deposits, and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

2. Items with a 50 Percent Conversion Factor.

Transaction-related contingencies are to be converted at 50 percent. Such contingencies include bid bonds, performance bonds, warranties, standby letters of credit related to particular transactions, and performance standby letters of credit, as well as acquisitions of risk participations in such standby letters of credit. Performance standby letters of credit represent obligations backing the performance of nonfinancial or commercial contracts or undertakings. To the extent permitted by law or regulation, performance standby letters of credit include arrangements backing, among other things, subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

The unused portion of commitments with an original maturity exceeding one year, including underwriting commitments, and commercial and consumer credit commitments also are to be converted at 50 percent. Original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which the following two conditions hold: 1) the bank can, at its option, unconditionally (without cause) cancel the commitment; and 2) the bank is scheduled to (and as a normal practice actually does) review the facility to determine whether or not it should be extended. Facilities that are unconditionally cancellable (without cause) at any time by the bank are not deemed to be commitments, provided the bank makes a separate credit decision before each drawing under the facility.

Commitments with an original maturity of one year or less are deemed to involve low risk and, therefore, are not assessed a capital charge. Such short-term commitments are defined to include unused lines of credit on retail credit cards that a bank can unconditionally cancel at any time.

Commitments are defined as any legally binding arrangements that obligate a banking organization to extend credit in the form of loans or leases; to purchase loans, securities, or other assets; or to participate in loans and leases. They also include overdraft facilities, revolving credit, or similar transactions. Normally, commitments involve a written contract or agreement and a commitment fee, or some other form of consideration. Commitments are included in weighted risk assets regardless of whether they contain "material adverse change" clauses or other provisions that are intended to relieve the issuer of its funding obligation under certain conditions.

In the case of commitments structured as syndications, the risk asset framework includes only the banking organization's proportional share of such commitments. After a commitment has been converted at 50 percent, portions that have been conveyed to other domestic depository institutions as participations in which the originating banking organization retains the full obligation to the borrower if the participating bank fails to pay when the instrument is drawn, would be assigned to the 20 percent risk category. This treatment is analogous to that accorded the conveyances of risk participations in standby letters of credit. The acquisition of such a participation would be converted at 50 percent and assigned to the risk category appropriate to the account party obligor.

Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and other similar arrangements also are converted at 50 percent. These are facilities under which a borrower can issue on a revolving basis short-term paper in its own name, but for which the underwriting organizations have a legally binding commitment either to purchase any notes the borrower is unable to sell by the roll-over date or to advance funds to the borrower.

3. Items with a 20 Percent Conversion Factor.

Short-term, self-liquidating trade-related contingencies which arise from the movement of goods are converted at 20 percent. Such contingencies include commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

4. Items with a Zero Percent Conversion Factor. These

include unused commitments with an original maturity of one year or less. Unused retail credit card lines are deemed to be

short-term commitments if the bank has the unconditional option to cancel the card at any time.

E. Interest Rate and Foreign Exchange Rate Contracts

1. Scope. Credit equivalent amounts are to be computed for each of the following off-balance sheet interest rate and foreign exchange rate instruments:

a. Interest Rate Contracts

- Single currency interest rate swaps.
- Basis swaps.
- Forward rate agreements.
- Interest rate options purchased (including caps, collars, and floors purchased).
- Any other instrument that gives rise to similar credit risks (including when-issued securities).

b. Exchange Rate Contracts

- Cross-currency interest rate swaps.
- Forward foreign exchange contracts.
- Currency options purchased.
- Any other instrument that gives rise to similar credit risks.

Over-the-counter options purchased would be treated in the same way as the other interest rate and exchange rate contracts. That is, the credit equivalent amount would be the sum of the marked-to-market replacement cost and the "add-on" amount for potential future exposure. Exchange rate contracts with an original maturity of seven days or less and instruments traded on exchanges that require daily payment of variation margin are excluded.

2. Calculation of Credit Equivalent Amounts. Credit equivalent amounts are to be calculated for each individual contract of the types listed above. To calculate the credit equivalent amount of its off-balance sheet interest rate and exchange rate instruments, a banking organization should, for each contract, sum:

- a. the mark-to-market value (positive values only) of the contract (that is, its current exposure)²⁰ and;

²⁰Mark-to-market values should be measured in dollars, regardless of the currency or currencies specified in the contract.

- b. an estimate of the potential future increases in credit exposure over the remaining life of the instrument.

Potential exposure on a contract is determined by multiplying the notional principal amount of the contract, including contracts with negative mark-to-market values, by one of the following credit conversion factors, as appropriate:

<u>Remaining Maturity</u>	<u>Interest Rate Contracts</u>	<u>Exchange Rate Contracts</u>
Less than one year	-0-	1.0%
One year and over	0.5%	5.0%

Examples of the calculation of credit equivalent amounts for these instruments are contained in Table V.

Because exchange rate contracts involve an exchange of principal upon maturity, and exchange rates are generally more volatile than interest rates, higher conversion factors have been established for foreign exchange contracts than for interest rate contracts.

No potential future credit exposure should be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts should be evaluated solely on the basis of their mark-to-market value.

3. Risk Weights. Once the credit equivalent amount for interest rate and exchange rate instruments has been determined, that amount should be assigned to a risk weight category according to the identity of the counterparty or, if relevant, the nature of collateral or guarantees. In accordance with the Basle capital framework, however, the maximum weight applied to the credit equivalent amount currently is 50 percent. The Federal Reserve intends to monitor the quality of credits in the interest rate and exchange rate markets and, in the future, would consider, if appropriate, assigning credit equivalent amounts for contracts involving standard risk obligors to the 100 percent risk category, as is the case with other off-balance sheet instruments.

4. Accounting. In certain cases, credit exposures arising from the interest rate and exchange instruments covered by these guidelines may already be reflected, in part, on the balance sheet. To avoid double counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the types of instruments covered by these guidelines may need to be excluded from balance sheet assets in calculating banking organizations' total weighted risk asset

ratios. The Federal Reserve will address this issue in designing appropriate reporting systems.

In accordance with the terms of the Basle capital framework, netting of swaps and similar contracts will not be recognized for purposes of calculating the risk-based ratio at this time. While the Federal Reserve encourages any reasonable arrangements designed to reduce the risks inherent in these transactions, the Basle Supervisors' Committee felt that the legal issues posed by netting arrangements require further consideration prior to the implementation of a netting mechanism on an international basis.

IV. TARGET RATIO STANDARD

A. Minimum Risk-Based Ratio After Transition Period.

As reflected in Table VI, by year-end 1992, all bank holding companies²¹ and state member banks should meet a minimum ratio of total capital to weighted risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of core capital (Tier 1).²² Core capital is defined as the sum of common stockholders' equity (including retained earnings and any minority interest in the common stockholders' equity accounts of consolidated subsidiaries) minus any goodwill carried on an organization's balance sheet.²³

The maximum amount of supplementary (Tier 2) capital elements that would qualify as capital is limited to 100 percent of the total amount of core capital, that is, the sum of Tier 1 capital components (net of goodwill). Within Tier 2, the maximum amount of the allowance for loan and lease losses that would qualify as Tier 2 capital is limited to 1.25 percent of weighted risk assets. In addition, the combined maximum amount of subordinated debt and intermediate-term preferred stock that qualifies as Tier 2 capital is limited to 50 percent of Tier 1 capital.

²¹As noted above, bank holding companies with less than \$150 million in consolidated assets would generally be exempt from the calculation and analysis of risk-based ratios on a consolidated basis.

²²Section II contains definitions of capital-related terms used in this section.

²³Goodwill that state member banks are permitted to include in capital as a result of supervisory mergers with troubled or failed banking organizations would not be deducted.

Total capital is calculated by adding core capital (defined to exclude goodwill) to supplementary capital (limited to 100 percent of core capital) and then deducting from this sum any capital investments in unconsolidated banking and finance subsidiaries, reciprocal holdings of banking organization capital securities, or other items at the direction of the Federal Reserve.

B. Transitional Arrangements.

The transition period, intended to facilitate implementation of the risk-based capital ratio, ends on December 31, 1992. The transitional arrangements include an interim target risk-based capital ratio to be met by year-end 1990. Any organization not meeting the interim target or final supervisory ratios would be expected to develop and discuss with the Federal Reserve a plan setting forth how the organization intends to reach the minimum supervisory ratios.

1. Initial Arrangements. No formal risk-based capital minimum level will be set initially. However, any organization that has a risk-based ratio of less than 8 percent is expected to undertake a sustained effort to move in the direction of that target during the transition period. Banking organizations with ratios of 8 percent or lower should not make adjustments to their risk profiles or undertake growth plans that would lower their ratios.

While the Basle capital framework does not establish an initial standard for the minimum level of capital during this period, it does permit the core capital of an organization to include some limited supplementary capital elements. Specifically, a maximum of 25 percent of core capital (before any deduction of goodwill) may consist of supplementary capital elements, with the remainder consisting of common stockholders' equity. By year-end 1990, banking organizations would be expected to reduce the amount of supplementary capital included in core capital to no more than 10 percent of core capital.

For bank holding companies, any goodwill acquired before March 12, 1988, would be grandfathered until year-end 1992. Goodwill acquired by holding companies on or after March 12, 1988, and all goodwill on holding company books after year-end 1992, would be deducted from Tier 1 capital components to compute core capital.

State member banks are generally not permitted to recognize goodwill on their balance sheets or to include goodwill for capital purposes under current policies. Thus, all goodwill in state member banks would be deducted immediately from Tier 1 components to determine core capital, except for goodwill acquired and approved in connection with supervisory mergers with troubled or failed banks.

Initially, the allowance for loan and lease losses may be included in an organization's supplementary capital without limit. However, by year-end 1990, loan loss reserves counted in supplementary capital may not exceed 1.5 percent of weighted risk assets.

The existing supervisory capital-to-total assets ratios, as outlined in Appendix A (the leverage measure) of the Capital Adequacy Guidelines, would continue to be employed during this initial period. The Board will, prior to year-end 1990, consider whether a maximum leverage ratio will continue to be employed in conjunction with the implementation of the risk-based standard. If a maximum leverage ratio is employed after year-end 1990, the Board may, after appropriate consideration, adopt definitions of capital for leverage purposes that are consistent with the definitions in the risk-based capital guidelines.

2. Year-end 1990 through year-end 1992. By year-end 1990, banking organizations would be expected to meet a minimum interim target ratio for total capital to weighted risk assets of 7.25 percent, at least one-half of which should be in the form of core capital. In addition, as noted above, during this period up to 10 percent of an organization's core capital (before any deduction for goodwill) may consist of supplementary capital elements. Thus, the 7.25 percent interim target ratio implies a minimum ratio of core capital to weighted risk assets of 3.6 percent (one-half of 7.25) and a minimum common stockholders' equity to weighted risk assets ratio of 3.25 percent (nine-tenths of the core capital ratio). By year-end 1992, an organization's required core capital must consist solely of common stockholders' equity, including minority interest in common equity accounts of consolidated subsidiaries.

The maximum amount of the allowance for loan and lease losses reserves that may qualify as supplementary capital will be limited to 1.5 percent of weighted risk assets (that is, 1.5 percentage points of the minimum required total of 7.25 percent), declining to 1.25 percent by year-end 1992. Allowances for loan and lease losses in excess of these limits may, of course, be maintained, but would not be included in an organization's total capital base. The Federal Reserve will continue to require banks and bank holding companies to maintain reserves at levels fully sufficient to cover losses inherent in their loan portfolios.

Board of Governors of the Federal Reserve System,
effective March 1, 1988.

(signed) William W. Wiles
William W. Wiles
Secretary of the Board

Table I

Sample Calculation of Risk-Based Capital Ratio

Example of a bank with \$6,000 in total capital and the following assets and off-balance sheet items:

Balance Sheet Assets

Cash	\$10,000
Long-term U.S. Government securities	20,000
Balances at domestic banks	5,000
Loans to private corporations	<u>65,000</u>
Total Balance Sheet Assets	\$100,000

Off-Balance Sheet Items

Standby letters of credit ("SLCs") backing general obligation debt issues of U.S. municipalities ("GOs")	\$10,000
Long-term commitments to private corporations	<u>20,000</u>
Total Off-Balance Sheet Items	\$30,000

This bank's total capital to total assets ratio would be:

$$(\$6,000/\$100,000) = 6.00\%.$$

Table I
(continued)

To compute the bank's weighted risk assets:

1. Compute the credit equivalent amount of each off-balance sheet ("OBS") item.

<u>OBS Item</u>	<u>Face Value</u>		<u>Conversion Factor</u>		<u>Credit Equivalent Amount</u>
SLCs backing municipal GOs	\$10,000	x	1.00	-	\$10,000
Long-term commitments to private corporations	\$20,000	x	0.50	-	\$10,000

2. Multiply each balance sheet asset and the credit equivalent amount of each OBS item by the appropriate risk weight.

0% Category

Cash	\$10,000	x	0	-	\$0
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10% Category

Long-term U.S. Government securities	\$20,000	x	0.10	-	\$2,000
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20% Category

Balances at domestic banks	\$5,000				
Credit equivalent amounts of SLCs backing GOs of U.S. municipalities	10,000				
	<u>\$15,000</u>	x	0.20	-	\$3,000

50% Category

No items

100% Category

Loans to private corporations	\$65,000				
Credit equivalent amounts of long-term commitments to private corporations	10,000				
	<u>\$75,000</u>	x	1.00	-	<u>\$75,000</u>

Total Risk-Weighted Assets \$80,000

This bank's risk-based capital ratio would be:

$$(\$6,000/\$80,000) = 7.50\%$$

Table II
Definition of Qualifying Capital

<u>Components</u>	<u>Minimum Requirements and Limitations After Transition Period</u>
<u>Core Capital (Tier 1)</u>	Must equal or exceed 4% of weighted risk assets
Common stockholders' equity	No limit
Minority interest in common equity accounts of consolidated subsidiaries	No limit
Less: Goodwill and other disallowed intangibles*	
<u>Supplementary Capital (Tier 2)</u>	Total of Tier 2 is limited to 100% of Tier 1**
Allowance for loan and lease losses	Limited to 1.25% of weighted risk assets**
Perpetual and long-term preferred stock (original maturity 20 yrs. or more)	No limit within Tier 2, long-term preferred is amortized for capital purposes as it approaches maturity.
Hybrid capital instruments (including perpetual debt and mandatory convertible securities)	No limit within Tier 2

*Goodwill on books of bank holding companies before March 12, 1988 would be "grandfathered" for transition period. All goodwill and disallowed intangibles in banks, except previously grandfathered intangibles or goodwill approved in supervisory mergers, would be deducted immediately as under current policies. All deductions are for capital adequacy purposes only; deductions would not affect accounting treatment.

**Amounts in excess of limitations are permitted but do not qualify as capital.

TABLE II (continued)

Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 7 years or more)	Subordinated debt and intermediate-term preferred stock are limited to 50% of Tier 1**; amortized for capital purposes as they approach maturity
Revaluation reserves (equity and building)	Not included; regulators would encourage banks to disclose; would evaluate on case-by-case basis for international comparisons; and would take into account in making overall assessment of capital.
<u>Deductions (from sum of Tier 1 and Tier 2)</u>	
Investments in unconsolidated banking and finance subsidiaries	
Reciprocal holdings of bank issued capital securities	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority	On case-by-case basis or as matter of policy after formal rulemaking
<u>Total Capital (Tier 1 + Tier 2 - Deductions)</u>	Must equal or exceed 8% of weighted risk assets

**Amounts in excess of limitations are permitted but do not qualify as capital.

Table III

Summary of Risk Weights and Risk Categories

Category 1: Zero percent

1. Cash (domestic and foreign)
2. Balances due from, and claims on, Federal Reserve Banks.
3. Securities (direct obligations) issued by the U.S. Government or its agencies* with a remaining maturity of 91 days or less.

Category 2: 10 percent

1. Securities issued by the U.S. Government or its agencies* with remaining maturities of over 91 days and all other claims (loans and leases) on the U.S. Government or its agencies*.
2. Securities and other claims guaranteed by the U.S. Government or its agencies (including portions of claims guaranteed).
3. Portions of loans and other assets collateralized** by securities issued by, or guaranteed by, the U.S. Government or its agencies, or by cash on deposit in the lending institution.
4. Federal Reserve Bank stock.

Category 3: 20 percent

1. All claims (long- and short-term) on domestic depository institutions.
2. Claims on foreign banks with an original maturity of one year or less.
3. Claims guaranteed by, or backed by the full faith and credit of, domestic depository institutions.

*For the purpose of calculating the risk-based capital ratio, a U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the U.S. Government.

**Degree of collateralization is determined by current market value.

Table III (continued)

4. Local currency claims on foreign central governments to the extent the bank has local currency liabilities in the foreign country.
5. Cash items in the process of collection.
6. Securities and other claims on, or guaranteed by, U.S. Government-sponsored agencies (including portions of claims guaranteed).***
7. Portions of loans and other assets collateralized**** by securities issued by, or guaranteed by, U.S. Government-sponsored agencies.
8. General obligation claims on, and claims guaranteed by, U.S. state and local governments that are secured by the full faith and credit of the state or local taxing authority (including portions of claims guaranteed).
9. Claims on official multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or a contributing member.

Category 4: 50 Percent

1. Revenue bonds or similar obligations, including loans and leases, that are obligations of U.S. state or local governments, but for which the government entity is committed to repay the debt only out of revenues from the facilities financed.
2. Credit equivalent amounts of interest rate and foreign exchange rate related contracts, except for those assigned to a lower risk category.

Category 5: 100 Percent

1. All other claims on private obligors.

***For the purpose of calculating the risk-based capital ratio, a U.S. Government-sponsored agency is defined as an agency originally established or chartered to serve public purposes specified by the U.S. Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government.

****Degree of collateralization is determined by current market value.

Table III (continued)

2. Claims on foreign banks with an original maturity exceeding one year.
3. Claims on foreign central governments that are not included in item 4 of Category 3.
4. Obligations issued by state or local governments (including industrial development authorities and similar entities) repayable solely by a private party or enterprise.
5. Premises, plant, and equipment; other fixed assets; and other real estate owned.
6. Investments in any unconsolidated subsidiaries, joint ventures, or associated companies -- if not deducted from capital.
7. Instruments issued by other banking organizations that qualify as capital.
8. All other assets (including claims on commercial firms owned by the public sector).

Table IV

Credit Conversion Factors for Off-Balance Sheet Items

100 Percent Conversion Factor

1. Direct credit substitutes (general guarantees of indebtedness and guarantee-type instruments, including standby letters of credit serving as financial guarantees for, or supporting, loans and securities).
2. Acquisitions of risk participations in bankers acceptances and participations in direct credit substitutes (e.g., standby letters of credit).
3. Sale and repurchase agreements and asset sales with recourse, if not already included on the balance sheet.
4. Forward agreements (that is, contractual obligations) to purchase assets, including financing facilities with certain drawdown.

50 Percent Conversion Factor

1. Transaction-related contingencies (e.g., bid bonds, performance bonds, warranties, and standby letters of credit related to a particular transaction).
2. Unused commitments with an original maturity exceeding one year, including underwriting commitments and commercial credit lines.
3. Revolving underwriting facilities (RUFs), note issuance facilities (NIFs) and other similar arrangements.

20 Percent Conversion Factor

1. Short-term, self-liquidating trade-related contingences, including commercial letters of credit.

Zero Percent Conversion Factor

1. Unused commitments with an original maturity of one year or less or which are unconditionally cancellable at any time.

Table IV (Continued)

Credit Conversion for Interest Rate and Foreign Exchange Contracts

The total replacement cost of contracts (obtained by summing the positive mark-to-market values of contracts) would be added to a measure of future potential increases in credit exposure. This future potential exposure measure would be calculated by multiplying the total notional value of contracts by one of the following credit conversion factors, as appropriate:

<u>Remaining Maturity</u>	<u>Interest Rate Contracts</u>	<u>Exchange Rate Contracts</u>
Less than one year	0	1.0%
One year and over	0.5%	5.0%

No potential exposure would be calculated for single currency floating/floating interest rate contracts; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value. Exchange rate contracts with an original maturity of seven days or less would be excluded. Also, instruments traded on exchanges that require daily payment of variation margin would be excluded.

Table V

Calculation of Credit Equivalent Amounts
Interest Rate and Foreign Exchange Rate Related Transactions

Type of Contract (remaining maturity)	POTENTIAL EXPOSURE			+	CURRENT EXPOSURE		=	CREDIT EQUIVALENT AMOUNT (dollars)
	Notional Principal (dollars) (1)	x	Potential Exposure Conversion Factor (2)	=	Potential Exposure (dollars) (3)	Replacement Cost ^{1/} (4)	Current Exposure (dollars) ^{2/} (5)	
(1) 120-day forward foreign exchange	5,000,000		.01		50,000	100,000	100,000	150,000
(2) 120-day forward foreign exchange	6,000,000		.01		60,000	-120,000	-0-	60,000
(3) 3-year single- currency fixed/ floating interest rate swap	10,000,000		.005		50,000	200,000	200,000	250,000
(4) 3-year single- currency fixed/ floating interest rate swap	10,000,000		.005		50,000	-250,000	-0-	50,000
(5) 7-year cross- currency floating/ floating interest rate swap	20,000,000		.05		1,000,000	-1,300,000	-0-	1,000,000
TOTAL	\$51,000,000							\$1,510,000

^{1/} These numbers are purely for illustration.

^{2/} The larger of zero or a positive mark-to-market value.

TABLE VI

	<u>Transitional Arrangements</u>		<u>Final Arrangement</u>
	Initial	Year-End 1990	Year-End 1992
1. Minimum standard of total capital to weighted risk assets	None	7.25%	8.0%
2. Definition of tier 1 capital	Common equity <u>plus</u> supplementary elements ^{1/} <u>less</u> goodwill and other disallowed intangibles. ^{2/}	Common equity <u>plus</u> supplementary elements ^{3/} <u>less</u> goodwill and other disallowed intangibles. ^{2/}	Common equity <u>less</u> goodwill and other disallowed intangibles
3. Minimum standard of tier 1 capital to weighted risk assets	None	3.625%	4.0%
4. Minimum standard of common stockholders' equity to weighted risk assets	None	3.25%	4.0%
5. Limitations on supplementary capital elements			
a. Allowance for loan and lease losses	No limit within supplementary capital	1.5% of weighted risk assets	1.25% of weighted risk assets
b. Subordinated debt and intermediate term preferred stock	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1
c. Total qualifying supplementary capital	May not exceed tier 1 capital	May not exceed tier 1 capital	May not exceed tier 1 capital
6. Definition total capital	Tier 1 <u>plus</u> tier 2 <u>less:</u> - reciprocal holdings of banking organization capital instruments - investments in unconsolidated banking and finance subsidiaries	Tier 1 <u>plus</u> tier 2 <u>less:</u> - reciprocal holdings of banking organization capital instruments - investments in unconsolidated banking and finance subsidiaries	Tier 1 <u>plus</u> tier 2 <u>less:</u> - reciprocal holdings of banking organization capital instruments - investments in unconsolidated banking and finance subsidiaries

^{1/} Up to 25% of Tier 1 (before deduction of goodwill and other disallowed intangibles) may consist of supplementary elements.

^{2/} See the Notice of Proposed Guidelines and the actual text of the proposed guidelines for discussion of relevant definitions and grandfathering arrangements for goodwill.

^{3/} Up to 10% of Tier 1 (before deduction of goodwill and other disallowed intangibles) may consist of supplementary elements.