

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 9995]
[January 30, 1986]

PROPOSED SUPPLEMENTAL ADJUSTED CAPITAL MEASURE

Comment Requested by April 25, 1986

*To All Depository Institutions in the Second
Federal Reserve District, and Others Concerned:*

Our Circular No. 9989, dated January 22, 1986, contained the text of a joint statement issued by the Board of Governors of the Federal Reserve System, the FDIC, and the Comptroller of the Currency indicating that the three Federal bank regulatory agencies intend to request public comment on proposed standards for measuring capital on a risk-adjusted basis. The Board of Governors of the Federal Reserve System has issued such a request, the text of which follows:

The Federal Reserve Board has issued for public comment a proposal intended to bring its policies on bank capital into better alignment with the risk profile of the banking industry. The overall objective of this Supplemental Adjusted Capital Measure is to enhance the strength and promote the safety and soundness of the banking system.

Comment is requested by April 25, 1986.

The proposed guideline, which establishes categories for assets and off-balance sheet items, would supplement, but not replace, the existing capital standards that the bank regulatory agencies have strengthened in recent years.

Specifically these proposed measures are designed to achieve the following policy objectives:

- to address off-balance sheet exposures, which have expanded rapidly at many large institutions over the last several years;
- to temper disincentives inherent in the existing guidelines to hold low risk, relatively liquid assets;
- to move U.S. capital adequacy policies more closely in line with those of other major industrial countries; and
- to provide more explicit guidance to bankers and examiners for relating capital to risk profiles.

The proposed guideline would assign assets and certain off-balance sheet items to one of four *broad* risk categories. The categories would be weighted according to their relative risk.

The aggregate dollar value of the assets and off-balance sheet items in each category would be multiplied by the weight assigned to that category. The sum of these weighted asset values would be the weighted risk asset total against which actual primary capital would be compared. The resulting ratio would be used in tandem with the current primary and total capital-to-total asset ratios as a guide to determining minimum capital requirements.

The proposed guideline is designed as an *additional* tool, in effect providing a "second opinion", to encourage banks to make adjustments in either the risk composition of their portfolios or their overall level of primary capital.

The proposal is not meant to take explicit account of all of the many types of risks to which banking organizations are exposed. The proposed measure also is not intended to substitute for examiner judgment in the assessment of an organization's capital adequacy.

In reaching a final judgment of capital adequacy, examiners would be required to calculate and assess the Supplemental Adjusted Capital Measure, consider all other qualitative risk factors, and, in particular, take into account the level and severity of examiner-classified assets.

(OVER)

The four categories are briefly described as follows:

Cash and Equivalents — weight, zero percent. This category would include assets generally considered to be riskless, such as vault cash and balances due from Federal Reserve Banks, balances due from foreign central banks in immediately available funds, cash items in process of collection, transactions accounts due from U.S. depository institutions, and U.S. Treasury securities held in investment accounts with original or remaining maturities of one year or less.

Money Market Risk — weight, 30 percent. This category would cover those assets which generally have little or no risk of default and a high degree of liquidity. Examples include all holdings of U.S. Treasury securities with over one year to maturity, all U.S. Government agency securities, those portions of loans that are fully guaranteed by the U.S. Government, claims of 90 days or less on U.S. depository institutions (excluding those included in Cash and Equivalents), and other specified money market instruments.

Moderate Risk — weight, 60 percent. This category would cover assets having more credit and liquidity risk than Money Market Risk items, but significantly less than the standard commercial bank loan portfolio. Included are: all state, county and municipal securities (except industrial development bonds); claims of over 90 days on U.S. depository institutions; all claims on governments and banks in twenty industrial countries; local currency claims on governments and banks of non-industrial countries to the extent funded by local currency liabilities; commercial letters of credit; standby letters of credit which are performance related, issued on a secured basis to support broker/dealers or in support of state, county and municipal securities; and other moderate risk instruments.

Standard Risk — weight, 100 percent. This category would cover those assets generally found in a typical bank loan portfolio and those not included in the previously listed categories. Included are all commercial and industrial loans and lease financing receivables, customers' acceptance liabilities, loans to individuals, loans secured by real estate, farm-related loans, and all other claims on foreign borrowers. This category is additionally composed of all corporate securities and commercial paper, industrial development bonds, and all other standby letters of credit that are not included in the previously listed categories, and loans sold with recourse.

The following table illustrates the calculation of the Supplemental Adjusted Capital Measure with the amounts in dollars. This example assumes a banking organization with \$100,000 total assets, \$50,000 in certain off-balance sheet items, and \$7,000 in primary capital.

<i>Risk Category</i>	<i>Amount of On- and Off-Balance Sheet Items in Category</i>	<i>Risk Weight</i>	<i>Weighted Risk Assets and Off-Balance Sheet Items</i>
Cash and equivalents	\$ 5,000	× 0	= 0
Money market risk	35,000	× .30	= 10,500
Moderate risk	30,000	× .60	= 18,000
Standard risk	<u>80,000</u>	× 1.00	= <u>80,000</u>
Total (including \$100,000 in total assets and \$50,000 in Off-Balance Sheet items)	\$150,000		\$108,500

Primary capital: \$7,000

Primary capital to total assets ratio (as defined under existing guidelines): $7,000 \div 100,000 = 7.0\%$

Supplemental Adjusted Capital Measure (as proposed): $7,000 \div 108,500 = 6.5\%$

Enclosed, for depository institutions in this District, is the text of the Board's official notice in this matter. It will be published in the *Federal Register*, and copies will be furnished upon request directed to our Circulars Division (Tel. No. 212-791-5216). Questions concerning the proposal may be directed to Donald E. Schmid, Manager, Bank Analysis Department (Tel. No. 212-791-6611). Comments on the proposal, which should refer to Docket No. R-0567, should be submitted to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th and Constitution Avenue, N.W., Washington, D.C. 20551.

E. GERALD CORRIGAN,
President.

FEDERAL RESERVE SYSTEM

12 C.F.R. Part 225, APPENDIX A

[Reg. Y; Docket No. R-0567]

Capital Maintenance:

Supplemental Adjusted Capital Measure

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed Rulemaking.

SUMMARY: Capital adequacy is one of the critical factors the Board of Governors of the Federal Reserve System is required to analyze in taking action on various types of applications, such as mergers and acquisitions by bank holding companies, and in the conduct of the Board's various supervisory activities related to safety and soundness of individual banks and bank holding companies and the banking system. In April 1985, the Board announced revised Guidelines for minimum and appropriate levels of capital for bank holding companies and state chartered banks that are members of the Federal Reserve System. (50 Fed. Reg. 16057 (1985)) These revised Guidelines, contained in Appendix A to the Board's Regulation Y, 12 C.F.R. Part 225, were designed to establish, in conjunction with other federal bank regulatory agencies, uniform capital standards for all federally regulated banking organizations regardless of size. These uniform capital standards were based on ratios of primary and total capital to total assets.

The Board historically has taken account of risk factors in addition to relying on capital-to-total assets ratios, and the nature and degree of risk exposure have always been important subjective factors in assessing capital adequacy. The Board believes that there is a need to modify its capital policies to be more explicitly and systematically sensitive to the risk exposure of individual banking organizations. Consequently, the Board is proposing to amend its current Guidelines by adding the following supplemental adjusted capital measure that the Board would consider in tandem with existing minimum primary and total capital-to-total assets ratios in analyzing the capital levels of bank holding companies and state chartered banks that are members of the Federal Reserve System. The Board has previously determined pursuant to section 910 of the International Lending Supervision Act of 1983 ("ILSA") (12 U.S.C. 390(a)(2)) that application of capital standards to bank holding companies on the same basis as banks is necessary to maintain adequate levels of capital in individual banking organizations and the banking system and thus to meet the purposes and objectives of ILSA.

DATE: Comments must be received by April 25, 1986.

ADDRESS: All comments, which should refer to Docket No. R-0567, should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th and Constitution Avenue, N.W., Washington, D.C. 20551, or should

be delivered to the Office of the Secretary, Room 2200, Eccles Building, 20th and Constitution Avenue, N.W., between the hours of 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room 1122, Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays.

FOR FURTHER INFORMATION CONTACT: Richard Spillenkothen, Deputy Associate Director (202/452-2594), Anthony G. Cornyn, Assistant Director (202/452-3354), or Catherine Piché, Financial Analyst (202/728-5871), Division of Banking Supervision and Regulation or James E. Scott, Senior Attorney, Legal Division (202/452-3513) of the Board's staff; or Andrew Spindler, Vice President, Federal Reserve Bank of New York (212/791-5846).

SUPPLEMENTARY INFORMATION:

1. BACKGROUND

The Need for a Supplemental Adjusted Capital Measure.

In announcing its revised Capital Adequacy Guidelines in April 1985, 50 Fed. Reg. 16057, the Board expressed its continuing concern that the emphasis in the Guidelines on ratios based on the total amount of assets should not be interpreted to exclude considerations of risk. The Board proposed to deal with the issue of risk on a case-by-case basis, stating: (1) that it would assess the overall capital position of a banking organization by taking account not only of the volume of the organization's risk assets but also of its off-balance-sheet risks (although such risks were not explicitly included in the capital ratios); (2) that the

Guideline ratios were minimums and banking organizations with high levels of on- or off-balance-sheet risk would be expected to operate above the minimum ratios, and (3) that the banking organizations would be expected to avoid the practice of attempting to meet the minimum ratios by decreasing the level of liquid assets relative to total assets. The Board also indicated that it would continue to review the need for more explicit procedures for factoring on- and off-balance-sheet risks into the assessment of capital adequacy.

In response to comments received in connection with the 1985 revisions to the Capital Adequacy Guidelines, the Board acknowledged that, in addition to an assessment of minimum and adequate capital levels based solely upon the total quantity of assets, there would be significant analytical value to a systematic evaluation of appropriate capital levels based upon consideration of the degree of risk associated with such assets.

Several developments over the last few years suggest the need to modify the Board's capital policies to make them more sensitive to certain risk exposures of individual banking organizations. First, there has been a substantial growth in off-balance-sheet risks--a phenomenon that does not appear to have been significantly tempered by the subjective factoring of these risks into overall assessments of capital adequacy. One indication of this trend has been the growth in standby letters of credit issued by multinational banks, which have increased,

on average, from 5.8 percent of the aggregate assets of those banking organizations at the end of 1981 to 11.4 percent of assets at midyear 1985. Among multinational bank holding companies, this one category of off-balance-sheet risk ranges from less than five percent to well over 15 percent of total assets. In absolute terms, the volume of standby letters of credit for the multinational institutions has more than doubled from \$49 billion in 1981 to \$105 billion at midyear 1985.

Significant growth has also occurred in legally binding loan commitments, including those issued in connection with commercial paper programs and Euromarket note issuance facilities. The advent of other financial innovations, such as interest rate swaps, has also had the result of creating significant off-balance-sheet exposure. Taken together, off-balance-sheet items represent a very substantial exposure that is not now factored explicitly into the Federal Reserve's minimum capital ratios.

Second, there is some evidence that the holdings of low-risk, liquid assets in relation to total assets, particularly by the larger banking organizations, have declined over recent years. This suggests that, while capital to total assets ratios may have improved over time, capital in relation to risk exposure may not have improved commensurately. For the multinational banks, liquid assets (defined as bank certificates of deposit, Fed funds sold and securities maturing within one year) have declined as a percent of total assets

from 15.6 percent at the end of 1981 to 12.8 percent at June 30, 1985. Beyond this, examiners have generally observed decreases in liquid assets at banks regarded as more aggressive with respect to capital management and growth, and it has been argued that existing capital policies provide incentives to deemphasize low-risk, low-yield business.

While there may be a number of reasons for these balance sheet adjustments, the Board is concerned that they may be, in part, a response to the imposition of capital requirements that do not distinguish explicitly among various risk categories of assets and that do not make explicit allowance for the lessened threat to capital inherent in low-risk activities. Thus, some banking organizations appear to be reducing their holdings of low-risk assets and deemphasizing their conduct of low-risk activities in an effort to meet more stringent capital requirements. Although these adjustments may improve or otherwise maintain capital ratios at what appear to be acceptable levels, they do not, especially in conjunction with the growth in off-balance-sheet risks, strengthen an organization's risk profile. Indeed, such adjustments could, under certain circumstances, undermine an organization's financial condition.

Third, increased international competition points toward the need for a greater degree of convergence in the policies of various countries for supervising the capital adequacy of multinational banking organizations. In this

regard, many European countries have developed risk-based capital measures, and a similar supervisory approach is evolving in Japan.

Finally, the growth and change in the nature of risks to which banking organizations have become exposed suggest the need to provide more explicit guidance to bankers and examiners for assessing capital needs in relation to risk.

The Purpose of the Proposed Supplemental Adjusted Capital Measure.

The Board believes that adoption of a supplemental adjusted capital measure based upon an assessment of distinct but necessarily broad risk categories could provide a valuable additional analytical tool in assessing the financial strength and stability of individual organizations and the banking system as a whole. Even such a limited risk-adjusted measure of capital adequacy would provide the Board with a supplemental means of assessing whether the capital level of individual banks and bank holding companies is fully adequate to serve the key functions of capital, namely to provide a buffer to absorb losses in times of poor performance, to promote the safety of depositors' funds, to help maintain public confidence in banking organizations, and to support the reasonable growth of such organizations. To achieve these purposes, it is essential that an organization's capital base bear a reasonable relationship to the risk profile of that organization.

In addition to providing another tool for assessing capital adequacy, the proposed supplemental adjusted capital measure will further certain policy objectives. By including an assessment of off-balance-sheet risk as part of the supplemental adjusted capital ratio, this measure would permit the Board to address off-balance-sheet exposures, which, as indicated above, have expanded rapidly over the last several years. The proposed measure would also temper somewhat the disincentives inherent in the existing Guidelines to hold low-risk, relatively liquid assets. In addition, adoption of this proposal would begin to move capital adequacy policies in the United States more closely in line with those of other major industrial countries. Finally, the proposed measure would provide more explicit guidance to bankers and examiners for relating capital to risk profiles.

2. DESCRIPTION OF THE PROPOSAL

Introduction and Overview

This proposal involves a risk-sensitive capital measure that would supplement the Board's existing Capital Guidelines. The proposal is based upon an additional capital ratio, in this case a ratio of primary capital to total assets adjusted for risk, that the Board will consider in tandem with, rather than in place of, the minimum primary and total capital ratios defined in the current Guidelines. The proposed supplemental adjusted capital measure would be incorporated as an additional section of the current Capital Adequacy Guidelines, Appendix A to Regulation Y, 12 C.F.R. Part 225.

Moreover, while the proposal endeavors to relate in a more systematic fashion an organization's capital needs to its overall risk profile, the proposed supplemental adjusted capital ratio does not purport to take explicit account of all of the many types of risks to which banking organizations are exposed. For example, the proposal does not take explicit account of the risks associated with significant asset concentrations, or with exposure to interest rate changes. In addition, the measure is not intended to substitute for examiner judgment in the assessment of an organization's capital adequacy. If the supplemental capital measure is adopted, examiners and regulators will still be required to consider the entire range of qualitative and subjective factors, such as the quality of an organization's management, internal systems and controls, and lending standards, as well as other relevant financial factors, such as the quality of assets and the strength, trend and variability of earnings and liquidity, in order to assess fully an organization's capital adequacy.

The Supplemental Adjusted Capital Ratio.

The proposed supplemental adjusted capital measure would relate primary capital, as defined in the Board's current Guidelines, to total assets weighted for risk considerations. To determine the asset portion of the supplemental adjusted capital ratio, assets and certain off-balance-sheet items are assigned to one of four broad risk categories and weighted

according to the relative risk of that category. The determination of asset groupings and the assignment of weights primarily reflect credit risk considerations, with some sensitivity to liquidity concerns. The types of assets and off-balance-sheet items in each category and the rationale for assigning certain items to a particular category are discussed below. The proposed amendment to the Guidelines contains a listing of the components of each risk category and the weight assigned to that category.

a. Category I: Cash and equivalents. This category includes assets generally considered to be riskless such as vault cash and balances due from Federal Reserve Banks, balances due from foreign central banks in immediately available funds, and "near cash" assets, such as cash items in the process of collection and transaction accounts due from U.S. depository institutions.^{1/} In addition, United States Treasury securities held in the investment account with original or remaining maturities of one year or less are included in this category. These items are assigned a zero weight.

^{1/} The terms U.S. banks and U.S. depository institutions for purposes of this proposal refer to depository institutions chartered under the laws of the United States and include the foreign branches of these institutions. While banks chartered in the U.S. that are subsidiaries of foreign banking organizations are also included in the definition, U.S. branches and agencies of foreign banks are not considered to be U.S. banks or depository institutions for purposes of the supplemental adjusted capital measure.

b. Category II: Money market risk. The assets included in this category generally have little or no risk of default and a high degree of liquidity. This category includes all holdings of long-term (remaining maturity of over one year) United States Treasury securities, all United States government agency securities, and those portions of loans that are fully guaranteed by the United States government, as well as short-term (90 days or less) claims on U.S. depository institutions. Other money market instruments comprise a significant portion of the remaining assets in this category, including acceptances of other U.S. banks, all Fed funds sold, loans to broker/dealers secured by United States Treasury or agency securities, and securities purchased under agreements to resell. In addition, this category includes all trading account assets, which are typically marked to market on a regular basis. Finally, all legally binding loan commitments, including note issuance facilities^{2/} are included in this category. These items are assigned a 30 percent risk weight.

c. Category III: Moderate risk. This category is composed of those assets with more credit and liquidity risk than those in Category II, but significantly less risk than the standard

^{2/} A note issuance facility is a medium-term (5 to 7 years) commitment to help a borrower obtain short-term financing. Participating banks commit to provide funds under a revolving credit or standby arrangement if the client fails to sell notes within a range of predetermined contractual rates.

commercial bank loan portfolio. Included in this category are: all state, county, and municipal ("SCM") securities (excluding industrial development bonds); longer-term claims (over 90 days) on U.S. depository institutions; all claims on governments and banks in industrial countries (as defined herein); holdings of acceptances of banks in industrial countries; and local currency claims on governments and banks of non-industrial countries to the extent funded by local currency liabilities.^{3/} Also included are loans to broker/dealers collateralized by other marketable securities (as defined by the SEC), commercial letters of credit, and standby letters of credit which are performance-related, or issued on a secured basis to support broker/dealers, or issued in support of SCM securities (excluding those supporting industrial development bonds). This risk category is assigned a 60 percent weight.

d. Category IV: Standard risk. This category generally comprises those assets found in a typical bank loan portfolio and those not included in the categories above. Thus, this category includes commercial and industrial loans and leases, loans to individuals, loans secured by real estate, farm-related loans, and all other claims on foreign borrowers. This category also includes loans to nondepository financial

^{3/} "Banks" are defined to include their foreign branches and are categorized by the country under whose laws they are chartered.

institutions including insurance companies, mortgage companies, finance companies and bank holding companies. The category is further comprised of all corporate securities and commercial paper, industrial development bonds, and all other standby letters of credit (including those backing industrial development bonds) that are not included in categories above. Finally, the category includes loans sold with recourse, including those that, in the case of bank holding companies, may not, under generally accepted accounting principles, be retained as assets on the balance sheet. (Under bank call report instructions, loans sold with recourse are not removed from the balance sheet.) This risk group contains the bulk of banking assets, including many of significantly dissimilar risk characteristics. This category is assigned a 100 percent risk weight.

Table I contains a list of the types of assets and off-balance-sheet items found in each risk category and the weighting of each category.

TABLE I:
RISK CATEGORIES AND WEIGHTS

CASH AND EQUIVALENTS (Weight 0%)

U.S. currency and coin and balances due from Federal Reserve banks
Cash items in process of collection and transaction accounts due from U.S. depository institutions*

* U.S. depository institutions refers to depository institutions chartered under the laws of the United States and the foreign branches of those institutions, and such U.S. depository institutions that are subsidiaries of foreign banking organizations. U.S. branches and agencies of foreign banks are not U.S. depository institutions.

Short-term** U.S. Treasury securities in investment account
Foreign currency and balances due from central banks in immediately available funds

MONEY MARKET RISK (Weight 30%)

Long-term U.S. Treasury securities held in investment account
U.S. Government agency securities held in investment account
Those portions of loans that are fully guaranteed by U.S. Government
Short-term claims (90 days or less) on U.S. depository institutions
Acceptances of other U.S. banks
All Fed funds sold
Loans to broker/dealers collateralized by U.S. Treasury and agency securities, and securities purchased under agreement to resell (RPs)
Assets held in trading account
Legally binding loan commitments (including note issuance facilities)

MODERATE RISK (Weight 60%)

All state, county and municipal (SCM) securities held in investment account (excluding industrial development bonds)
All other claims on U.S. depository institutions
All claims on governments and banks of industrial countries
Acceptances of banks in industrial countries
Local currency claims on governments and banks of non-industrial countries***
Loans to broker/dealers collateralized by other marketable securities
Commercial letters of credit
Standby LCs (net) backing SCM securities (excluding those backing industrial development bonds), supporting broker/dealers on secured basis or performance related

** Short-term Treasury securities are those with an original or remaining maturity of one year or less.

*** To the extent funded by local currency liabilities. If not funded by local currency liabilities, such local currency claims are included in the Standard Risk category.

STANDARD RISK (Weight 100%)

All assets found in a typical bank loan portfolio,
including:

All commercial and industrial loans and leases
Residential real estate and individual loans
Loans to nondepository financial institutions

All other claims on foreign obligors

Corporate securities and commercial paper, and
industrial development bonds

Customers' acceptance liabilities****

All assets not included elsewhere

All other standby LCs (net), including those
backing industrial development bonds

Loans sold with recourse*****

**** Include customers' liabilities associated with acceptance participations purchased. Participations sold are included in Money Market Risk if the purchaser is a U.S. depository institution, Moderate Risk if the purchaser is a bank in an industrial country, and Standard Risk for all other purchasers.

***** Include loans involved in transactions of the type that are required to be reported as borrowings (as opposed to sales) under bank call report instructions. For purposes of the supplemental adjusted capital measure, bank holding companies should include the same type of items in this category even if, under generally accepted accounting principles, such loans sold with recourse may be treated as sales and removed from the balance sheet.

The aggregate dollar value of the items in each category would be multiplied by the weight assigned to that category. The sum of these weighted values would be the weighted risk asset and off-balance sheet total against which actual primary capital would be compared. The ratio derived by dividing primary capital by this weighted total would be defined as the supplemental adjusted capital ratio. Table II provides an example of how this supplemental adjusted capital ratio would be calculated.

Table II:
Illustration of Calculation of Supplemental
Adjusted Capital Measure

<u>Risk Category</u>	<u>Dollar Amount of Items in Category</u>		<u>Risk Weight</u>	<u>Weighted Risk Assets and Off-Balance- Sheet Items</u>
Cash and equivalents	5,000	x	0	0
Money market risk	35,000	x	.30	10,500
Moderate risk	30,000	x	.60	18,000
Standard risk	<u>80,000</u>	x	1.00	<u>80,000</u>
Total (including \$100,000 in aggregate assets and \$50,000 in off-balance sheet items)	150,000			108,500
Aggregate primary capital	7,000			
Primary capital to total assets ratio (as defined under existing Guidelines)	<u>7,000</u> 100,000	=	7.0%	
Supplemental adjusted capital ratio (as proposed)	<u>7,000</u> 108,500	=	6.5%	

Note: This example assumes a bank with total assets (before deducting the loan loss reserve) of \$100,000, off-balance sheet items of \$50,000, and primary capital of \$7,000.

The choice of groupings for assets and off-balance-sheet items reflects an effort to delineate reasonable risk categories while avoiding excess complexity. In addition, the Board paid close attention to the treatment afforded assets and off-balance-sheet items in similar risk asset systems abroad. Finally, decisions on where to slot certain items and where to set relative risk weights were influenced by a desire to avoid artificial pricing distortions which might lead to awkward or undesirable changes in credit flows or financing practices, and to temper the gradation of implied capital costs between items in the various risk categories.

In developing this proposal, the Board made difficult policy decisions involving the treatment of country risk and off-balance-sheet items. First, the proposal draws a distinction between claims on governments and banks in industrial countries, i.e., those presently designated as such by the International Monetary Fund (IMF) and World Bank, versus claims on governments and banks in all other countries.^{4/} This distinction represents the most acceptable alternative among a variety of possible groupings intended to distinguish,

^{4/} Industrial countries as currently designated by the IMF and World Bank include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, United Kingdom, West Germany.

in a broad sense, among differences in transfer risk, that is, the possibility that an asset cannot be serviced in the currency of payment because of a lack of foreign exchange needed for payment in the country of the obligor. The Board views the approach embodied in this proposal as more workable than a country by country evaluation of transfer risk that would require frequent updating and revision.

All claims on banks and governments in industrial countries would be included in the Moderate Risk category. This treatment is designed to minimize the possible distortions in credit flows in the international interbank money market which would result from substantially different capital requirements for claims on domestic and foreign banks competing alongside one another in the market. The list of industrial countries includes just about all countries with significant international banks, while excluding the countries viewed by the market as likely to entail a meaningful degree of transfer risk. Claims involving transfer risk on banks and governments in non-industrial countries, and all claims on private nonbank borrowers in foreign countries, would be included in the Standard Risk category. Although the proposed group of industrial countries for risk asset purposes currently comprises those nations designated as such by the IMF and World Bank, developments in the future could warrant a modification of this designation. Thus, the designation for risk asset

purposes may not at all times coincide with the IMF and World Bank lists.

The proposed treatment of claims on foreign banks incorporated in this proposal differs from the typical approach in risk-based capital measures used in other industrial countries. Generally speaking, those measures assign a very low (often zero) risk weight to claims on their own government, while assigning claims on all other governments to the equivalent of a standard risk category. In terms of interbank claims, however, the typical approach is to combine claims on all foreign and domestic banks and place both of these types of assets in the same relatively low risk category. By and large, this latter approach was developed prior to the advent of significant concerns over country or transfer risk. Therefore, it does not recognize how claims on banks in different countries can be affected by transfer risk, including those claims on banks in the less developed countries which have been involved in extensive debt restructurings. Moreover, such an approach has the anomalous effect of placing claims on foreign banks in a lower risk category than claims on the governments that are generally viewed as providing the safety net for these banks. Finally, assigning a lower risk treatment to claims on foreign banks than on their governments could create unintended incentives to substitute claims on banks for claims on other parties that may be involved in debt restructurings. For these reasons, the Board felt it necessary to depart from the more or less typical approach to the treatment of interbank claims.

The Board also made certain basic decisions involving the treatment of various types of off-balance-sheet items. The proposal divides standby letters of credit into two broad components. The first such component, which is included in the Moderate Risk category, consists of performance bonds, secured letters of credit supporting broker/dealers, and standbys supporting state and local government securities (excluding those supporting industrial development bonds). The second component, which would be assigned to the Standard Risk category, consists of all other standbys, including those backing commercial paper, industrial development bonds, and other financial instruments and loans included in the Standard Risk category. This broad distinction is based on the nature of the underlying credit risk and how that risk would be treated if it were on the balance sheet. The distinction also is generally consistent with the way in which comparable off-balance-sheet items are treated in risk asset frameworks abroad.

The proposal places two other off-balance-sheet items, legally binding commitments and note issuance facilities in the Money Market Risk category. The placement of these items in the Money Market Risk category, rather than a higher risk category, was influenced by the following considerations: (1) these commitments often retain a conditional, as well as contingent, character as a consequence of "adverse material change" clauses and other covenants which may enable banks to

avoid losses by avoiding or curtailing drawdowns; (2) unlike standby letters of credit, when drawings on commitments do occur they carry a greater likelihood that the resulting assets will be of higher quality; (3) supervisors should be evaluating the volume of these commitments in terms of the overall funding capacity of a bank, not just its capital adequacy; and, perhaps most importantly, (4) it seems more appropriate to impose a relatively low capital charge to give banks time to adjust their commitment policies to any amendment to the Guidelines that includes off-balance-sheet risk.

There are other aspects of off-balance-sheet risk associated with securities and foreign exchange trading activities and managing interest rate risk, including interest rate swaps. In this regard, adoption of a supplemental capital measure that takes account of some types of risk may require the use of more refined supervisory techniques to measure (1) risk involved in securities and foreign exchange trading activities at those banking organizations which are heavily involved in such activities, and (2) interest rate exposure resulting from the rate sensitivity of assets, liabilities and off-balance-sheet activities. As discussed below, the Board is seeking comment on how some of these risks might be assessed within the proposed supplemental adjusted capital framework.

Administration of a Risk-Based Capital Measure. As the current Guidelines emphasize with respect to primary and total capital ratios, the proposed supplemental adjusted capital ratio would

be used as a guideline in the assessment of capital adequacy. The Board wishes to emphasize that the introduction and calculation of a supplemental capital measure adjusted to account for some forms of risk would in no way lessen the need for supervisors and examiners to make judgments on capital adequacy--judgments which reflect a broad mix of qualitative and quantitative considerations. Thus, in assessing an organization's capital adequacy, examiners must consider, among other things, the quality, trend and variability of earnings; liquidity and the structure of liabilities; vulnerability to interest rate changes; the quality of management, internal systems and controls and operating procedures; the effectiveness of loan and investment policies; and the quality of loans and investments.

In the assessment of capital adequacy, asset quality considerations are especially critical. These include the risk composition and profile of the loan portfolio, credit and sovereign risk concentrations, and the level and severity of examiner classified and criticized assets. Before an overall assessment of capital adequacy can be made, therefore, examiners must take into account all of these factors, including, in particular, the level and severity of classified assets.

The Board proposes to use the supplemental adjusted capital ratio in tandem with the current primary and total capital-to-total assets ratios. Thus, if this proposal is adopted, individual banking organizations would still be

subject to an overall constraint on total leverage, with the supplemental adjusted capital measure used as an additional guideline designed to encourage banking organizations to make appropriate adjustments in either the risk composition of their portfolios or their overall level of primary capital. To minimize public confusion and facilitate tandem operation, this proposal contemplates eliminating existing zones for total capital, while retaining the current minimum guidelines for the primary and total capital ratios, at 5.5 percent and 6.0 percent, respectively, for all banking organizations.

As is the case under the Board's current Guidelines, this proposal envisions that supplemental adjusted capital ratios would be calculated for all state member banks and bank holding companies on a consolidated basis. (Bank holding companies with less than \$150 million in consolidated assets would be exempt under the same terms and conditions as provided in the current Guidelines.) The risk asset framework would be employed to evaluate the capital of all banking organizations regardless of size since the rationale for relating capital needs to risk profiles applies to both large and small institutions. Nonetheless, it is important to point out that many of the considerations driving the development of this supplemental adjusted capital measure at this time are primarily operative at larger banking organizations. In particular, these institutions have been the primary participants in those off-balance-sheet activities that the proposed standards seek to address, and these organizations in

recent years have also decreased their relative holdings of liquid assets.

In light of these considerations, the Board proposes to establish numerical zones for the supplemental adjusted capital ratio, but to limit the application of such zones to banking organizations with assets of \$1 billion or more (the regional and multinational institutions). For smaller organizations, those with assets totaling less than \$1 billion, supplemental adjusted capital ratios would be computed in the same manner as for larger institutions, but zones would not be employed. Rather a smaller organization's supplemental adjusted capital ratio would be calculated and considered in light of the quality and diversification of its loan portfolio and other local risk considerations. In this regard, it is important to note that the proposed risk-adjusted asset measure is not particularly sensitive to large concentrations of exposure within local communities and lending markets--exposures to which small banks are particularly susceptible. Therefore, small (as well as large) organizations with significant asset concentrations will generally be expected to operate above minimum primary and total capital-to-total assets ratios, even if they have relatively high supplemental adjusted capital ratios.

For organizations with assets of \$1 billion or more, the tandem operation of the supplemental adjusted capital ratio and the minimum primary capital ratio is illustrated by the

following proposed zone descriptions for the supplemental adjusted capital ratio:

1. Zone 1 - Organizations with supplemental adjusted capital ratios in this zone would be presumed to have adequate capital in relation to risk, barring significant asset quality or other financial or operating concerns, including excessive asset concentrations. For these organizations, assets could be increased even if the primary capital-to-total asset ratio dropped close to the existing minimum threshold of 5.5 percent.
2. Zone 2 - Organizations with supplemental adjusted capital ratios in this zone would be considered to have acceptable capital in relation to risk, depending upon where they were within the zone, as well as how the institution fared on the basis of qualitative and financial considerations. Particularly for organizations in the upper half of the zone, there might be scope for asset growth and declines in the primary capital-to-total asset ratio, barring asset quality or other financial concerns.
3. Zone 3 - Supplemental adjusted capital ratios in this zone would be below the minimum acceptable level. Organizations with such supplemental adjusted ratios would be presumed to have inadequate capital in relation to risk even if their primary capital-to-total assets ratios were above the 5.5 percent minimum. Such organizations would be expected to develop and submit to their supervisory authorities plans to bring their supplemental adjusted ratios to an adequate level, either by raising new capital or by adjusting the risk profile of their activities.

The proposal does not specify at this time the actual ratio cutoffs for the various supplemental adjusted capital zones. Instead, it would appear to be more appropriate to receive and evaluate public comments on the supplemental adjusted capital measure and to use the information received in establishing numerical zones. The Board hopes to encourage

commenters to focus their comments on the underlying policy considerations of this proposal rather than on the mechanical features. The Board will provide an additional opportunity for public comment on the numerical zones.

The Board does invite comment on the factors that it should consider in setting the numerical zones. To that end, the Board offers the following comments on how it proposes to set the zones. Since a principal goal of the supplemental adjusted capital measure is to relate capital needs to risk profiles, the Board will attempt to establish zones at levels that would affect primarily any institution with assets in excess of \$1 billion whose capital position is less than fully adequate in relation to its risk profile. Moreover, the Board will attempt to establish numerical zones that are broadly consistent with prevailing aggregate capital levels in the banking system and with the banking system's ability to generate capital from retained earnings and from the issuance of primary capital securities.

Banking organizations will be able to comply with supplemental adjusted capital measures in several ways, some of which do not require raising new external capital. For example, institutions can moderate their growth and/or increase their earnings retention. More importantly, however, within a risk sensitive capital framework, an organization can raise its supplemental adjusted capital ratio by reducing its risk profile over time, even though such on- or off-balance-sheet

adjustments may not necessarily result in lower total assets. This could be done by reducing off-balance-sheet risk or by placing proportionately greater emphasis on those balance sheet activities that carry lower risk weights.

For all of these reasons, it is not possible to state with certainty how much, if any, additional capital would have to be raised in response to the advent of this proposal. It can be said, however, that a measure that relates capital needs to risk profiles should temper the unintended incentives associated with sole reliance on capital-to-total asset ratios and will encourage those organizations with high risk profiles either to raise additional primary capital to support their risk-bearing activities or to curtail the scope of these activities. The Board believes both of these responses will enhance the financial strength of individual organizations and promote the safety and soundness of the banking system.

3. ISSUES FOR FURTHER CONSIDERATION.

While seeking public comments on all aspects of the proposal, the Board requests comment in six specific areas as described below.

First, should the Board further refine the Standard Risk category by adding an additional category that would contain certain specified assets that entail risks higher than those typically associated with the Standard Risk group? In particular, should the Board include a category to take account of the higher risks associated with certain nonbanking activities and the holding of nontraditional loans or assets?

The Board could, for example, assign a weight substantially above 100 percent for all assets held by a particular banking organization in connection with certain high risk activities not considered traditional activities for banking organizations. In the alternative, the Board could consider such nontraditional, high risk activities on a nonconsolidated basis and require appropriately higher capital levels for these nontraditional assets separate and apart from the capital required to support the other assets of the banking organization. Another option would be to deduct the capital invested in these high risk subsidiaries from the consolidated organization's primary capital before calculating the supplemental adjusted capital ratio.

Similarly, the Board seeks comments on whether it should attempt to identify certain types of loans that would be moved from the Standard Risk category and placed in a separate category with a risk weight below 100 percent?

By grouping together a wide array of risks in the Standard Risk category, the proposed supplemental adjusted capital measure could still have some unintended incentives for banks to pursue riskier types of lending or high risk nontraditional activities to bolster income, while, possibly, curtailing loans to high quality, low risk borrowers. In light of this concern, consideration was given to grouping certain assets felt to be significantly riskier than others in a separate high risk category with a risk weight above 100

percent. Similarly, as already noted, several types of assets included in the Standard Risk category, such as loans to high quality, high rated borrowers, arguably could be included in a lower risk category. The principal benefit of such an approach would be that it would relate capital needs more closely to an organization's risk profile. It could also serve to discourage certain high risk activities while avoiding disincentives to direct bank lending to high quality, low risk customers.

The major practical drawback, on the other hand, would be the difficulty of defining the boundary line between the types of financing activities that would be included in high or low risk categories. More importantly, this approach could heighten concern over the potential for the supplemental adjusted capital measure evolving into a credit allocation device, and could be interpreted by some institutions as an indication that they were free to expand the volume of high risk lending provided they held the "correct" amount of capital to support that lending. This would go far beyond the intent of the proposed supplemental adjusted capital measure and could potentially undercut other sources of supervisory discipline designed to limit excessive risk-taking. For these reasons the Board did not propose the division of the Standard Risk category into either an additional higher or lower risk category.

Second, should the supplemental adjusted capital measure attempt to take account of concentration of assets? A

major factor in analyzing the overall risk of banking organizations is the degree of diversification in the loan and investment portfolios. Because undue asset concentrations violate the widely accepted principle of risk diversification, in theory the supplemental adjusted capital ratio could be further refined by including an explicit factor for the level of asset concentrations. Practical difficulties exist, however, in defining appropriate business categories for risk assessment purposes and in assigning a meaningful primary business classification to companies that have diversified into many different types of financial and nonfinancial activities. While the proposal contemplates continuation of the current policy whereby examiners subjectively evaluate asset concentrations, the Board seeks comment on whether asset concentrations should be factored explicitly into the supplemental adjusted capital ratio and, if so, how this might be done on a practical basis.

Third, the treatment of country risk in the proposal represents a choice among imperfect alternatives. The decision to segregate industrial economies from all others was based on the view that, among the alternatives considered, it would minimize possible distortions in credit flows within the interbank market and among countries. The Board also seeks comment on the most appropriate way to deal with broad country risk considerations.

Fourth, while the supplemental adjusted measure attempts to deal with the major forms of off-balance sheet risk, some off-balance sheet activities that typically involve credit risk are not included in the framework. For example, interest rate swaps, in which a bank acts as a counterparty in arranging the exchange of interest payment streams between two third-party borrowers, can involve risk if one party defaults and the bank is obligated to assume the role of the defaulting party and replace the stream of cash flows at current market rates. In light of these considerations, the Board seeks comment on how best to assess and incorporate the credit risks associated with interest rate swaps into the proposed supplemental adjusted capital measure. Moreover, commenters are also asked to identify other significant types of off-balance-sheet risks not addressed by the proposal and how such risks could best be factored into the proposed measure.

An additional example of risk exposure not captured in the proposed supplemental adjusted capital measure involves unconsolidated joint ventures. Banking organizations can be exposed to considerable risks through such unconsolidated joint ventures if these entities issue significant amounts of debt and undertake risk-bearing activities. Despite the fact that such risks may not be fully reflected on the bank's consolidated balance sheet, the banking organization may, in effect, be obligated to support at least its proportionate share of the risk assets of the joint venture or all of the

joint venture's assets if the joint venture encounters problems and the other joint venture partners are unable to provide assistance. The Board seeks public comment on whether to deduct investments in unconsolidated joint ventures from primary capital for the purpose of calculating supplemental adjusted capital ratios or whether to employ an alternative technique to capture the exposure of banking organizations to such joint ventures.

Fifth, it would be desirable to supplement the proposed capital measure with more refined techniques to measure the risk involved in securities and foreign exchange trading activities at those banking organizations which are heavily involved in these activities. This could entail applying to banking organizations some of the guidelines and principles on evaluating trading risks that have been developed by the Federal Reserve Bank of New York for evaluating risk at U.S. Government securities dealers. Thus, the Board seeks comment on techniques for evaluating foreign exchange risk, including how the supplemental adjusted capital measure could treat (i) exchange rate and interest rate risk, (ii) counterparty credit risk, and (iii) futures, options and swaps used in foreign exchange operations.

Similarly, it may be appropriate to develop a more systematic approach to assessing overall interest rate risks (as distinct from credit risks) resulting from the rate sensitivity of assets, liabilities, and off-balance-sheet

activities. Such an approach might be used in conjunction with an adjusted capital measure to evaluate vulnerability to changes in interest rates. Therefore, the Board seeks comment on how to factor interest rate risk into the assessment of capital adequacy.

Finally, the Board seeks comment on the long-run administration of the supplemental adjusted capital measure in relation to the existing minimum primary and total capital-to-total assets ratios. As indicated above, the supplemental adjusted capital ratio is to be used in tandem with the Board's existing minimum primary and total capital ratios. However, as banking organizations restructure their balance sheets and reduce their risk profiles, the minimum capital-to-total assets ratio may become binding and prevent further leveraging, even though an individual organization may have a high and strong supplemental adjusted capital ratio. As experience is gained with the supplemental adjusted capital measure, it may be appropriate to place greater emphasis on this measure over time relative to the capital-to-total assets ratios. In this regard, it may be appropriate in the long-run to reconsider the role of the capital-to-total assets ratios, especially if the supplemental adjusted ratio proves to be a reliable measure of capital needs in relation to overall risk.

Regulatory Flexibility Act Analysis

The Board does not believe that adoption of this proposal would have a significant economic impact on a

substantial number of small business entities, in this case small bank holding companies and state member banks, within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). While all bank holding companies and state member banks would presumably be required to revise their reporting requirements to permit quarterly tracking of supplemental adjusted capital ratios, the proposal contemplates only for regional and multinational banking organizations (that is, those in excess of \$1 billion in assets) the establishment of objective zones for the proposed supplemental adjusted capital ratio.

In addition, this proposal clearly indicates that it is designed primarily to take account of those practices, such as the increased use of off-balance-sheet risk and the decline in the holdings of low-risk, liquid assets, which have been engaged in primarily by certain larger banking organizations and that it is directed at institutions whose capital positions are less than fully adequate in relation to their risk profiles. Moreover, the Board has indicated that zones would be established at levels that are broadly consistent with prevailing aggregate capital levels in the banking industry and with the banking system's ability to generate capital from retained earnings and from the issuance of primary capital securities. It is not anticipated, therefore, that adoption of this proposal would require a substantial number of banking organizations, including smaller banking organizations, to raise additional capital.

This proposal contemplates a new measure of capital adequacy that supplements, but does not replace, existing capital measures. This proposal does not duplicate, overlap or conflict with any existing federal laws and regulations governing state member banks and bank holding companies.

List of Subjects in 12 C.F.R. Part 225. Banks, banking; Federal Reserve System; Holding Companies, Capital Adequacy; State Members Banks.

For the reasons outlined above, the Board proposes to amend Appendix A of 12 C.F.R. Part 225 (Regulation Y) as set forth below:

Part 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

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

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

2. In Part 225, it is proposed to amend Appendix A by deleting the description of total capital zones as follows (Current regulatory language proposed to be deleted appears in brackets.)

Appendix A - Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks

* * *

Capital Guidelines

The Board has established a minimum level of primary capital to total assets of 5.5 percent and a minimum level of total capital to total assets of 6.0 percent. Generally,

banking organizations are expected to operate above the minimum primary and total capital levels. Those organizations whose operations involve or are exposed to high or inordinate degrees of risk will be expected to hold additional capital to compensate for these risks.

[In addition, the Board has established the following three zones for total capital for banking organizations of all sizes:

	<u>Total Capital Ratio</u>
Zone 1	Above 7.0%
Zone 2	6.0% to 7.0%
Zone 3	Below 6.0%]

The capital guidelines assume adequate liquidity and a moderate amount of risk in the loan and investment portfolios and in off-balance sheet activities.

* * *

Supervisory Action

The nature and intensity of supervisory action will be determined by an organization's compliance with the required minimum primary capital ratio as well as by the zone in which the company's total capital ratio falls. Banks and bank holding companies with primary capital ratios below the 5.5 percent minimum will be considered undercapitalized unless they can demonstrate clear extenuating circumstances. Such banking organizations will be required to submit an acceptable plan for achieving compliance with the capital guidelines and will be

subject to denial of applications and appropriate supervisory enforcement actions.

[The zone in which an organization's total capital ratio falls will normally trigger the following supervisory responses, subject to qualitative analysis:

For institutions operating in Zone 1, the Federal Reserve will:

- consider that capital is generally adequate if the primary capital ratio is acceptable to the Federal Reserve and is above the 5.5 percent minimum.

For institutions operating in Zone 2, the Federal Reserve will:

- pay particular attention to financial factors, such as asset quality, liquidity, off-balance sheet risk, and interest rate risk, as they relate to the adequacy of capital. If these areas are deficient and the Federal Reserve concludes capital is not fully adequate, the Federal Reserve will intensify its monitoring and take appropriate supervisory action.

For institutions operating in Zone 3, the Federal Reserve will:

- consider the institution is undercapitalized, absent clear extenuating circumstances;
- require the institution to submit a comprehensive capital plan, acceptable to the Federal Reserve, that includes a program for achieving compliance with the required minimum ratios within a reasonable time period; and
- institute appropriate supervisory and/or administrative enforcement action, which may include the issuance of a capital directive or denial of applications, unless a capital plan acceptable to the Federal Reserve has been adopted by the institution.]

* * *

3. In Part 225, it is proposed to amend Appendix A by adding a Supplemental Adjusted Capital Measure as follows:

Supplemental Adjusted Capital Measure

In addition to its reliance on the ratios of primary capital and total capital to total assets, the Board will assess the capital adequacy of bank holding companies and state chartered banks that are members of the Federal Reserve System, on the basis of a ratio of primary capital to total assets (including certain off-balance sheet items) adjusted for risk. For purposes of the supplemental adjusted capital ratio "primary capital" is comprised of the same components and calculated in the same manner as defined above in the section of these Guidelines entitled "Definition of Capital to be Used in Determining Capital Adequacy of Bank Holding Companies and State Member Banks."

The assets component of the supplemental adjusted capital ratio is computed in accordance with the following list of risk categories and weights. The assets of a bank holding company or state member bank, as well as certain off-balance-sheet items are assigned to one of four broad risk categories. The aggregate dollar value of the assets and off-balance-sheet items in each category is multiplied by the weight assigned to that category. The sum of these weighted values would be the weighted risk asset and off-balance sheet total against which actual capital is compared. The ratio derived by dividing primary capital by this weighted total is the supplemental adjusted capital ratio.

TABLE I:
RISK CATEGORIES AND WEIGHTS

CASH AND EQUIVALENTS (Weight 0%)

- U.S. currency and coin and balances due from Federal Reserve banks
- Cash items in process of collection and transaction accounts due from U.S. depository institutions*
- Short-term** U.S. Treasury securities in investment account
- Foreign currency and balances due from central banks in immediately available funds

MONEY MARKET RISK (Weight 30%)

- Long-term U.S. Treasury securities held in investment account
- U.S. Government agency securities held in investment account
- Those portions of loans that are fully guaranteed by U.S. Government
- Short-term claims (90 days or less) on U.S. depository institutions
- Acceptances of other U.S. banks
- All Fed funds sold
- Loans to broker/dealers collateralized by U.S. Treasury and agency securities, and securities purchased under agreement to resell (RPs)
- Assets held in trading account
- Legally binding loan commitments (including note issuance facilities)

MODERATE RISK (Weight 60%)

- All state, county and municipal (SCM) securities held in investment account (excluding industrial development bonds)
- All other claims on U.S. depository institutions
- All claims on governments and banks of industrial countries

* U.S. depository institutions refers to depository institutions chartered under the laws of the United States and the foreign branches of those institutions, and such U.S. depository institutions that are subsidiaries of foreign banking organizations. U.S. branches and agencies of foreign banks are not U.S. depository institutions.

** Short-term Treasury securities are those with an original or remaining maturity of one year or less.

Acceptances of banks in industrial countries
Local currency claims on governments and banks
of non-industrial countries***
Loans to broker/dealers collateralized by other
marketable securities
Commercial letters of credit
Standby LCs (net) backing SCM securities (excluding
those backing industrial development bonds),
supporting broker/dealers on secured basis or
performance related

STANDARD RISK (Weight 100%)

All assets found in a typical bank loan portfolio,
including:
 All commercial and industrial loans and leases
 Residential real estate and individual loans
 Loans to nondepository financial institutions
All other claims on foreign obligors
Corporate securities and commercial paper, and
industrial development bonds
Customers' acceptance liabilities****
All assets not included elsewhere
All other standby LCs (net), including those
backing industrial development bonds
Loans sold with recourse*****

*** To the extent funded by local currency liabilities. If
not funded by local currency liabilities, such local
currency claims are included in the Standard Risk
category.

**** Include customers' liabilities associated with acceptance
participations purchased. Participations sold are
included in Money Market Risk if the purchaser is a U.S.
depository institution, Moderate Risk if the purchaser is
a bank in an industrial country, and Standard Risk for
all other purchasers.

***** Include loans involved in transactions of the type that
are required to be reported as borrowings (as opposed to
sales) under bank call report instructions. For purposes
of the supplemental adjusted capital measure, bank
holding companies should include the same type of items
in this category even if, under generally accepted
accounting principles, such loans sold with recourse may
be treated as sales and removed from the balance sheet.

Table II:
Illustration of Calculation of Supplemental
Adjusted Capital Measure

<u>Risk Category</u>	<u>Dollar Amount of Items in Category</u>		<u>Risk Weight</u>	<u>Weighted Risk Assets and Off-Balance- Sheet Items</u>
Cash and equivalents	5,000	x	0	0
Money market risk	35,000	x	.30	10,500
Moderate risk	30,000	x	.60	18,000
Standard risk	<u>80,000</u>	x	1.00	<u>80,000</u>
Total (including \$100,000 in aggregate assets and \$50,000 in off-balance sheet items))	150,000			108,500
Aggregate primary capital	7,000			
Primary capital to total assets ratio (as defined under existing Guidelines)	$\frac{7,000}{100,000}$	=	7.0%	
Supplemental adjusted capital ratio (as proposed)	$\frac{7,000}{108,500}$	=	6.5%	

Note: This example assumes a bank with total assets (before deducting the loan loss reserve) of \$100,000, off-balance sheet items of \$50,000, and primary capital of \$7,000.

SUPERVISORY ACTION

While the supplemental adjusted capital ratio establishes a guideline for assessing the capital adequacy of individual banking organizations, the ratio measures only certain types of risk in a general and relatively broad manner. The Board will continue to make judgments on capital adequacy in individual cases, judgments which reflect a broad mix of qualitative and quantitative considerations that may not

be contained in the ratio. The Board will continue to consider, among other things, the quality, trend and variability of earnings; liquidity and the structure of liabilities; vulnerability to interest rate changes; the quality of management, internal systems and controls, and operating procedures; the effectiveness of loan and investment policies; and the quality of loans and investments. Asset quality considerations are especially critical in the assessment of capital adequacy. These include the risk composition and profile of the loan portfolio, credit and sovereign risk concentrations, and the level and severity of examiner classified and criticized assets. The Board will continue to assess capital adequacy by (1) calculating and assessing the supplemental adjusted capital ratio, (2) evaluating all other risk factors and, in particular, (3) taking into account the level and severity of classified assets.

The supplemental adjusted capital ratio is to be used in tandem with the primary and total capital-to-total asset ratios as a guide in determining minimum capital requirements. Individual banking organizations will continue to be subject to constraints on total leverage, with the supplemental adjusted capital ratio as an additional guideline to encourage banking organizations to make appropriate adjustments in either the risk composition of their portfolios or the overall level of primary capital. Banking organizations, however, will be required to maintain primary and total capital ratios at least equal to the minimum levels set forth in these Guidelines.

Supplemental adjusted capital ratios should be calculated for all state-member banks and bank holding companies on a consolidated basis.^{5/} The Board will use the supplemental adjusted capital measure to evaluate the capital of all banking organizations regardless of size, but it has established certain objective standards for the ratios of regional and multinational organizations, i.e., those with more than \$1 billion in consolidated assets.

For organizations with assets of \$1 billion or more, the tandem operation of the supplemental adjusted capital ratio and the minimum primary capital ratio is illustrated by the following zone descriptions for the supplemental adjusted capital ratio.

1. Zone 1 - Organizations with supplemental adjusted capital ratios in this zone would be presumed to have adequate capital in relation to risk, barring significant asset quality or other financial or operating concerns, including excessive asset concentrations. For these organizations, assets could be increased even if the primary capital-to-total asset ratio dropped close to the existing minimum threshold of 5.5 percent.
2. Zone 2 - Organizations with supplemental adjusted capital ratios in this zone would be considered to have acceptable capital in relation to risk, depending upon where they were within the zone,

^{5/} The supplemental adjusted capital ratio for bank holding companies with less than \$150 million in consolidated assets should be calculated on a bank only basis unless (1) the holding company or any nonbank subsidiary is engaged directly or indirectly in any nonbank activity involving significant leverage or (2) the holding company or any nonbank subsidiary has outstanding significant debt held by the general public.

as well as how the institution fared on the basis of qualitative and financial considerations. Particularly for organizations in the upper half of the zone, there might be scope for asset growth and declines in the primary capital-to-total asset ratio, barring asset quality or other financial concerns.

3. Zone 3 - Supplemental adjusted capital ratios in this zone would be below the minimum acceptable level. Organizations with such supplemental adjusted ratios would be presumed to have inadequate capital in relation to risk even if their primary capital-to-total assets ratios were above the 5.5 percent minimum. Such organizations would be expected to develop and submit to their supervisory authorities plans to bring their supplemental adjusted ratios to an adequate level, either by raising new capital or by adjusting the risk profile of their activities.

Since the supplemental adjusted capital ratio does not take explicit account of all risk factors, banking organizations with financial or operating characteristics that are cause for supervisory concern, including significant asset problems (as reflected in the level and severity of classified assets), and undue asset concentrations, will be expected to operate above minimum primary and total capital ratios and, if applicable, above the minimum supplemental adjusted capital ratio.

Board of Governors of the Federal Reserve System,
January 24, 1986.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board