Capital Equivalency Report

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CAPITAL EQUIVALENCY REPORT

EXECUTIVE SUMMARY: COMPARABILITY OF CAPITAL STANDARDS AND ESTABLISHMENT OF GUIDELINES

Section 214(b) of the Foreign Bank Supervision Enhancement Act of 1991 requires the Board and the Secretary of the Treasury jointly to submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives a report analyzing: (1) the capital standards contained in the Basle Accord for measurement of capital adequacy; (2) foreign regulatory capital standards that apply to foreign banks conducting banking operations in the United States; and (3) the relationship of the Basle and foreign capital standards to the risk-based capital and leverage requirements applicable to U.S. banks. The report by the Board and the Secretary of the Treasury also is required to include guidelines to be used by the Board in converting data on the capital of foreign banks to the equivalent risk-based capital and leverage requirements for U.S. banks for purposes of determinations under Sections 3 and 4 of the Bank Holding Company Act of 1956 and Section 7 of the International Banking Act of 1978, as amended. The Board and Treasury will continue to work together to consider issues related to the analysis in this report and any necessary modification of the guidelines, with a view to the preparation of the annual updates to this report mandated by Section 214(b).

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The capital standards of a broad range of countries were included in the sample employed in the study pursuant to Section 214(b). Capital standards in these countries generally fall into two categories: risk-based capital requirements or requirements based upon the amount of capital in relation to total assets or categories of liabilities. This study has demonstrated the extent to which risk-based capital requirements have become the accepted international standard for the measurement and assessment of capital adequacy. Of the twenty-two foreign countries included in the sample underlying this study, supervisors in only two (Brazil and Venezuela) continue to rely upon a capital measure other than a risk-based capital standard.

In those countries applying the risk-based capital framework, all are implementing uniformly the Basle minimum capital ratios of four percent Tier 1 capital and eight percent total capital in relation to total risk-weighted assets. These ratios constitute the minimum requirements; national authorities have the discretion, under the Basle Accord, to require banks to maintain higher risk-asset ratios. In addition, national discretion is provided regarding whether to allow banks to include certain of the components in Tier 2 capital and, to a lesser degree, in Tier 1 capital. The discretion exercised by national authorities with regard to the capital components results in definitions of qualifying capital that are equivalent,

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although not identical, among countries subscribing to the Accord.

The Board and Treasury agree that, in assessing the capital of foreign banks in connection with applications, capital ratios should be equivalent, but not necessarily identical, to those required of U.S. banks. This approach is consistent with the Board's existing policy, which has been based upon the recognition that financial markets in different countries, and the instruments issued in those markets, vary but that these variations do not necessarily have a substantive effect on overall safety and soundness. Banking regulators in the United States have recognized that strict application to foreign banks of capital standards with definitions identical to those applied to U.S. banks would disregard important differences in capital instruments and accounting practices in other countries. A fundamental premise of the Basle Accord is the acceptance of such differences in order to advance the international convergence of capital standards.

With regard to the definition and composition of Tier 1 capital, a high degree of convergence has been achieved. Some differences arise with respect to the composition of Tier 2 capital and the application of risk weights; the Basle Accord specifically permits limited national discretion in the implementation of these areas of the risk-based framework. Generally, these differences do not have a significant impact on

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the equivalence of capital requirements applicable to internationally active banks.

With regard to the composition of Tier 1 capital, a high degree of comparability exists among the countries subscribing to the Accord. A few minor differences arise which render certain components of Tier 1 capital unavailable to banks in certain countries due to either the structure and limitations of their capital markets or differences in accounting practices. These differences have no effect on the equivalence of Tier 1 or core capital ratios among countries, but instead relate primarily to the absence of a market for certain components of core capital in many countries subscribing to the Accord. Capital markets in the United States are such that U.S. banks have considerable flexibility regarding the availability of Tier 1 capital instruments, principally preferred stock.

Tier 2, or supplementary, capital was included in the definition of total capital in the Accord because it was agreed that some components of a bank's balance sheet, which do not qualify as Tier 1 capital, do provide protection to depositors and can enhance safety and soundness. The Basle Committee also recognized that the existence and utilization of various eligible components of Tier 2 differed from country to country, due in large part to differences in local capital markets, accounting and disclosure practices, and certain historical developments. Therefore, the Committee adopted a menu approach to these Tier 2 capital items, which the Committee agreed served the purpose of

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supplementary capital, with different countries making use of the various components to differing degrees. The greatest variation among countries with regard to Tier 2 arises in relation to the availability of hybrid capital and subordinated debt instruments and the inclusion of latent reserves stemming from the revaluation of equity securities.

With regard to hybrid capital and subordinated debt instruments, the degree of innovation in, and the depth of, local capital markets in certain countries provide banks greater access to such instruments. Banks in the United States benefit from access to the U.S. capital markets in this regard and, consequently, Tier 2 capital has not been a constraining factor in meeting the minimum total capital standard.

With regard to latent revaluation reserves, banks from a few countries have been allowed to include such reserves, to some extent, in Tier 2. These reserves arise primarily from the revaluation of equity securities held for investment. Latent revaluation reserves, however, can be volatile, as the recent decline in the Japanese stock market has demonstrated. Partly for that reason, such reserves are allowable in Tier 2 only with a discount. Even so, banks placing significant reliance upon such reserves risk having their capital diminish as equity prices fall; Tier 2, therefore, may be a constraining factor for such banks over time.

Despite differences in the composition of Tier 2 among countries, all elements eligible for inclusion in Tier 2 were

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considered by the Basle Committee members to be acceptable forms of supplementary capital. Overall, taking these differences into account, there is broad equivalence among countries in the quality of Tier 2 capital in relation to its role as a supplement to core capital.

The risk weights assigned by countries to asset categories are virtually identical aside from three differences. As discussed at pages 35 to 36 below, two of these differences are likely to be only transitional in nature. The third area relates to mortgage-backed securities which, to date, have been issued primarily in the United States.

Capital standards in countries that have adopted risk-based capital frameworks obviously differ from standards in countries that employ other measures of assessing capital. Under any of these standards, the definition of capital may be similar. A risk-based capital standard relates capital to the composition of assets and off-balance sheet items. Alternative measures take into account neither the composition of the balance sheet nor levels of off-balance sheet activities.

Guidelines to be used by the Board in the future when evaluating the capital of foreign banking organizations in connection with applications are set out at pages 42 to 45 of this report. These guidelines are broadly consistent with the Board's existing approach to the evaluation of the financial condition of foreign banks in connection with such applications. Thus, in general, foreign banks seeking to establish operations

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in the United States have been expected to meet the same general standards of strength, experience, and reputation as required for domestic institutions. The Board has sought to assure itself of the foreign bank's ability to support its U.S. operations.

For purposes of making determinations in the future with regard to applications submitted by foreign banks, the Board will continue to take into account a number of factors indicative of a bank's financial condition, including capital. In determining whether a bank's capital meets the minimum standard, as an initial requirement applicants from countries that adhere to the Basle Accord will be required, at a minimum, to meet the Basle guidelines as administered by their home country supervisors. The Basle standard provides a common basis for evaluating the general equivalency of capital among banks from various countries. In acting on applications submitted by banks from countries not subscribing to the Basle Accord, the applicant will be required to provide information regarding the capital standard applied by its home country supervisor, information sufficient to evaluate the applicant's capital position adjusted as appropriate for accounting and structural differences, and, to the extent possible, information comparable to the Basle framework.

It must be pointed out that simply meeting the minimum capital standard will not automatically imply that the financial condition of the foreign bank applicant is consistent with the Board's approval of any particular application. As with

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applications by U.S. banking organizations, the capital ratio necessary for applications by foreign banking organizations to be considered for approval by the Board will depend on the level of risk associated with the activities which are the subject of the application. For example, the capital ratio necessary to obtain full underwriting and dealing authority will be higher than the ratio required to conduct a low-risk activity.

The table below summarizes the key conclusions with regard to each of the elements of the risk-based capital standard referenced above. Page numbers are provided to indicate the location in the text of further discussion of each point.

Findings on Comparability of Risk-Based Capital Standards

Tier 1:	Uniform definition (page 21)
	Minor differences in usage of Tier 1 instruments (pages 22-25)
Tier 2:	Menu of eligible components (page 26)
	Common definition of components (page 26)
	Differing levels of reliance on certain components among countries (pages 26-33)
	Overall equivalence of Tier 2 components (page 26)
Risk Weights:	Identical risk weights for most assets (page 35)
	Differences in the risk weight assigned to privately-issued mortgage-backed securities (page 35)
	Some differences in treatment of claims on government entities within limits of authorized national discretion (page 36)

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I. INTRODUCTION

Section 214(b) of the Foreign Bank Supervision Enhancement Act of 1991[1/] requires the Board and the Secretary of the Treasury jointly to submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives a report analyzing: (1) the capital standards contained in the Basle Accord for measurement of capital adequacy; (2) foreign regulatory capital standards that apply to foreign banks conducting banking operations in the United States; and (3) the relationship of the Basle and foreign capital standards to the risk-based capital and leverage requirements applicable to U.S. banks.[2/]

The report also is required to include guidelines to be used by the Board in converting data on the capital of foreign banks to the equivalent risk-based capital and leverage requirements for U.S. banks for purposes of determinations under Sections 3 and 4 of the Bank Holding Company Act of 1956 and Section 7 of the International Banking Act of 1978, as

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[1/] The full text of Section 214(b) of the Foreign Bank Supervision Enhancement Act of 1991 is attached as Appendix A.

[2/] Section 214(b) also requires that an update of this report shall be prepared annually explaining any changes in the analysis regarding capital equivalency and any resulting changes in the Board's guidelines.

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amended.[3/] As required by Section 214(b) of the Foreign Bank Supervision Enhancement Act, this report will discuss relevant capital requirements, summarizing and comparing U.S. and foreign capital standards.

Broadly, there are two categories of capital: equity, which consists of funds contributed by shareholders, and other instruments which are also subordinated to the interests of depositors and other creditors. The former instills discipline by placing shareholders' funds at risk and is essential for maintaining the bank as a going concern; the latter, although a junior form of capital, provides additional protection for depositors and any relevant deposit insurance fund.

In order to protect depositors and maintain a stable banking system, banking supervisors adopt capital standards which must be met by banking institutions in their respective

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[3/] Section 3 of the Bank Holding Company Act requires, subject to certain exemptions, application to the Board in relation to the formation or merger of bank holding companies. Application is also required under this section for acquisition of subsidiary banks or bank assets and acquisition of control of bank or bank holding company securities. Section 4 requires application to the Board with regard to the acquisition of permissible non-banking companies or engaging directly in such non-banking activities. Section 7 of the International Banking Act, inter alia, requires the approval of the Board prior to a foreign bank establishing a federally or state-licensed branch or agency or acquiring ownership or control of a commercial lending company.

Factors considered by the Board in acting on such applications, among other things, include the financial condition and managerial resources of the entities involved, any anti-competitive effects and the convenience and needs of the community to be served. With regard to financial condition, the Board also takes into account whether current and projected capital positions and levels of indebtedness conform to standards and policies established by the Board.

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countries. The financial markets also impose discipline upon banks seeking access to funds regarding the quality and amount of capital. One capital standard adopted by banking regulators is the risk-based capital standard, which gained international acceptance through the efforts of the Basle Committee on Banking Supervision,[4] of which the United States is a member. Recognition of the importance of achieving convergence internationally in the measurement and assessment of capital adequacy led to the adoption of the Accord by the Basle Committee members in 1988.

It is important to note, however, that capital adequacy is only one indicator of the financial condition of banks. Other factors taken into account in assessing financial condition include profitability, concentrations of risk, the nature of the bank's operations and strategic plan, liquidity, asset quality, adequacy of loan loss reserves, accounting systems and controls, management and the degree of home country supervision.

Following passage of the International Banking Act of 1978, two policy statements were issued by U.S. banking regulators addressing the supervision and regulation of the U.S.

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[4] The Basle Committee on Banking Supervision (hereafter referred to as "the Basle Committee") is comprised of representatives of the central banks and supervisory authorities from the Group of Ten ("G-10") countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) and Luxembourg. The Basle Committee meets at the Bank for International Settlements in Basle, Switzerland. The Committee is currently chaired by the President of the Federal Reserve Bank of New York.

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operations of foreign banks.[5] These policy statements made clear that the regulators would seek to ascertain that a foreign bank had the ability to support its U.S. operations. In addition, it was recognized that foreign banks operate outside the United States in accordance with different banking and accounting practices and traditions and in different legal and social environments.

Given these differences, the Board's policy in relation to foreign banks has been that capital ratios should be equivalent, but not necessarily identical, to those required of U.S. banks. This policy stems from the Board's recognition that financial markets in different countries, and the instruments issued in those markets, vary but that these variations do not necessarily have a substantive effect on overall safety and soundness. Banking regulators in the United States have recognized that strict application to foreign banks of capital standards with definitions identical to those applied to U.S. banks would disregard important differences in capital instruments and accounting practices in other countries. A fundamental premise of the Accord is the acceptance of such differences in order to advance the international convergence of capital standards.

For purposes of this study, the capital standards of a sample of twenty-two foreign countries were analyzed and compared

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[5] See 65 F.R.B. 634 (August, 1979); 1 F.R.R.S. 4-835.

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to U.S. capital standards.[6] Banks from these twenty-two countries collectively held, as of December 31, 1991, approximately 97 percent of total U.S. banking assets held by foreign banks. The sample encompasses countries that are Basle Committee members, countries that have voluntarily subscribed to the principles of the Accord, and countries that have not adopted the Basle framework.

II. CONVERGENCE OF INTERNATIONAL CAPITAL STANDARDS

History of convergence. Banking regulators in the United States have long advocated appropriate capital standards for banks in order to safeguard safety and soundness and to minimize risk of loss to depositors and the insurance fund. The United States Congress has evidenced the same concern and passed the International Lending Supervision Act of 1983, which directed the Federal Reserve and the Treasury to encourage other countries to work toward maintaining or improving the capital of banks.[7]

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[6] The sample includes ten of the twelve Basle Committee member countries, namely Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, and the United Kingdom. Also included are Australia, Austria, Finland, Hong Kong, Ireland, Israel, Korea, Mexico, Spain and Taiwan, which, although not members of the Basle Committee, voluntarily subscribe to the principles of the Accord. Two additional countries, namely Brazil and Venezuela, which do not subscribe to the Accord, were also included.

[7] The Omnibus Trade and Competitiveness Act of 1988 also requires discussions with the governments of countries that are major financial centers aimed at, inter alia, developing uniform supervisory standards for banking organizations and securities companies, including uniform capital standards.

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The early 1980's were characterized by declining capital levels at major international banks. Banking regulators in different countries attempted to reverse this trend in various ways, including, for example, the adoption of risk-weighted capital requirements in many European countries. In the United States, a different approach was taken by regulators, namely, the adoption of leverage ratios, which related primary and total capital to total assets without regard to the relative risk of the assets. These leverage ratios had the advantage of being straightforward in application and, to some extent, they achieved the goal of curbing the erosion of capital levels. However, use of these ratios encouraged U.S. banks to divest low-risk, liquid assets and to move business off the balance sheet in order to reduce capital requirements.

The decline in capital ratios of some internationally active banks, the diverse approaches to the measurement of capital in major industrialized countries, the increasing trend towards globalization of banking operations, innovations in the financial markets, and liberalization of these markets underscored the importance of efforts to reach international agreement on capital standards. Supervisors in the United States also wished to remove the bias in favor of off-balance sheet activities and against the holding of low-risk, liquid assets created by the introduction of leverage ratios.

After extensive efforts to promote the international convergence of capital standards, the Board and the Bank of

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England announced in January 1987 that an agreement had been reached on common standards for evaluating capital adequacy. The convergence agreement provided a common definition of capital, a minimum capital ratio for "internationally active" banks, a system for assessing the relative riskiness of various activities and the inclusion of off-balance sheet activities in making capital adequacy determinations. Trilateral discussions subsequently proceeded among the United States, the United Kingdom and Japan, following which agreement was reached broadly on the same basis.

On December 10, 1987, the Basle Committee announced that its members had adopted a proposal for "international convergence of capital measurement and capital standards" (commonly referred to as the "Basle Accord"). The proposal served as a basis for discussion and public comment in the member countries. In light of comments received from the public by the different supervisory authorities, a number of changes were subsequently made to the proposal. Central banking authorities of the G-10 countries endorsed the Basle Accord in July 1988.

The Basle framework. The Basle Accord is a risk-based capital framework that applies a standard system of assessment and measurement of capital to internationally active banks from member countries. The principal objectives of the Accord are to strengthen the capital positions of internationally active banks and to provide a framework that is fair and has a high degree of consistency in its application to banks in different countries.

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In developing the framework, the Basle Committee sought to give due regard to the structure of the financial markets and particular features of the supervisory and accounting systems in individual member countries.

The Basle Accord establishes an analytical framework that relates regulatory capital requirements to differences in risk profiles among banks, including off-balance sheet exposures, and minimizes disincentives for banks to hold liquid, low-risk assets. The Basle framework establishes minimum levels of capital for internationally active banks; national authorities are free to adopt more stringent capital requirements.

The Accord focuses principally on broad categories of credit risk. The Accord does not yet take explicit account of other factors that may affect a bank's financial condition, such as overall interest-rate exposure, liquidity, and market risks.

The risk-based capital standard established by the Accord is composed of four basic elements: (1) an agreed definition of Tier 1 (or core) capital, consisting primarily of common stockholders' equity and certain categories of perpetual preferred stock; (2) a "menu" of internationally agreed items, constituting Tier 2 capital, which supplements core capital; (3) a general framework for assigning assets and off-balance sheet items to broad risk categories, as well as procedures for calculating a risk-based capital ratio; and (4) a schedule for achieving, by no later than the end of 1992, a minimum ratio of total capital to risk-weighted assets of eight percent (of which

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at least four percent should be in the form of core capital). The provisions of the Accord are discussed in greater detail in Appendix B.

Ongoing efforts to improve international supervision. The Basle Committee continues to work on the international convergence of capital standards; it has always been recognized that convergence necessarily must be evolutionary in approach. The Basle Committee continues to address issues regarding risk weights and eligibility of instruments as Tier 1 and Tier 2 capital in order to remove potential differences that may arise among countries from time to time.

In addition, the Committee is dedicating significant resources to the evaluation of methods of measuring and assessing the non-credit risks that are inherent in a bank's balance sheet, such as interest rate, foreign exchange and other market risks. As noted above, these non-credit risks generally are not currently addressed by the Accord.

EC capital standards. The European Community, as part of the harmonization exercise underlying the development of a single market in financial services, adopted in 1989 a capital standard that will apply to all banks of member states. The EC Directives setting out these capital standards closely follow the Basle Accord, except that, in a number of respects, national discretion granted under the Accord to Basle members is removed. Whereas the Basle framework is non-compulsory, the EC Directives have the force of law within the EC and, therefore, establish

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mandatory minimum standards. The EC standard broadly follows the Basle definitions of Tier 1 and Tier 2 capital, risk weights and off-balance sheet treatment, and requires the same minimum capital ratios. Because the EC Directives, like the Basle Accord, establish only minimum standards, a number of member states have opted to implement more stringent capital standards.

A comparison of the capital standards implemented by the EC member states with the U.S. and other Basle subscribers is set out in section III. below. A more detailed discussion of the minimum capital standards established in the EC Directives is provided in Appendix C.

Effect of local capital markets on convergence. Any analysis of the convergence of international capital standards must take into account the importance of local capital markets and the structure of national banking and financial systems to the ability of banks to raise required amounts of capital. These factors affect the ability of banks to compete internationally.

The nature of local capital markets primarily affects banks' balance sheets in two ways. First, techniques have evolved in some markets that permit banks to securitize a number of different types of assets. This permits banks to remove these assets from their balance sheets, earn fees from loan originations and recycle capital in order to originate new loans. A major development in the U.S. market has been the securitization of residential mortgage loans. The only other

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securitized mortgage market of any significance is in the United Kingdom although, by comparison to the U.S. market, it is small.

Second, the nature of local financial markets will also be important in terms of the development of new instruments. Specifically, some markets have developed quasi-equity or hybrid capital instruments to supplement capital. In this regard, U.S. capital markets are very receptive to hybrid capital instruments, such as cumulative perpetual preferred stock, and U.S. banks have benefitted from ready access to these types of capital instruments. Banks in countries whose markets are less receptive to hybrid capital instruments have found it difficult, if not impossible, to issue such instruments.

The Basle risk-based capital standards, therefore, while establishing common capital definitions and assessment techniques, do not eliminate differences among financial markets of various countries. So long as these differences exist, the capital requirements for banks from different countries cannot be identical. Nevertheless, as discussed below, the Accord, by accommodating such differences, promotes the principle of capital equivalence for internationally active banks from countries subscribing to its terms and constitutes an unprecedented step forward in the convergence of international capital standards.

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III. COMPARISON OF CAPITAL STANDARDS OF COUNTRIES SUBSCRIBING TO THE BASLE ACCORD

A sample of twenty foreign countries which subscribe to the principles of the Basle Accord (Australia, Austria, Belgium, Canada, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Korea, Mexico, Netherlands, Spain, Sweden, Switzerland, Taiwan and the United Kingdom) was used for purposes of analyzing capital standards implemented under the Basle framework and comparing those standards to U.S. capital standards.[8] Several of the countries included in the sample are currently in the process of finalizing their rules implementing the Basle Accord.[9]

The data set out in this report reflect the most current information available; however, in some cases, national

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[8] Of these countries, Belgium, France, Germany, Italy, the Netherlands and the United Kingdom are members of both the Basle Committee and the European Community. Canada, Japan, Sweden, Switzerland and the United States are members of the Basle Committee. Ireland and Spain, although not members of the Basle Committee, effectively follow the Basle Accord by virtue of their membership in the EC. Austria, Finland and Switzerland, which are members of the European Free Trade Association (EFTA), also effectively follow the Basle Accord in anticipation of ratification of the European Economic Area (EEA) Agreement and planned entry into the European Community. Australia, Hong Kong and Israel voluntarily subscribe to the principles of the Basle Accord (as do many countries not included in this survey). Korea, Mexico and Taiwan also recently have adopted capital requirements in line with the Basle framework. All of these countries, for purposes of this report, will be referred to as "Basle subscribers."

[9] The Basle Accord permits, at national discretion, various transitional arrangements. Due to the fact that these arrangements, for the most part, must be phased out by year-end 1992, these arrangements are not addressed in this study.

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rules may be subject to change. Capital standards, in any event, are under continuous review by national authorities in light of developments in local financial markets and further work by the Basle Committee. Capital requirements applicable in the United States, including the different treatment of certain capital components for bank holding companies, are discussed in detail in Appendix D. Differences between U.S. standards and those in the sample countries are discussed below.

1. Tier 1 Capital

Within Tier 1 capital, there is a great deal of comparability and uniformity of definition among the countries subscribing to the Accord. Tier 1 is intended to be the purest form of capital and is accorded the greatest significance by banking supervisors and financial markets generally in assessing the adequacy of bank capital. Under the Accord, Tier 1 capital must constitute at least four percent of the eight percent total minimum capital requirement.

The components of Tier 1 capital include paid-up share capital (otherwise generally referred to as common stock), non-cumulative perpetual preferred stock, disclosed equity reserves (including the Fund for General Banking Risks described below), minority interests in the equity accounts of consolidated subsidiaries which are less than wholly owned, and current year profit (or loss). In calculating Tier 1 capital, goodwill is deducted from the total of these components.

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All countries include paid-up share capital and retained earnings within Tier 1. National banking authorities have discretion to include the following components in Tier 1 capital: non-cumulative perpetual preferred stock, current year profit or losses, and the Fund for General Banking Risks. Slight divergences in these areas occur among countries that subscribe to the Basle Accord. Some differences among countries also arise regarding intangible assets other than goodwill.[10] Each of these areas is discussed below.

Non-cumulative perpetual preferred stock. The divergence among countries in respect of the inclusion of this type of instrument in Tier 1 capital is not the result of differing definitions or treatment of this component but instead arises because not all Basle subscribers issue such instruments. It is important to note that, even in those countries which issue these instruments, the amount is very limited. This type of instrument is most prevalent in the United States; banks from Canada and the United Kingdom also have issued these instruments in the U.S. market. Banks from Germany, Sweden and Belgium,[11] to date have not issued any of this type of stock even though permitted to do so. Switzerland does not permit the inclusion of

[10] As discussed further below, the Accord is silent regarding the deduction of intangible assets other than goodwill.

[11] Examples included in this report regarding different national standards are included for purposes of illustrating the main areas of difference. Examples focus primarily on those countries in the sample which have the most internationally active banks.

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these instruments in capital and Japanese banks face legal obstacles in issuing such instruments.

Fund for General Banking Risks. The EC Directives establish a "Fund for General Banking Risks" (hereafter "the Fund"), which may be included in Tier 1 capital subject to certain limitations discussed below, in order to facilitate the gradual phasing out of so-called "hidden" or undisclosed reserves. Undisclosed equity reserves constitute shareholders' funds and, although not published or disclosed other than to supervisory authorities, are permitted by accounting practices in Belgium, Germany, Hong Kong and Switzerland. If published, these balances would have been included in Tier 1 capital as are retained earnings; however, because of their lack of transparency these reserves were included in Tier 2 or supplementary capital under the Basle Accord.

Limitations which apply to the Fund are: (1) amounts can only be transferred to or from the Fund via the post-tax balance on the profit and loss account, i.e., losses may not be directly charged to the Fund but must be taken through the profit and loss account; (2) the Fund must be disclosed separately in the bank's published accounts; and (3) the Fund must be freely available to a bank to meet losses as soon as they occur.

The Basle Committee has agreed that balances in such accounts are properly part of core capital and should be included in Tier 1 under the Accord; funds with the same characteristics in the accounts of non-EC countries will be entitled to similar

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treatment. The Committee will continue to review the inclusion of the Fund in Tier 1 capital to ensure that the desired effect of further convergence and improved quality of capital is achieved.

The EC Directives include the Fund in Tier 1 generally; however, the Fund must be deducted from Tier 1 for purposes of calculating the maximum level of Tier 2 capital. Member states may choose to restrict the inclusion of the Fund in Tier 1. It is anticipated that implementation of the terms of the relevant Directive permitting the establishment of the Fund for EC member states will occur in 1993. Until then, banks in these countries will not be able to include in Tier 1 capital amounts that they may wish to allocate to the Fund.

Current year profit (or loss). Australia, Canada, France, Italy, Japan, the Netherlands and the United States allow the inclusion of current year profit (and require the deduction of current year losses) in Tier 1 capital without restriction. In Germany, Hong Kong and Switzerland, the inclusion of current year profit is not permitted nor is the deduction of current year losses required; such profit or losses are only taken into the balance sheet in the following year as part of retained earnings. Belgium and Sweden also do not permit the inclusion of current year profit until taken into the balance sheet as retained earnings but do require the deduction of losses in the year in which they are incurred.

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Goodwill and other intangible assets. The Accord requires the deduction of goodwill from Tier 1 capital if carried on the balance sheet.[12/] The treatment of other intangible assets, however, is not addressed in the Accord largely because they do not exist in most countries other than the United States.

Banking regulators in the United States have allowed banks to book intangible assets (in addition to goodwill) if those assets qualify under certain criteria. Generally, any non-qualifying intangible asset is required to be deducted from capital. The amount of total qualifying intangible assets has been limited to a percentage of Tier 1 capital. Regulators have recently proposed that limited amounts of purchased mortgage servicing rights and purchased credit card receivables would constitute qualifying intangible assets due to the active, liquid market for such assets. United States banks, therefore, would not have to deduct these intangible assets up to specified limits from Tier 1 capital. These intangible assets generally are not available in other countries.[13/]

[12/] In a number of the countries surveyed, goodwill is not carried on the balance sheet and instead is required by national accounting practices to be charged off in the year acquired. Hence, the question of the deduction of goodwill does not arise in these countries.

[13/] U.K. banks, to a minor extent, also gain some capital benefit from the inclusion of U.S. purchased mortgage servicing rights held by their bank subsidiaries in the United States.

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2. Tier 2 - Supplementary Capital

As discussed above, Tier 1 capital is intended to be the purest form of capital and essentially represents unencumbered shareholder funds. It was also recognized by the Basle Committee in adopting the Accord that various instruments issued in different countries protect depositors to some degree and can enhance safety and soundness. Thus, the Committee also incorporated the concept of Tier 2 capital, which is structured to accommodate the differences in capital instruments prevalent in the member countries, as well as differences in accounting practices relating to the valuation of assets.

Tier 2 capital, therefore, could be viewed as a menu of capital enhancements to supplement Tier 1, or core, capital. On this basis, Tier 2 capital is limited to 100 percent of the amount of Tier 1. The Accord establishes common definitions of potentially eligible instruments, which Committee members agreed were acceptable for Tier 2 purposes, but discretion is provided to individual supervisory bodies regarding the use of such instruments in their national capital standards. Because a number of the Tier 2 capital items were included to accommodate the financial markets and accounting practices of different Basle members, not all of the components are available to each of the Basle members. Overall, taking these differences into account, there is broad equivalence among countries in the quality of Tier 2 capital as a supplement to core capital.

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Tier 2 capital includes: undisclosed reserves; asset revaluation items, including revaluation of fixed assets (normally banks' own premises) and latent revaluation of equity securities held for investment; general loan loss reserves; hybrid capital instruments, including, e.g., cumulative perpetual preferred stock; and term instruments, such as subordinated term debt and limited-life redeemable preferred stock. There are various limitations on the inclusion of certain of these instruments within Tier 2.

Tier 2 capital components may broadly be assigned to three categories, namely, undisclosed reserves, Tier 2 capital instruments, and other reserves (including revaluation and loan loss reserves). Differences among countries surveyed with regard to these categories are discussed below.

a. Undisclosed Reserves

As noted above, accounting systems in Belgium, Germany, Hong Kong and Switzerland have historically permitted banks to undervalue certain asset accounts or overstate liabilities in order to set aside funds to absorb the fluctuations in the return on assets inherent in banking. Such undervaluation leads to the creation of undisclosed, or so-called hidden, equity reserves. These reserves differ from latent revaluation reserves, which are addressed at page 32 of this report. Undisclosed reserves most closely resemble retained earnings included in Tier 1 capital, except for their lack of transparency. It was because of this lack of transparency that the Accord included such reserves in

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Tier 2 rather than Tier 1 capital. Although unpublished, these reserves must be passed through the profit and loss statement and must be accepted by the local supervisory authorities before they may be included in Tier 2 capital.

The extent to which these undisclosed reserves are permitted to be included in Tier 2 capital varies from country to country. For example, German and Swiss banks may only include in Tier 2 unpublished equity reserves that have been taxed; Belgian banks are prohibited from including any such reserves in capital. These types of reserves are not, however, permitted by the accounting principles in most other countries, including the United States. Instead, any such gains must be recognized and published and, therefore, are included in Tier 1.

In those countries which at present have such reserves, the general trend is towards reduction of this type of unpublished reserve. This trend is primarily the result of international market forces requiring more extensive disclosure. The Fund for General Banking Risks, discussed above, was established in the European Community to facilitate the gradual phasing out of these reserves by bringing them on to the balance sheet.

b. Tier 2 Capital Instruments

Tier 2 capital instruments are comprised of hybrid capital instruments and subordinated term debt instruments. Each of these is discussed below.

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Hybrid capital instruments that meet certain criteria may be included in Tier 2 capital without any sublimit. These instruments combine certain characteristics of both equity capital and debt. The precise specifications for hybrid capital differ from country to country. However, under the Accord, these instruments should meet the following general requirements: (1) issuance on an unsecured, subordinated and fully paid-up basis; (2) not redeemable at the initiative of the holder or without the prior consent of the supervisory authority; (3) available to participate in losses without the bank being obliged to cease trading; and (4) although the capital instruments may carry an obligation to pay interest that cannot be permanently reduced or waived, service obligations should be deferrable where the profitability of the bank would not support payment.

Examples of hybrid capital instruments issued in the United States are cumulative perpetual preferred stock, long-term preferred stock, perpetual subordinated debt and mandatory convertible debt instruments. German, French and U.K. banks also issue various types of hybrid capital instruments.

Hybrid capital instruments, however, are not prevalent in a number of countries that subscribe to the Accord, such as Belgium, Italy and the Netherlands. Japan historically has prohibited its banks from issuing such instruments, but this prohibition has recently been relaxed. Switzerland continues to prohibit its banks from issuing such instruments.

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Subordinated term debt includes conventional unsecured subordinated debt instruments and limited-life redeemable preferred stock, which may be counted as Tier 2 up to a limit of 50 percent of Tier 1 capital. Such term instruments, under the Accord, are included as Tier 2 capital because of the measure of protection they afford to depositors in the event of liquidation. The 50 percent limit, however, recognizes the less permanent nature of term instruments and the fact that such instruments afford minimal protection to depositors so long as the bank remains a going concern.

The major type of term instrument is subordinated term debt, which includes conventional unsecured subordinated debt instruments with a minimum original fixed term to maturity of more than five years. During the last five years to maturity, a cumulative discount or amortization factor of 20 percent per year is applied to reflect the diminishing value of these instruments as a continuing source of strength as they approach maturity.

Theoretically, banking regulators in all countries subscribing to the Accord, except Germany, permit the inclusion of subordinated term debt in Tier 2 within the 50 percent limit. Banks from almost all of the countries surveyed have issued subordinated debt and include such debt in Tier 2.[14] However, many countries, in practice, have not issued more specialized

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[14] Many countries impose conditions on subordinated term debt which are more restrictive than those imposed on U.S. banks. For example, several countries require an original fixed term to maturity of seven years or more compared to a minimum term of five years for U.S. banks.

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types of subordinated term debt, such as limited-life redeemable preferred stock for which there is a market in the United States. Countries that have not issued limited-life redeemable preferred stock to date include France, Japan[15], the Netherlands, Belgium, and Ireland. Two countries, Switzerland and Sweden, specifically disallow the inclusion of limited-life redeemable preferred stock in Tier 2.

c. Other Reserves

The capital structure of all banks includes items that are not actual instruments of capital. For this reason, the Accord also includes in Tier 2 certain types of accounts that accommodate the asset valuation practices or methods of provisioning for unidentified losses found in all countries in one form or another.

Revaluation reserves arise primarily in two ways. The first instance is with regard to the <u>revaluation of fixed assets</u> permitted in many countries. Revaluation on this basis is normally limited to the bank's premises and is designed to accommodate significant changes in market value relative to the original book value. These revaluations are reflected on the balance sheet through an increase in the value of the particular asset. The offsetting entry is an increase in the revaluation reserve, which is in the capital block. This type of revaluation is allowed in many countries including Belgium, France, Italy,

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[15] Until recently, Japanese banks were prohibited from issuing subordinated debt instruments.

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the Netherlands, the United Kingdom, and, to a more limited extent, Hong Kong. These reserves, however, generally have a limited affect on capital because fixed assets comprise only a small portion of a bank's total assets. Fixed-asset revaluations historically have not been permitted by accounting practices in the United States, Germany, Switzerland, Canada and Japan.

Another form of "reserve" is the so-called latent revaluation reserve, which arises from the implicit revaluation of long-term holdings of equity securities valued on the balance sheet at their original cost. Under the Basle Accord, latent revaluation reserves are permitted in Tier 2 subject to a discount of 55 percent, which is applied to the difference between the historic cost and the current market value of listed equity securities in the investment portfolio. The purpose of the discount is to reflect the potential volatility of this form of unrealized capital, as well as the tax charge which would be associated with an actual sale. Therefore, in practice, only 45 percent of such latent reserves may be included in Tier 2. To date, the only countries permitting the inclusion of latent revaluation reserves in Tier 2 capital are Japan and Hong Kong; the German authorities are currently considering the inclusion of these reserves subject to additional restrictions.[16]

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[16] The German authorities at present have under consideration a proposal to allow the inclusion of latent revaluation reserves within Tier 2, but only for banks with a Tier 1 capital ratio of at least five percent. Such reserves would be limited to a maximum of one percentage point of Tier 2.

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General loan loss reserves can also be taken into Tier 2 capital up to 1.25 percent of total risk assets. Under the Accord, such reserves are only eligible for Tier 2 if the reserves are created against the possibility of losses not yet identified and are freely available to meet losses which may subsequently materialize. Provisions allocated to the impairment of specific assets are excluded.

Countries such as the United States, the United Kingdom, France, Japan, the Netherlands, Italy and Australia permit the inclusion of general loan loss reserves up to the full 1.25 percent of total risk assets permitted by the Accord. Many countries, however, such as Canada, Belgium, Sweden, Switzerland and Hong Kong prohibit the inclusion of any loan loss reserves in Tier 2 capital.

The existence and treatment of general loan loss reserves within Tier 2 varies from country to country as does the distinction among specific, general and problem country loan loss reserves. In November, 1991, the Bale Committee amended the definition of general loan loss reserves for purposes of Tier 2 capital in order to remove some of these differences among countries. These changes were, at least in part, directed at U.S. practices with regard to the inclusion of country risk reserves in general provisions. The U.S. banking regulators concluded that the revised language was not in conflict with current U.S. practice and announced that no change in existing

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U.S. risk-based capital guidelines would be required by this amendment.

3. Deductions from Total Capital

The Accord requires the deduction from total capital of investments in unconsolidated banking and financial subsidiaries. This treatment of investments in unconsolidated banking and financial subsidiaries was intended to prevent the use of capital resources by different parts of the same banking group, which would effectively double-count existing capital where the subsidiaries are not consolidated. Under the EC Directives, this type of investment is deducted only if it constitutes more than 10 percent of the capital of the investee.

In addition, under the Accord, supervisory authorities have the discretion to require the deduction, in whole or in part, of investments in the capital of other banking and financial institutions. The practice of deducting a bank's holding of capital instruments issued by other banks or financial companies, whether equity or in other forms, stems from a desire to discourage national banking systems from creating cross-shareholdings of bank capital rather than seeking capital from sources outside the banking and finance sectors.

Most countries require deduction of such investments regardless of the purpose. These investments must be deducted by banks in the United States and Japan only if the sole purpose of the investment is to increase the capital ratio. The EC

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Directives require deduction only if the aggregate amount of this type of investment exceeds 10 percent of the capital of the reporting institution; only that part of the investment in excess of 10 percent is deducted.

4. Risk Weights

The risk weights in the Accord were developed to recognize the differences in risk between broad categories of assets. Risk weights act as a proxy for credit risk inherent in categories of assets. The weights range from zero percent to 100 percent. For the most part, only five weights are used. These are 0, 10, 20, 50, and 100 percent. Member countries have limited national discretion regarding the application of these weights.

Of the countries surveyed, there are only a few instances in which different risk weights have been assigned to similar asset categories. First, the risk weight assigned to privately-issued residential mortgage-backed securities varies from 50 percent in the United States to 100 percent in many other countries (particularly members of the European Community). Supervisors in the United States view mortgage-backed securities as indirect holdings of the underlying mortgages and, thus, U.S. banks may assign a 50 percent risk weight to such securities, as well as to direct holdings of residential mortgages. Most other countries do not have such a market for mortgage-backed

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securities and banks from these countries, therefore, generally hold residential mortgages on their books until maturity.

Second, claims collateralized by cash or OECD government securities are given different treatment. The majority of countries reviewed assign this particular asset category a zero percent risk weight; however, a few, such as the United Kingdom, Australia, Hong Kong, and Ireland, currently assign risk weights ranging between zero percent and 20 percent. The United States has assigned a 20 percent risk weight to these types of claims to limit the amount of assets in the zero percent risk category, as well as to address concerns regarding the operational risk of maintaining and liquidating collateral. The Board, however, is considering reducing the risk weight for certain of these collateralized transactions from 20 percent to zero percent.

A final area where there is some difference at this time is the risk weight assigned to loans secured by mortgages on commercial properties. Currently, Basle subscribers assign this particular asset category a 100 percent risk weight; however, the EC Directives permit Germany (as well as two other countries not included in the sample) to apply, until January 1, 1996, a 50 percent weight to assets secured by mortgages on commercial premises if the loan does not exceed 60 percent of the value of the property. In all other EC countries, mortgages on commercial premises are currently assigned a 100 percent risk weight.

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5. Off-balance Sheet Activities

One of the driving forces behind the development of the Basle Accord was the need to take into account, in the assessment of capital, the increasing level of off-balance sheet activities conducted by many internationally active banks. The Basle Accord accomplishes this by converting the various off-balance sheet activities into on-balance sheet credit equivalent amounts. The credit equivalent amount of an off-balance sheet transaction is intended to reflect the risk characteristics of the activity. The credit equivalent amount of an off-balance sheet transaction is assigned to one of the same risk categories that apply to on-balance sheet claims.

The Basle framework accords limited national discretion with regard to the conversion factors used to convert off-balance sheet transactions to on-balance sheet equivalents.There are, therefore, a few differences in the credit equivalent conversion factors used for particular off-balance sheet activities in different countries. Treatment of interest rate and foreign exchange rate contracts also varies among countries. These differences, however, are of a very technical nature and their effect is regarded as minor.

IV. CAPITAL STANDARDS IN COUNTRIES NOT SUBSCRIBING TO THE BASLE ACCORD AND COMPARISON WITH U.S. STANDARDS

Almost all of the countries included in the sample used for this study subscribe to the Basle Accord. However, two

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countries included in the sample - Brazil and Venezuela - do not follow the Basle framework. Banking supervisors in these countries evaluate the capital adequacy of local banking institutions with reference to local capital standards. The capital standards applied in these countries, however, do not involve risk-weighting assets, but instead compare each institution's total capital base to its total assets or to certain specified liabilities.

Banking regulators in both Brazil and Venezuela are in the process of revising the capital standards that banks must meet. The Brazilians have historically placed primary emphasis upon the relationship of capital to liabilities and have required banks to limit certain liability accounts to a specified multiple of capital. Banking regulators in Venezuela have judged the capital adequacy of banks on a case-by-case basis and have used a ratio relating capital to total assets as the primary tool in this evaluation. Several of the larger Venezuelan banks also have begun to publish voluntarily a statement of their capital position under the Basle framework in order to meet the informational requirements of the international markets.

The components of capital in these countries are limited predominantly to those elements of capital which under the Basle Accord comprise Tier 1, including paid-up share capital or common stock, disclosed equity reserves and minority interests. General loan loss reserves, which count as Tier 2 capital under the Accord, also would generally tend to be counted

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as part of total capital in these countries. This is similar to the treatment accorded such reserves under the capital guidelines in effect in the United States prior to adoption of the risk-based capital standard. The other types of capital instruments, which under the Accord are permitted in Tier 2 capital, generally are not issued. Banking supervisors in countries experiencing hyper-inflation, such as Brazil, also tend to permit banks to take asset revaluations into their balance sheet to adjust at least partially for the disruptive effects of hyper-inflation.

Although the capital standards in these countries are different from those established by the Basle Accord or the EC Directives, they still provide relevant and useful supervisory information with regard to the financial condition of individual institutions. As noted above, one of the moving forces behind the Basle Accord was concern within the G-10 regarding the increase of off-balance sheet activities and concern that a capital-to-assets standard, which was not risk-based, would not sufficiently account for the risk inherent in off-balance sheet activities. Typically, however, banks in these countries, which continue to rely upon ratios other than risk-based capital in assessing capital adequacy, do not have significant levels of off-balance sheet activities.

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V. THE U.S. LEVERAGE RATIO

Following implementation of the Basle Accord, a leverage ratio requirement has remained in effect for U.S. banks. The leverage ratio, as revised in August 1990, is defined as Tier 1 capital to total assets. The leverage measure requires a minimum ratio of three percent for banks that have received the best rating accorded on supervisory examinations and are not intending to grow inordinately. All other institutions are required to have ratios at least 100 to 200 basis points above the minimum depending on their risk profile, plans for expansion and other relevant factors.

This ratio was considered by U.S. regulators to be necessary because the risk-based capital ratio, by itself, would not constrain institutions from buying certain long-term securities with a zero or low credit-risk weighting using, for example, the proceeds of short-term borrowings. Thus the leverage ratio has been retained to address this aspect of interest-rate risk, which is not yet taken into account by the Basle framework. The leverage measure was intended to provide a temporary safeguard against heavy exposure to interest-rate risk until such time as a separate supervisory measure for this risk was devised and incorporated into the risk-based capital framework.

Pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991, U.S. regulators are currently in the

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process of developing proposals to supplement the risk-based capital framework in order to take into account non-credit risks, such as interest-rate risk. These issues also are being discussed by the Basle Committee. Once interest-rate risk has been incorporated into the risk-based capital framework, the need for a leverage measure will need to be revisited. At this time, no other country subscribing to the Accord has adopted a leverage measure, although many countries have other prudential or regulatory means for addressing non-credit risks.

While U.S. regulators are considering the continuing usefulness of leverage-ratio requirements generally, such requirements may be of limited relevance to internationally active foreign banks, especially once interest-rate risk is factored into the risk-based capital framework. The composition of these banks' balance sheets reflects the structure of national banking systems, the degree of sophistication of the markets in which the particular banks operate, and the types of instruments issued in those markets.

Although at the time of adoption of the Basle Accord U.S. regulators chose to retain, at least temporarily, a leverage ratio for U.S. banks, it was recognized that the internationally agreed basis for assessing the capital adequacy of internationally active banks was the risk-based capital standard. This standard accommodates the significant differences in asset structures of banks from different countries and takes into account off-balance sheet activities.

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VI. GUIDELINES FOR CONVERTING FOREIGN BANK CAPITAL DATA INTO EQUIVALENT U.S. STANDARDS

Section 214(b) of the Foreign Bank Supervision Enhancement Act of 1991 also requires the establishment of guidelines to be used by the Board in converting data on the capital of foreign banks to equivalent U.S. standards for purposes of determinations under Sections 3 and 4 of the Bank Holding Company Act of 1956 and Section 7 of the International Banking Act of 1978, as amended.

Section 3 of the Bank Holding Company Act requires prior approval by the Board for the formation or merger of bank holding companies and the acquisition of interests of banks, bank assets, or control of bank or bank holding company securities. Section 4 requires application to the Board with regard to the acquisition of permissible nonbanking companies or engaging directly in such nonbanking activities. Section 7 of the International Banking Act, inter alia, requires approval by the Board prior to a foreign bank establishing a federally or state-licensed branch or agency or acquiring ownership or control of a commercial lending company. As noted above, two policy statements previously have been issued by U.S. banking regulators regarding the supervision and regulation of the U.S. operations of foreign banks.

In acting on applications under these sections, the Board considers several factors, including the financial and managerial resources of the applicant, the future prospects of

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both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, and the competitive effects of the proposal. With respect to financial factors, specific areas of review have included profitability, concentrations of risk, liquidity, asset quality, adequacy of loan loss reserves, the proposed method of funding the transaction, current and projected capital positions, the risks associated with the proposed transaction, and the effect of the transaction on the applicant's overall financial resources.

In general, foreign banks seeking to establish operations in the United States have been expected to meet the same general standards of strength, experience, and reputation as required for domestic institutions. The Board has sought to assure itself of the foreign bank's ability to support its U.S. operations.

For purposes of making determinations in the future with regard to applications submitted by foreign banks pursuant to these sections, the Board will continue to take into account a number of factors. In determining whether a bank's capital meets the minimum standard, as an initial requirement applicants from countries that adhere to the Basle Accord will be required to meet the Basle guidelines as administered by their home country supervisors. This study has shown that the Basle standard provides a common basis for evaluating the general equivalency of capital among banks from various countries. The eight percent

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standard established by the Basle Accord is an agreed minimum necessary to conduct basic banking and financial activities by internationally active banks, both U.S. and foreign. In this regard, the guidelines should be applied to assure that any differences in capital standards do not place U.S. banks at a competitive disadvantage in their own market.

The Board will apply the minimum capital standard as part of its guidelines. However, it must be pointed out that simply meeting the minimum capital standard will not automatically imply that the financial condition of the foreign bank applicant is consistent with the Board's approval of any particular application. As with applications by U.S. banking organizations, the capital ratio necessary for applications by foreign banking organizations to be considered for approval by the Board will depend on the level of risk associated with the activities which are the subject of the application. For example, the capital ratio necessary to obtain full underwriting and dealing authority will be higher than the ratio required to conduct a low-risk activity.

As part of an overall financial analysis, all foreign banks from countries subscribing to the Basle Accord will be required to submit detailed information supporting their capital ratios. Such information would include the various components of Tier 1 and Tier 2 capital, a breakdown of assets by risk categories and an explanation of any material differences between U.S. accounting standards and those employed in the home country.

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The Board also anticipates receiving applications from banks in countries not subscribing to the Accord. In these cases, the applicant will be requested to provide information regarding the capital standard applied by its home country, as well as information sufficient to evaluate the applicant's capital position adjusted as appropriate for accounting and structural differences. The applicant will also be requested to provide, to the extent possible, information comparable to the Basle format.

As noted above, the capital position of both U.S. and foreign bank applicants is generally the starting point for the overall analysis of the financial condition of the applicant. As with domestic banks, a further analysis of the additional financial factors referenced above, including asset structure and quality, earnings, liquidity and supplementary capital composition, will be necessary to determine whether the applicant's financial strength is equivalent to that expected of U.S. banks. The Board, in making determinations on applications, never relies solely upon one factor. Instead, prior to reaching a determination, the Board will take into account all of the factors enumerated by the applicable statutes.

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APPENDIX A - TEXT OF SECTION 214(b) OF THE FOREIGN BANK SUPERVISION ENHANCEMENT ACT OF 1991

SEC. 214 MISCELLANEOUS AMENDMENTS TO THE INTERNATIONAL BANKING ACT OF 1978

(b) SECTION 7. - Section 7 of the International Banking Act of 1978 (12 U.S.C. 3105) is amended by adding at the end the following new subsection:

"(j) STUDY ON EQUIVALENCE OF FOREIGN BANK CAPITAL - Not later than 180 days after enactment of this subsection, the Board and the Secretary of the Treasury shall jointly submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives a report-

"(1) analyzing the capital standards contained in the framework for measurement of capital adequacy established by the Supervisory committee of the Bank for International Settlements, foreign regulatory capital standards that apply to foreign banks conducting banking operations in the United States, and the relationship of the Basle and foreign standards to risk-based capital and leverage requirements for United States banks; and

"(2) establishing guidelines for the adjustments to be used by the Board in converting data on the capital of such foreign banks to the equivalent risk-based capital and leverage requirements for United States banks for purposes of determining whether a foreign bank's capital level is equivalent to that imposed on United States banks for purposes of determinations under section 7 of the International Banking Act of 1978 and sections 3 and 4 of the Bank Holding Company Act of 1956.

An update shall be prepared annually explaining any changes in the analysis under paragraph (1) and resulting changes in the guidelines pursuant to paragraph (2).

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APPENDIX B - THE BASLE ACCORD

I. INTRODUCTION

The Basle Accord is a risk-based capital framework for the assessment and measurement of capital that is applicable to member countries. The Accord establishes an 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 framework is designed to establish minimum levels of capital for internationally active banks. National authorities are free to adopt arrangements that set higher levels. In addition, limited national discretion is provided regarding whether to allow banks to include certain components, which are eligible under the Accord, in capital.

The Basle Accord focuses principally on broad categories of credit risk, although the risk-based framework does take some transfer risk considerations, as well as limited instances of interest rate and market risk, into account in assigning certain assets to risk categories. The measure does not take explicit account of factors other than credit risk, which may affect an organization's financial condition, such as overall interest rate exposure; liquidity, funding and market risks; the quality and level of earnings; investment of loan portfolio concentrations; the quality of loans and investments;

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the effectiveness of loan and investment policies; and management's overall ability to monitor and control other financial and operating risks.

II. OVERVIEW OF THE BASLE ACCORD

The Accord comprises three basic elements: (1) an agreed definition of Tier 1 capital, consisting primarily of common stockholders' equity and certain categories of perpetual preferred stock, and a "menu" of internationally accepted items for supplementing core capital (Tier 2 capital); (2) a general framework for assigning assets and off-balance sheet items to broad risk categories and procedures for calculating a risk-based capital ratio; and (3) a schedule for achieving, by no later than the end of 1992, a minimum ratio of total capital-to-risk-weighted assets of eight percent (of which at least four percentage points should be in the form of core capital elements.)

A. Components of Capital

Under the risk-based framework, a bank's total capital is the sum of Tier 1 and Tier 2 capital, less any deductions. The various capital elements and deductions are described below. Included at pages 16 to 18 of this appendix is a table that

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summarizes the areas in which national discretion is permitted in the G-7 countries, as allowed by the Accord.

1. Tier 1 Capital (Core Capital)

A fundamental premise underlying the Basle Accord is that the key element of capital on which the main emphasis should be placed is equity capital. Accordingly, Tier 1 capital includes only permanent shareholders' equity (issued and fully paid common stock and noncumulative preferred stock and related surplus) and disclosed reserves created or increased by appropriations from post-tax retained earnings. It also includes minority interests in the equity accounts of consolidated subsidiaries that are less than wholly owned. This definition of equity capital excludes revaluation reserves and cumulative preferred stock. Equity capital is the only element of capital common to all countries' banking systems; this results from recognition of the importance of equity capital in maintaining a bank as a going concern.

2. Tier 2 Capital (Supplementary Capital)

The amount of Tier 2 capital included in total capital is limited to 100 percent of an institution's Tier 1 capital. Tier 2 capital elements consist of a menu of internationally accepted items for supplementing equity capital. Each of these elements may be included by national authorities at their discretion in light of their national accounting and supervisory regulations. These elements are discussed below.

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a. Undisclosed reserves

These reserves consist of portions of accumulated after-tax retained earnings that banking supervisors in some countries permit banks to maintain on an undisclosed basis. Apart from the fact that such reserves are not identified in the published balance sheet, they have the same high quality and character as disclosed capital reserves, which are included in Tier 1 capital.

b. Revaluation reserves

There are two types of such reserves. The first type arises from a formal revaluation, carried through to the balance sheet, of a bank's own premises. The second type arises from a notional addition to capital of latent, or hidden, values inherent in long-term holdings of equity securities valued on the balance sheet at the historic cost of acquisition. Latent revaluation reserves consist of the difference between the historic cost book value and market value of such securities.

Either form of revaluation reserve may be included in Tier 2 capital provided that the bank's national supervisory authority recognizes such reserves in capital and considers such reserves to be prudently valued, fully reflecting the possibility of price fluctuations and forced sale. In this connection, latent revaluation reserves associated with holdings of equity securities must be discounted by 55 percent to reflect the

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potential volatility of this form of unrealized capital and the notional tax charge on it.

c. General provisions/general loan loss reserves

This item includes provisions or loan loss reserves, which are held against future and presently unidentified losses and are freely available to meet losses that may subsequently materialize. This definition excludes provisions ascribed to the impairment of particular assets or known liabilities. The amount of such general provisions or general loan loss reserves permissible in Tier 2 capital is generally limited to 1.25 percent of risk-weighted assets.

d. Hybrid (debt/equity) capital instruments

These instruments combine characteristics of equity capital and of debt. Their precise specifications differ from country to country, but they should meet the following requirements: they are unsecured, subordinated and fully paid-up; they are not redeemable at the initiative of the holder or without the prior consent of the supervisory authority; they are available to participate in losses without the bank being obliged to cease trading (unlike conventional subordinated debt); and they should allow service obligations to be deferred where the profitability of the bank would not support payment.

The most widely known form of hybrid capital instrument

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is cumulative perpetual preferred stock. The Basle Accord notes that a number of instruments that are largely unique to individual countries may also qualify as hybrid capital instruments, such as U.S. mandatory convertible securities and U.K. perpetual debt instruments.

e. Subordinated term debt

Subordinated term debt includes conventional unsecured subordinated debt capital instruments and limited life preferred stock. To be included in capital, such instruments must have a minimum original maturity of five years. During the last five years to maturity, a cumulative discount (or amortization) factor of 20 percent per year is applied to the amount of such instruments to reflect the diminishing value as a continuing source of strength to the banks. Unlike instruments included in item (d) above, these instruments normally are not available to participate in the losses of a bank which continues trading. For this reason, the amount of such instruments permitted in Tier 2 capital is limited to a maximum of 50 percent of Tier 1 capital.

3. Deductions from Capital

The following deductions should be made from the capital base for the purpose of calculating the risk-weighted capital ratio. The deductions consist of:

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a. goodwill, an intangible asset which is deducted from Tier 1 capital elements;

b. investments in unconsolidated subsidiaries engaged in banking and financial activities. Normally such subsidiaries should be consolidated for the purpose of assessing the capital adequacy of banking groups. Where this is not done, deduction is essential to prevent the multiple use of the same capital resources in different parts of the banking group. The deduction for such investments is made against the total capital base. The assets representing the investments in subsidiary companies whose capital has been deducted from the parent's capital is not included in total assets for the purposes of computing the risk-based capital ratio;

c. at national supervisory discretion, banks' holdings of capital issued by other banks or deposit-taking institutions, whether in the form of equity or of other capital instruments, may be required to be deducted from the total capital base. As a general matter, reciprocal cross-holdings of bank

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capital designed to inflate artificially the capital position of the banks concerned should be deducted from organizations' total capital base.

B. Framework for Risk Categories

The risk-based framework relates capital to different categories of assets, weighted according to broad categories of relative riskiness, in assessing the capital adequacy of banks. The resulting risk ratio has three key advantages over the simpler gearing or leverage ratio, which relates capital to total assets: 1) it provides a fairer basis for making international comparisons between banking systems whose structures may differ; 2) it allows off-balance sheet exposures to be incorporated more easily into the capital calculations; and 3) it does not deter banks from holding liquid or other assets which carry low risk.

The framework of weights employs only five risk-weighted categories -- 0, 10, 20, 50 and 100 percent -- to which all claims, including on-balance sheet assets and credit equivalent amounts of off-balance sheet items, are assigned. The 100 percent risk weight is considered the standard risk weight to which the bulk of a bank's assets or off-balance sheet items normally is assigned. The assignment of various types of assets to particular risk-weight categories inevitably entails broad-

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brush judgments. Consequently, the risk category to which a claim is assigned should not be regarded as a substitute for commercial judgment for purposes of market pricing of that asset or off-balance sheet item.

Total risk-weighted assets are calculated by first multiplying the face amount of each asset or the credit equivalent amount of each off-balance sheet item by the risk-weight percentage of the risk category to which the claim is assigned. The resulting amounts are then added together to arrive at total risk-weighted assets.

Risk-Weight Categories

0% -- Cash

-- Claims on, or guaranteed by, central governments and central banks denominated in national currency and funded in that currency

-- Other claims on, or guaranteed by,

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OECD[1] central governments and central banks

-- Claims collateralized by cash or OECD central-government securities.

0, 10, 20,50% -- Claims on domestic public sector entities[2] and loans guaranteed by such entities

(at national discretion)

20% -- Claims on multilateral lending institutions and regional development banks and claims guaranteed by, or

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[1] In the context of the Basle Accord, OECD countries include all full members of the Organization for Economic Cooperation and Development (OECD), as well as all countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the Fund's General Arrangements to Borrow. The OECD includes the following countries: Australia, Austria, Belgium, Canada, Denmark, the Federal Republic of Germany, Finland, France, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Saudi Arabia has concluded special lending arrangements with the IMF associated with the Fund's General Arrangements to Borrow.

[2] Public sector entities are those entities below the level of the central government, for example, states and local authorities. A separate category was created for such entities in view of their special character and varying creditworthiness in different member countries. Such entities do not include commercial companies owned by the public sector, which are instead assigned a 100 percent risk weight to avoid competitive inequality vis-a-vis similar private sector commercial enterprises.

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collateralized by securities issued by, such entities

- -- Claims on banks incorporated in the OECD countries and loans guaranteed by such banks

- -- Claims on, or guaranteed by, banks incorporated in countries outside the OECD with a remaining maturity of one year or less.

- -- Claims on, or guaranteed by, nondomestic OECD public sector entities

- -- Cash items in process of collection

50% -- Loans fully secured by mortgages on residential property that is, or will be, occupied by the borrower or that is rented

100% -- Claims on the private sector

- -- Claims on, or guaranteed by, banks incorporated outside the OECD with a

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remaining maturity of over one year

- Claims on, or guaranteed by, central governments outside the OECD that are not denominated in the local currency and funded in that currency

- Claims on commercial companies owned by the public sector

- Premises, plant, and equipment and other fixed assets

- Real estate and other investments

- Capital instruments issued by other banks (unless deducted from capital)

- All other assets

C. Off-Balance Sheet Activities

The Basle Committee considered that it was also of great importance that all off-balance sheet activity should be captured within the capital adequacy framework. It was also

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recognized, however, that there was only limited experience in assessing the risks associated with some of the activities and that, for some countries, a complex analytical approach and detailed reporting systems could not easily be justified because the amounts of such business, particularly in the newer, more innovative instruments, were small.

The approach that was adopted is comprehensive in that all categories of off-balance sheet activities, including recent innovations, are converted to credit risk equivalents by multiplying the nominal principal amounts by a credit conversion factor with the resulting amounts then being weighted according to the nature of the counterparty. The different off-balance sheet activities are divided into five broad categories, which are as follows:

1. those which substitute for loans (for example, general guarantees for indebtedness, bank acceptance guarantees, and standby letters of credit serving as financial guarantees for loans and securities). This particular category will carry a 100 percent credit risk conversion factor;

2. certain transaction-related contingencies (for example, performance bonds, bid bonds, warrants and standby letters of credit relating to particular transactions). A 50 percent credit risk conversion factor will be applied to this category;

3. short-term, self-liquidating, trade-related contingent liabilities arising from the movement of goods (for example, documentary credits collateralized by the underlying shipments).

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A 20 percent credit risk conversion factor will be applied to this category;

4. commitments with an original majority exceeding one year and all Note Issuance Facilities (NIFs) and Revolving Underwriting Facilities (RUFs). A 50 percent credit risk conversion factor will be applied to this category; and

5. interest and exchange-rate related items (for example, swaps, options, futures).

With regard to the last item above, the Basle Committee felt that special treatment was needed for such off-balance sheet items due to the fact that banks are not exposed to credit risk for the full notional amount of the contracts involved but rather only to the replacement costs associated with the contracts if a counterparty defaults. The Accord permits members to choose one of two methods to calculate replacement cost. Under the first method, the current replacement cost is calculated by marking to market the relevant contracts and adding a factor to represent potential exposure during the remaining life of the contract. The alternative approach is to use conversion factors based upon the notional principal sum underlying each contract according to its type and maturity.

D. Target Standard Ratio

The Basle Accord establishes a target minimum ratio of total capital to total risk-weighted assets that international banks generally are expected to achieve by the end of the

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transitional period, that is, by year-end 1992. The standard has been set at a level that is deemed to be consistent with the objective of securing, over time, soundly-based and consistent capital ratios for all international banks. Accordingly, the target standard ratio of total capital to total risk-weighted assets has been set at eight percent, of which at least half, or four percent, should be in the form of Tier 1 capital. The transitional period to the end of 1992 (March 1993 for Japanese banks as this is their fiscal year end for 1992) is intended to allow time for progressive steps toward adjustment by banks that may need to build up to the eight percent minimum level and to obviate any requirement for such banks to take immediate or precipitous action.

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Risk-Based Capital Accord: Summary of Areas in which National Discretion is Permitted in G-7 Countries

	United States	Japan	Germany[1]	Canada	United Kingdom	France	Italy
TIER 1 (Core Capital):							
Non-Cumulative Perpetual Preferred Stock	Permitted	Permitted	Permitted; however none issued to date	Permitted	Permitted	Issues not permitted in domestic market	Permitted
Current-Year Profit (or Loss)	Profits may be included; losses must be deducted	Profits may be included; losses must be deducted	Profits may not be included; losses do not have to be deducted	Profits may be included; losses must be deducted	Profits included only if published[2]; losses must be deducted	Profits may be included; losses must be deducted	Profits must be included; losses must be deducted
Deductions from Tier 1 Capital							
• Deduction of Intangible Assets Other than Goodwill (OIA)	Required with exception of Purchased Mortgage Servicing Rights (PMSRs) and Purchased Credit Card Receivables (PCCRs)	Not permitted by local accounting principles	Not required; OIA permitted by local accounting principles only in exceptional cases	Not permitted by local accounting principles	Required with exception of U.S. PMSRs	Required with exception of lease renewal rights	Required

NOTE: This table was compiled based upon various sources, including information supplied by central bank officials from the respective countries. Because the table is a summary, it cannot encompass the full complexity of the topics addressed.

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	United States	Japan	Germany[1]	Canada	United Kingdom	France	Italy
TIER 2 (Supplementary Capital):							
Undisclosed Reserves	Not permitted by local accounting principles	Not permitted by local accounting principles	Allowed only if such reserves have been taxed and audited	Not permitted by local accounting principles	Not permitted to commercial banks	Not permitted by local accounting principles	Not permitted by local accounting principles
Hybrid Capital Instruments (including cumulative perpetual preferred stock)	Permitted	Permitted, but not prevalent	Permitted (up to 25 percent of total capital)	Permitted	Permitted	Permitted	Permitted, but not prevalent
Term Instruments (up to 50 percent of Tier 1)							
• Subordinated Term Debt	Permitted	Permitted	Not permitted	Permitted	Permitted	Permitted	Permitted
• Limited Life Redeemable Preference Shares	Permitted and issued	Permitted, but not issued	Not permitted	Permitted and issued	Permitted and issued	Permitted, but not issued	Permitted, but only for Italian subsidiaries of foreign banks
Fixed Asset Revaluation Reserves (On-balance sheet)	Not allowed by local accounting principles	Not allowed by local accounting principles	Not allowed by local accounting principles	Not allowed by local accounting principles	Permitted	Permitted	Permitted periodically, when allowed by special legislation
"Latent" Revaluation Reserves (with 55 percent discount on equities in investment portfolio)	Excluded	Included	Excluded	Excluded	Excluded	Excluded	Excluded
General Loan Loss Reserves (up to 1.25 percent)	Included	Included	Excluded	Excluded	Included	Included	Included

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	United States	Japan	Germany[1]	Canada	United Kingdom	France	Italy
Deductions from Total Capital							
• Investments in the capital of other banks and financial institutions	Required, only if sole purpose is to raise capital ratio	Required, only if sole purpose is to raise capital ratio	Not Required	Required, if in excess of 10 percent of voting shares or if sole purpose is to raise capital ratio	Required, but with a market making exemption (up to a specific percent of investor's or investee's capital)	Only if in excess of a specific percent of investor's or investee's capital	Only if in excess of a specific percent of investor's or investee's capital

1. Major changes to the German Banking Law implementing the EC Capital Directives are expected by year-end 1992.

2. Profits must also be verified by the auditors.

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APPENDIX C - CAPITAL STANDARDS IN THE EUROPEAN COMMUNITY

Seven of the twelve members of the Basle Committee on Banking Supervision are also member states of the European Community.[1/] There is, therefore, a great deal of comparability between the Basle Accord and the EC capital standards set out in relevant EC Directives. The two primary Directives addressing capital standards are the Own Funds and Solvency Ratio Directives, which were adopted in April 1989 and December 1989, respectively, following the adoption of the Basle Accord in July 1988. These Directives are part of the harmonization exercise underlying the development of a single market in financial services in the European Community.

These Directives establish a common definition of capital, as well as minimum standards for capital adequacy for credit institutions. Implementation by EC member states was required by January 1991; however, credit institutions are not required to meet the minimum eight percent standard until January 1, 1993. These transitional arrangements correspond closely to those included in the Basle Accord.

Whereas the Basle framework is non-compulsory and applies only to internationally active banks, the EC Directives have the force of law within the EC and, therefore, establish mandatory minimum standards. These standards apply to all credit institutions incorporated in the member states rather than only

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[1/] The twelve member states of the European Community are Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom.

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to internationally active banks. If the treaty establishing the European Economic Area (EEA) is ratified, these directives also will have the force of law within the seven countries of the European Free Trade Association (EFTA).[2/]

The EC capital standard, like the Basle Accord, is based on a minimum eight percent risk-weighted capital ratio. Similar to the Basle Accord, EC member states have national discretion to impose capital standards which are more stringent than the minimum established in the Directives.

The EC Directives, however, in some respects depart from the provisions of the Basle Accord. Some departures from the Accord are minor in nature and were necessary in order to accommodate the differences in banking structures and financial markets within the European Community and to accomplish harmonization of minimum capital standards within EC member states prior to the establishment of a single market in 1993. Other differences are more significant and, for the most part, remove some of the flexibility permitted by the Accord regarding the components of Tier 1 and Tier 2 capital,[3/] deductions from capital, and risk weightings. These differences are discussed below.

[2/] The seven EFTA countries are Austria, Finland, Iceland, Liechtenstein, Norway, Sweden and Switzerland.

[3/] It should be noted that the E.C. Directives refer to "original own funds" and "additional own funds" rather than to Tier 1 (core) capital and Tier 2 (supplementary) capital which are the terms used in the Basle Accord. These differences in terminology have no substantive effect and, therefore, for purposes of this report, the Basle terminology will be used.

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1. Tier 1 Capital

Under the Basle Accord, all current year profits may be included in Tier 1 at national discretion. Under the EC standards, however, current year profits may only be included in Tier 1 if those profits have been verified by auditors.

The EC Directives also establish a "Fund for General Banking Risks" which will be included in Tier 1 capital, subject to certain limitations discussed below. The European Community provided for the establishment of this Fund in the Bank Accounts Directive (which must also be implemented by member states by January 1993) in order to facilitate the gradual phasing out of so-called "hidden" reserves. These reserves constitute shareholders' funds and, although not published or disclosed other than to supervisory authorities, are permitted by the accounting practices in a few member states. Such balances would have been included in Tier 1 capital if published, like, e.g., retained earnings; however, because of their lack of transparency they were included in Tier 2, or supplementary, capital under the Basle Accord.

Limitations which apply to the Fund are: 1) amounts can only be transferred to or from the Fund via the post-tax balance on the profit and loss account, i.e., losses may not be directly charged to the Fund but must be taken through the profit and loss account; 2) the Fund must be disclosed separately in the bank's published accounts; and 3) the Fund must be freely available to a bank to meet losses as soon as they occur. The

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Basle Committee has agreed that balances in such accounts are properly part of core capital and should be included in Tier 1; funds with the same characteristics in the accounts of non-EC countries will be entitled to similar treatment. The Committee will keep this area under review to ensure that the desired effect of further convergence and improved quality of capital is achieved.

2. Tier 2 Capital

Although the Basle Accord permits the inclusion of undisclosed reserves in Tier 2 capital without limit, under the terms of the relevant EC Directives, the portion of these reserves which may remain undisclosed (and continue to count as Tier 2 capital) is limited to four percent of designated assets. Any excess over the permitted four percent, in order to be included in capital, must qualify for inclusion in the Fund for general banking risk, discussed above, by being disclosed, taxed and passed through the statement of profit and loss.

The EC capital standards also deny to its member states the use of the latent revaluation reserves which are permitted under the Accord. Consequently, the EC does not allow 45 percent of latent revaluation reserves to be included in Tier 2 supplementary capital. The EC Directives only permit disclosed revaluation reserves (those formally recognized in financial statements) to be included in Tier 2 capital.

With regard to general loan loss reserves, the EC Directives place such reserves in the "other items" category for

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which there is no separate limit in Tier 2 capital. The Basle Accord restricts general loan loss reserves in Tier 2 to 1.25 percent of risk-based assets.

3. Deductions from Capital

The Basle Accord grants national discretion to supervisory authorities to either require deduction (in whole or in part) or a 100 percent risk weighting of all holdings of capital of other banks and financial institutions. The EC Directives, however, require investments in capital of other banks and financial institutions to be deducted from capital when such investments are in excess of 10 percent of the investee institutions capital. In such cases, the entire amount of the investment is deducted. If investments in the capital of other banks and financial institutions are in excess of 10 percent of the reporting institution's own funds, the excess amount only is required to be deducted.

4. Risk Weightings

Some minor differences also exist between risk weightings included in the Basle Accord and the EC Directives. For example, EC member states may, at national discretion, apply a 10 percent weighting to claims on institutions specializing in the interbank and public debt markets. These assets were not categorized separately in the Basle framework. Second, a more extensive allowance for collateral applies under the EC directives than under the Basle framework as member states are permitted to weight assets collateralized by securities issued by

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OECD regional governments or local authorities or by deposits with, or certificates of deposits issued by, OECD banks at 20 percent.

5. Conversion Factors

The capital framework established by the EC Directives also encompasses off-balance sheet activities, which are broadly divided into two groups: (1) interest rate and foreign exchange risks; and (2) all other off-balance sheet activities. Generally, with regard to interest rate and foreign exchange contracts, banks may choose either the marking to market (or current replacement cost) approach or the original exposure (or residual maturity) approach to measure the risks associated with these transactions. With regard to other off-balance sheet activities, they are first classified and valued according to the risk characteristics of the activities. The off-balance sheet values for these activities are then multiplied by the risk weightings attributable to the relevant counterparties.

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APPENDIX D - U.S. CAPITAL STANDARDS -- IMPLEMENTATION OF THE BASLE ACCORD

I. INTRODUCTION

Banks and bank holding companies in the United States have been required to follow risk-based capital guidelines since early 1989. The guidelines were issued by the three federal banking agencies following discussions at the Basle Committee and opportunity for public comment. The risk-based capital guidelines of the three federal banking agencies are very similar and closely follow the requirements of the Basle Accord. These guidelines are subject to ongoing review as part of the efforts of the Basle Committee to further refine the Accord.

While the Basle Accord is specifically directed towards internationally active banks, the three federal banking agencies extend the application of the risk-based capital framework to all U.S. banks under their jurisdiction.[1] The Board also applies the broad principles of the risk-based capital framework to U.S. bank holding companies on a consolidated basis.

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[1]The Office of Thrift Supervision also employs a risk-based framework for assessing the capital adequacy of savings associations under its jurisdiction. The regulation implementing this framework was issued in October 1989. This regulation parallels the risk-based capital guidelines for banks but contains some differences meant to accommodate thrifts' large involvement in mortgage-related transactions.

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II. U.S. APPLICATION OF THE RISK-BASED CAPITAL FRAMEWORK

As permitted by the Basle Accord, U.S. regulators exercise national discretion with regard to the inclusion of certain categories of capital, as well as various risk weights of assets. The U.S. approach to the components of Tier 1 and Tier 2 capital, deductions from total capital and risk weights of assets is described below.

1. Tier 1 Capital

U.S. regulators define Tier 1 capital as paid-up share capital, retained earnings, minority interests and current year profits (or losses). In addition, banks may include any non-cumulative perpetual preferred stock that has been issued. Goodwill is deducted from Tier 1, as required by the Accord. The U.S. guidelines also require the deduction of other intangible assets with the exception of limited amounts of purchased mortgage servicing rights and purchased credit card receivables.

In applying the risk-based capital framework to holding companies, the Board adopted a definition of Tier 1 capital that differs somewhat from the definition contained in the Basle Accord for international banks. This difference involves the inclusion of <u>cumulative</u> perpetual preferred stock in Tier 1 capital, which the Basle Accord restricts to Tier 2 capital. Under the U.S. risk-based capital guidelines, bank holding companies (but not banks) are allowed to include cumulative

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perpetual preferred stock in Tier 1 capital up to 25 percent of Tier 1 capital.

2. Tier 2 Capital

Under the Basle Accord, national discretion is applied to all categories of capital permitted in Tier 2. U.S. regulators define Tier 2 as general loan loss reserves (up to 1.25 percent of risk-weighted assets), hybrid capital instruments and term instruments such as subordinated term debt and limited life redeemable preferred stock. The term instruments are limited to 50 percent of Tier 1 capital. U.S. regulators permit the inclusion of country risk reserves in general loan loss reserves.

U.S. banks are prohibited by generally accepted accounting principles from maintaining undisclosed equity reserves. Full disclosure by U.S. banks means that all equity reserves are included in Tier 1 capital. U.S. banks are also prohibited by accounting principles from revaluing fixed assets or marking investment portfolios to market.

3. Deductions from Total Capital

Under the Basle Accord and U.S. guidelines, the aggregate amount of investments in unconsolidated banking or finance subsidiaries are deducted from a bank's total capital base. The Accord also states that national supervisors, at their discretion, may require banks to deduct holdings of capital

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instruments issued by other banks or financial institutions from their total capital. The U.S. guidelines generally require deduction of reciprocal holdings of capital instruments of other banking organizations only if these cross-holdings are intentional.

4. Risk Weights

The U.S. guidelines regarding the risk weights for assets closely follow those specified in the Accord except in a few minor respects. The Basle Accord allows claims collateralized by cash or OECD government securities to be assigned a zero percent risk weight. The U.S. guidelines, however, weight these claims at 20 percent in order to limit the amount of assets in the zero percent risk category, as well as to address concerns regarding the operational risks of maintaining and liquidating collateral. The Board is proposing to lower the risk weight from 20 percent to zero percent for certain low-risk collateralized transactions.

The Basle Accord allows national discretion to weight claims on, or guaranteed by, domestic public sector entities (PSEs) in the zero, 10, 20, or 50 percent risk category. PSEs are defined in the Accord as entities "below the level of central government (e.g., states, local authorities, etc.)." The U.S. considers state and local governments to be PSEs. However, the risk weight assigned to PSEs under U.S. guidelines depends on the type of claim. A 20 percent risk weight is assigned to general

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obligation claims and a 50 percent risk weight is assigned to revenue obligation claims on such entities. Industrial development bonds issued by state and local governments are assigned to the 100 percent risk category.

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