

**FEDERAL RESERVE BANK  
OF NEW YORK**

[ Circular No. 10155 ]  
[ February 25, 1987 ]

**PROPOSED RISK-BASED CAPITAL FRAMEWORK**

**Comment Invited by May 13**

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

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has requested comment on a proposed risk-based capital framework for banks and bank holding companies.

The Board's risk-based capital proposal is based upon the proposed U.S./U.K. Agreement on primary capital and capital adequacy assessment. This proposed Agreement is the result of discussions between the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Bank of England.

The proposal encompasses a common definition of primary capital and risk categories aimed at bringing together the assessment of capital adequacy and the establishment of minimum capital standards on an international basis.

Comments should be received by the Board on this matter by May 13, 1987.

Enclosed — for depository institutions, bank holding companies, and branches and agencies of foreign banks in this District — is the complete text of the proposal, which has been reprinted from the *Federal Register* of February 19, 1987; copies will be furnished to others upon request directed to the Circulars Division of this Bank (Tel. No. 212-720-5215 or 5216). Comments may be sent to the Board of Governors, as specified in the notice, by May 13, 1987.

Questions on the proposal may be directed to Donald E. Schmid, Manager, Bank Analysis Department (Tel. No. 212-720-6611).

E. GERALD CORRIGAN,  
*President.*

Excerpt from

# federal register

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Vol. 52, No. 33

**Proposed Risk-Based Capital Framework**

[Enc. Cir. No. 10155]

## Proposed Rules

Federal Register

Vol. 52, No. 33

Thursday, February 19, 1987

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

### FEDERAL RESERVE SYSTEM

#### 12 CFR Part 225

[Regulation Y; Docket No. R-0567]

#### Capital Maintenance; Revision to Capital Adequacy Guidelines

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Proposed rulemaking.

**SUMMARY:** 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 FR 16057 (1985)). These revised Guidelines, contained in Appendix A to the Board's Regulation Y, 12 CFR 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.

While these ratios of capital to total assets are a useful tool for assessing capital adequacy, the Board believes that there is a need for a measure that is more explicitly and systematically sensitive to the risk profiles of individual banking organizations. As a result, the Board proposed on January 24, 1986, to amend its Guidelines by adding a supplemental adjusted capital measure that the Board would consider in tandem with existing ratios of capital to total assets. Based in part on comments received by the Board on that earlier proposal and extensive discussions with other federal banking agencies and the Bank of England, the Board has revised its January 24, 1986 proposal in a number of respects. The Board is seeking comment on this revised proposal, which would amend the Board's Guidelines to include a risk-based capital measure (also known as a risk asset ratio) to be used in tandem with existing capital ratios, and would

amend the definition of primary capital for purposes of computing existing capital-to-total assets ratios. This revised proposal represents an effort to establish uniform capital standards for all federally supervised banking organizations operating in the United States and to continue the process of coordinating with regulatory authorities of other countries to establish appropriate capital standards, in accordance with the International Lending Supervision Act of 1983 ("ILSA"), 12 U.S.C. 3901 *et seq.*  
**DATE:** Comments must be received by May 13, 1987.

**ADDRESS:** All comments should refer to Docket No. [R-0567], and should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551, or should be delivered to the Office of the Secretary, Room 2223, Eccles Building, 20th and Constitution Avenue NW., between the hours of 9:00 a.m. and 5:00 p.m. weekdays. Comments may be inspected in Room 1119, Eccles Building, between 9:00 a.m. and 5:00 p.m. weekdays.

**FOR FURTHER INFORMATION CONTACT:** Richard Spillenkothen, Deputy Associate Director (202/452-2594), Anthony G. Cornyn, Assistant Director (202/452-3354), Stephen M. Lovette, Manager (202/452-3622), or Roger Pugh, Manager (202/452-5883), Division of Banking Supervision and Regulation, Board of Governors; or James E. Scott, Senior Counsel (202/452-3513), or Conrad G. Bahlke, Attorney (202/452-3707), Legal Division, Board of Governors; or Andrew Spindler, Vice President (212/720-5846), Donald E. Schmid, Manager (212/720-6611), or Jeffrey Bardos, Financial Analyst (212/720-7962), Federal Reserve Bank of New York. For the hearing impaired *only*, Telecommunication Device for the Deaf, Earnestine Hill or Dorothea Thompson 202/452-3544.

#### SUPPLEMENTARY INFORMATION:

##### Background

##### *The Purpose of the Proposed Adjusted Capital Measure*

In announcing its revised Capital Adequacy Guidelines in April, 1985, 50 FR 16057, the Board expressed its continuing concern that the emphasis in the Guidelines on ratios based on the

amount of total 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 that: (1) It would assess the overall capital position of a banking organization by taking into account both the volume of the organization's risk assets and its off-balance sheet risks (although the latter were not explicitly included in the capital ratios); (2) the ratios stated in the Guidelines 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) 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 assessing capital adequacy on the basis of the total quantity of assets, there would be significant analytical value to a systematic evaluation of capital based upon the degree of risk associated with such assets.

In an effort to address the degree of risk associated with certain assets and off-balance sheet exposures, the Board issued for public comment on January 24, 1986, a proposal to add a supplemental adjusted capital measure to the Board's Capital Adequacy Guidelines for bank holding companies and state member banks.

In recent months, the Federal Reserve staff has worked with the staffs of the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC") and the Bank of England to devise a method for bringing the capital requirements of U.S. and U.K. banking organizations into closer alignment, and to facilitate further international convergence of capital requirements among other major industrialized nations, consistent with the terms of ILSA. Discussions between these U.S. banking agencies and the Bank of England have resulted in the proposed United States/United Kingdom Agreement ("U.S./U.K. Agreement")

that is the basis for this revised proposal. The text of the proposed Agreement is attached to this Federal Register Notice. In light of the discussions resulting in the U.S./U.K. Agreement, and comments submitted in connection with the Board's January 1986 proposal, the Board continues to believe that there is a need to modify or supplement the Board's Guidelines to include greater sensitivity to certain types of risk exposures of individual banking organizations.

In its January 1986 proposal, the Board stated its belief that a supplemental adjusted capital measure, based upon an assessment of distinct but necessarily broad risk categories, could prove useful in assessing the financial strength and stability of individual organizations and the banking system as a whole. The Board believes that its revised risk-based capital proposal, based upon the U.S./U.K. Agreement, would provide the Board with an additional means of assessing whether the capital level of an individual bank or bank holding company is adequate to serve the key functions of capital, namely, providing a buffer to absorb losses in times of poor performance, promoting the safety of depositors' funds, maintaining public confidence in banking organizations, and supporting the reasonable growth of such organizations. This revised proposal attempts to achieve these purposes by requiring 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 Board's revised proposed capital measure will further the policy objectives of its January 1986 proposal by addressing the rapid expansion of off-balance sheet exposures, tempering the disincentives inherent in the existing Guidelines to hold low-risk, relatively liquid assets, and moving capital adequacy policies in the United States more closely in line with those of other major industrial countries so as to develop a framework for achieving greater international convergence in the supervision of capital positions of large international banking organizations. Finally, the proposed measure would provide more explicit guidance to bankers and examiners for relating capital to risk profiles.

The Board's revised proposal differs in several respects from its January 1986 proposal, primarily as a result of further discussions with the OCC and the FDIC, review of the public comments on the January 1986 proposal, and actions to coordinate the proposals of the three

federal banking agencies with the views of the Bank of England. Some of the major differences between this revised proposal, which is based on the proposed U.S./U.K. Agreement, and the January 1986 proposal, are discussed below.

First, the January 1986 proposal did not address the definition of capital. However, the Board believes that a common understanding of what constitutes primary capital, as incorporated in the proposed U.S./U.K. Agreement, is an essential part of any effort to achieve greater convergence of capital requirements on an international basis. To that end, the Board's revised proposal includes a definition of primary capital that would revise the definition contained in the Board's current Guidelines. The revised definition of primary capital would be used in calculations of both a risk-based capital ratio and the primary and total capital-to-total assets ratios specified in the Board's current Guidelines. Thus, while the proposed risk-based measure would be used in tandem with existing measures, as was proposed in the Board's January 1986 proposal, the numerator of the existing primary and total capital-to-total assets ratios would be redefined. The revised proposal creates two categories of primary capital: base primary capital, which consists of certain primary capital funds that would be counted in full in the calculation of capital ratios; and limited primary capital, which would be included to a limited extent as primary capital in calculating capital ratios. The proposal also includes certain deductions from primary capital for purposes of calculating these capital ratios.

Second, as set forth in the proposed U.S./U.K. Agreement, the regulatory authorities intend to set a uniform minimum ratio of adjusted primary capital to weighted risk assets applicable to banking organizations in both the United States and the United Kingdom. Moreover, the proposal is intended to serve, in part, as a vehicle to seek broader convergence in the assessment of the capital adequacy of international banking organizations. In contrast, the Board's January 1986 proposal would have applied to only U.S. banking organizations. As the proposed U.S./U.K. Agreement points out, most institutions would be expected to operate with capital ratios above the minimum level. At this time, the Board is seeking comments on the terms and structure of the revised proposal, and has decided to defer proposing a

numerical minimum risk-based capital ratio.

Third, the Board's revised proposal includes five categories of risk assets, to be weighted at 0, 10, 25, 50, or 100 percent, depending on the identity of the obligor and, where appropriate, on the maturity of the instrument. (See Table 1 on page 28). These categories represent a change from the Board's January 1986 proposal, which included four categories of risk assets: 0, 30, 60, and 100 percent. This change results in a somewhat lower risk weight for many of the assets originally assigned to the 30 and 60 percent risk asset categories and a somewhat higher weight for some items originally assigned to the 0 percent category. In addition, the list of assets that would be assigned to each category differs in some significant respects from the list proposed in the Board's January 1986 proposal.

Fourth, the Board's revised proposal does not distinguish between claims on foreign banks or governments based upon the identity of the foreign country. The revised proposal also places claims on U.S. banks in the same risk category as claims on foreign banks. The January 1986 proposal generally placed claims on foreign banks and governments of industrial countries in a lower risk category than claims on foreign banks and governments of nonindustrial countries, and generally placed short-term claims on U.S. banks in a lower risk category than similar claims on foreign banks.

Fifth, in the case of off-balance sheet items, risk weights are determined by a two-step process, rather than by a simple categorization of off-balance sheet items in one of the risk asset categories, as suggested in the January 1986 proposal. First, the face amount of each off-balance sheet item is multiplied by an appropriate "credit conversion factor," a ratio designed to translate the face amount of certain off-balance sheet exposures into rough on-balance sheet credit equivalents. (See Table 2 on page 29.) The resulting figure is then placed in one of the five risk asset categories and included in the asset component of the risk-based capital ratio. (See Table 3 on pages 30 and 31.) This revised treatment results in risk weights for some off-balance sheet items that are slightly lower than the weights originally proposed.

Sixth, the Board's revised proposal includes loan commitments to consumers as a form of credit commitment that requires some capital support. The January 1986 proposal did not define such loan commitments to

include explicitly commitments to extend credit to consumers.

The general construction of most aspects of the Board's revised proposal remains similar to that of the Board's January 1986 proposal. First, an institution's risk-based capital ratio continues to be determined by dividing its primary capital base by the sum of its weighted risk assets. The weighted risk assets are determined by assigning all assets (as well as off-balance sheet items) to appropriate risk categories. An illustration of how the proposed ratio would be calculated is contained in Table 3 on pages 30 and 31.

Second, this revised proposal contemplates, as did the January 1986 proposal, that the calculation of a risk-based capital ratio is only one step in evaluating capital adequacy. Many other factors must be taken into account in connection with the examination and supervisory processes before an overall determination of capital adequacy can be made, including the quality and diversification of the loan portfolio, the quality, trend and variability of earnings, the dividend payout ratio and the level and trend of retained earnings, liquidity and the structure of liabilities, the effectiveness of loan and investment policies, and management's overall ability to monitor and control risks. Of these factors, asset quality is particularly critical. Thus, while not explicitly incorporated into the proposed risk-based ratio, the assessment of capital adequacy must take account of the composition of the loan portfolio, including foreign or domestic loan concentrations, and the level and severity of problem and classified assets. Adjustments based upon these factors made by examiners and supervisors mean that the final supervisory judgment of an organization's capital adequacy may differ significantly from conclusions that might be drawn solely from the absolute level of the organization's risk-based capital ratio.

Third, as in the January 1986 proposal, the revised risk-based capital framework contemplates that U.S. banking regulators would apply the minimum risk-based capital ratio to all banking organizations that they supervise. Thus, the Board would apply the proposed measure to all state member banks and to bank holding companies with consolidated assets of \$150 million or more. Bank holding companies with less than \$150 million in consolidated assets would generally be exempt from the calculation and analysis of risk-based capital ratios on a consolidated holding company basis

under the same terms and conditions as provided in the current Guidelines.<sup>1</sup> The application of the risk-based capital framework to both large and small banking organizations will avoid the possible introduction of a dual standard based upon size.

Fourth, the revised proposal does not factor in all types of risk, and it contemplates, as did the January 1986 proposal, continued efforts to evaluate and refine the risk-based ratio. Under the proposed U.S./U.K. Agreement, the Board, the OCC, the FDIC and the Bank of England are committed to continue efforts to develop techniques for factoring counterparty credit risks on interest rate swaps and other interest rate and foreign exchange contracts into the risk-based capital ratio in the near future. In addition, the proposed U.S./U.K. Agreement indicates a commitment to introduce a capital requirement for exchange rate risk. Finally, the Agreement also reflects a commitment to factor a more direct measure of overall interest rate risk into the capital ratio. In the interim, the proposed U.S./U.K. Agreement addresses interest rate risk in a limited manner by assigning higher risk weights to long-term domestic national government debt.

#### The Proposed Definition of Capital

The proposed risk-based capital ratio would relate an institution's adjusted primary capital (the numerator of the ratio) to its weighted risk assets (the denominator). One of the principal qualities of primary capital is that it is freely available to absorb current losses while permitting an organization to continue to function as a going concern. Under the proposed U.S./U.K. Agreement, primary capital is defined for purposes of the risk-based ratio to consist of two classes of capital funds: "base primary capital," that is, capital funds treated as primary capital without limit, and "limited primary capital," that is, primary capital funds that are limited to a specified percentage of base primary capital. The types of capital that would be considered to be base primary capital and limited primary capital are discussed below. The proposed Agreement includes a listing of the components of the two categories of primary capital.

<sup>1</sup> The current Guidelines apply to bank holding companies with less than \$150 million in consolidated assets on a bank-only basis unless (1) the holding company or any nonbank subsidiary is engaged directly or indirectly in any nonbank activity involving significant leverage or (2) the holding company or any nonbank subsidiary has outstanding debt held by the general public.

#### 1. Base Primary Capital: Capital Funds That Are Treated as Primary Capital Without a Percentage Limitation

These capital funds include common stockholders' equity (common stock, surplus and retained earnings); general reserves for unidentified losses (including the allowance for losses on loans and leases, but excluding reserves that, in effect, have been allocated for known losses such as the "allocated transfer risk reserve"); and minority interests in the equity accounts of consolidated subsidiaries.

Although the proposed U.S./U.K. Agreement includes general (valuation) reserves as base primary capital, U.S. and U.K. regulators agree that provisions made against identified losses should not be regarded as primary capital. Such provisions, having been set aside to absorb identified losses, cannot be viewed as being freely available to absorb estimated or anticipated, but unidentified, losses, a principal function of primary capital.

#### 2. Limited Primary Capital: Capital Funds That Are Treated as Primary Capital Subject to a Percentage Limitation

Limited primary capital is considered to be primary capital to the extent that on a combined basis it does not exceed 50 percent of the amount that results from subtracting from base primary capital all intangible assets, including those intangible assets that are otherwise considered "grandfathered" intangible assets as discussed below. Existing limited primary capital instruments in excess of this limitation would be "grandfathered" and, therefore, included in primary capital, provided that such limited primary capital instruments were issued prior to the final adoption of the risk-based capital ratio and only to the extent that such limited primary capital instruments complied with the Board's then existing definition of primary capital and with the related limitations on the amounts of such instruments included in primary capital. However, if the grandfathering provision causes the aggregate amount of limited primary capital instruments to exceed the amount permitted under this proposal as based upon the U.S./U.K. Agreement, new limited primary capital instruments would not be included as primary capital until the new limited primary capital instruments, together with the grandfathered instruments, comply with the new proposed limitation on the amount of limited primary capital.

Limited primary capital funds include: perpetual preferred stock<sup>2</sup> and limited-life preferred stock with an original maturity of at least 25 years<sup>3</sup>; debt that is subordinated to deposits (or, for bank holding companies, debt that is unsecured) and that meets the new criteria set forth in the proposed U.S./U.K. Agreement for inclusion in primary capital; and the amount of mandatory convertible securities that were issued before the final adoption of the risk-based ratio and that counted as primary capital under the Board's then existing guidelines.

Although the Board has established a policy that common stockholders' equity should remain the dominant form of capital, the Board believes that the inclusion of some long-term limited-life preferred stock as primary capital is appropriate. The Board believes it would be appropriate to adjust for the amount of limited-life preferred stock included in primary capital by discounting such limited-life preferred stock with an original maturity of 25 years or more as maturity approaches. This discounting process is necessary because as limited-life preferred stock approaches maturity it must either be redeemed or refunded, thereby becoming more like a current liability and less like a component of capital. The Board is seeking comment on the best method of discounting limited-life preferred stock for capital adequacy purposes as maturity approaches. One such discounting method would be to discount the original outstanding balance for capital assessment purposes by 20 percent each year during the instrument's last five years before maturity. The amount of outstanding limited-life preferred stock that is not included in primary capital as a result of this discounting process would be included in secondary capital, provided it meets the general criteria in the Guidelines for inclusion in secondary capital.

The proposed U.S./U.K. Agreement also establishes new criteria for including debt instruments in primary capital. These criteria are designed to ensure that such debt instruments (a) are permanent; (b) provide strength and

loss absorption capacity and, when serious losses occur, permit the organization to continue to operate as a going concern; and (c) provide the issuer with the option, under certain conditions, to defer interest payments during periods of serious financial adversity.

The new criteria for state member banks and bank holding companies, which are essentially similar to those incorporated in the Board's existing definition of perpetual debt, are:

(i) The instruments must be subordinated to deposits or, if issued by bank holding companies, unsecured.

(ii) The instruments can only be converted into or redeemed with equity or equity equivalents. This means that (a) the instrument cannot provide the holder with any right to demand repayment of principal (even in the event of non-payment of interest), except in the event of bankruptcy, insolvency or reorganization; and (b) the issuer cannot voluntarily redeem the securities without the approval of the Federal Reserve, except that securities may be simultaneously replaced by a like amount of capital instruments that qualify as primary capital under the U.S./U.K. Agreement's new definition.

(iii) The instruments must be available to absorb losses when necessary to allow the organization to continue to operate as a going concern. Thus, the instrument must convert automatically to common or preferred stock that qualifies as primary capital in the event that the issuer's retained earnings and surplus accounts become negative.

(iv) The instruments must provide the option for the issuer to defer (they may also allow the issuer to reduce or eliminate) cash interest payments if the issuer does not report a profit in the preceding period (defined as combined profits for the most recent four quarters) and/or the issuer eliminates cash dividends on common and preferred stock. This provision is intended to provide the issuer with the option of mitigating the burden associated with interest payments during a period of severe financial stress.

Any debt instrument meeting these broad criteria, so long as the debt instrument does not contain other provisions inconsistent with safe and sound banking practices, would qualify as primary capital. Mandatory convertible securities, as presently defined by the Federal Reserve, would henceforth be included in primary capital only to the extent that such instruments also satisfy the proposed criteria set forth above. Thus, mandatory convertible instruments that

provide for conversion to equity and deferment of interest in accordance with the criteria specified above would qualify as primary capital. Moreover, mandatory convertible securities issued before the date that the risk-based capital ratio is finally adopted by the Board and that comply with the then existing, but not the new, criteria for inclusion in primary capital would be "grandfathered" as limited primary capital. However, only the amount of such mandatory convertible securities that was included in primary capital under the previous limitations would be grandfathered.

### 3. Deductions From Primary Capital

The Board's revised proposal, and the U.S./U.K. Agreement on which the proposal is based, calculate adjusted primary capital by first adding base primary capital and limited primary capital, and then deducting all intangible assets (except "grandfathered" intangible assets as discussed below), equity investments in unconsolidated subsidiaries and associated companies, and investments in certain consolidated subsidiaries as discussed below.

All intangible assets, other than those previously approved or permitted by the Board under its current Guidelines, would be deducted from primary capital. Generally, the Board's current guidelines do not deduct any intangibles from bank holding company capital and include all intangibles, except goodwill, in the capital of state member banks. Thus, the specific intangibles that were acquired before the final adoption of the risk-based ratio and that were permitted to be included in bank holding company and state member bank capital under the Board's then existing Guidelines would not be deducted from primary capital. Rather, such intangible assets would be grandfathered for a limited, but as yet unspecified, period of time, such as the assets' useful lives or a shorter period. Intangible assets acquired after the date of final adoption of the risk-based ratio would be deducted from primary capital. It should be noted that specific intangible assets would be grandfathered; existing dollar amounts of intangibles would not be permanently grandfathered. Moreover, while goodwill, along with all other intangibles acquired after the ratio is adopted, would be deducted from primary capital for the purpose of assessing capital adequacy, the Board may on a case-by-case basis exempt from this deduction goodwill and other intangibles acquired in connection with

<sup>2</sup> Perpetual preferred stock is defined as preferred stock that does not have a stated maturity date and may not be redeemed at the option of the holder of the instrument.

<sup>3</sup> Limited-life preferred stock currently is considered to be an element of secondary capital; thus, the U.S./U.K. Agreement represents a change from the Board's current Capital Adequacy Guidelines. The maturity of limited-life preferred stock is defined as the stated maturity date or the earliest point in time at which the instrument can be redeemed at the option of the holder, if the latter comes first.

a supervisory merger with a failing institution.

Because the manner in which intangible assets are grandfathered may have a significant impact on an institution's capital ratios, the Board is seeking public comment on the most appropriate approach for grandfathering intangible assets, including the possible adoption of an approach that would grandfather intangible assets for the lesser of the useful lives of such intangible assets or some other specified period of time, such as ten years, shorter than the useful lives of such intangibles.

While U.S. regulators intend to grandfather existing intangible assets for the purpose of calculating capital ratios, the Federal Reserve will continue to monitor the level and quality of all intangible assets and, as it does now, to consider tangible as well as stated capital ratios in assessing an organization's overall capital adequacy. In this regard, the Board expects banking organizations experiencing substantial growth, internally or through acquisitions, to maintain strong capital positions substantially above minimum supervisory ratios without significant reliance on intangibles, particularly goodwill.

The revised risk-based proposal contemplates deducting equity investments in all unconsolidated subsidiaries and associated companies, including joint ventures,<sup>4</sup> from capital, the numerator, as well as from the denominator of both the proposed risk-based ratio and the existing capital-to-total-assets ratios. The Board believes that because the assets of unconsolidated subsidiaries and associated companies are not fully reflected in a banking organization's consolidated total assets, such assets are the equivalent of off-balance sheet assets. Although such assets are not explicitly taken into account in calculating a banking organization's capital ratio, they nonetheless expose the organization to risk. For this reason, the Board believes that it would be appropriate to view the equity capital invested in these entities as primarily supporting the risks inherent in these off-balance sheet assets, and not generally available to support risks elsewhere in the organization. Thus, the proposal provides for the deduction of the equity capital supporting these activities from an organization's consolidated primary capital. While this

treatment suggests that the assets of unconsolidated subsidiaries and joint ventures would not be included in the calculation of an organization's consolidated risk-based capital ratio, the Federal Reserve would continue to evaluate the capital adequacy of these entities and their potential impact on the consolidated organization.

Under this revised proposal and the proposed U.S./U.K. Agreement, the Board will evaluate the activities of other consolidated subsidiaries in order to determine whether to deduct investments in such activities from primary capital and, if so, how such deductions should be made. Such determinations could be made through amendments to the Board's Capital Guidelines (or other regulations) for all subsidiaries engaged in certain activities, or could be made on a case-by-case basis in light of prudential considerations. For example, the Board has already proposed, in connection with its proposed rulemaking concerning bank holding company investments in real estate development activities, that investments in subsidiaries engaged in such real estate development activities would be deducted from capital in determining compliance with capital adequacy guidelines. As has been the case regarding real estate activities, 52 FR 543 (January 7, 1987), the Board would normally seek comment on any proposed regulatory amendment to deduct investments in certain other subsidiaries for the purpose of assessing capital adequacy.

Under the proposed Agreement, the Bank of England would continue its current practice of deducting from capital all interbank holdings of capital, that is, holdings of capital securities issued by other banks. U.S. regulatory agencies have agreed to monitor banking organizations' holdings of capital instruments issued by other commercial banking organizations and may, on a case-by-case basis, require the deduction from primary capital of holdings of primary capital instruments issued by other banking organizations. Such deductions would be made in the case of reciprocal or other formal or informal arrangements in which banking organizations swap primary capital instruments in order to raise their capital ratios without in reality raising new capital funds. Deductions would not be made in the case of legitimate interstate "stake out" investments that comply with the Board's Policy Statement on Nonvoting Equity Investments, 12 CFR 225.143. Moreover, holdings of capital instruments issued by other banking organizations but

taken in satisfaction of debts previously contracted would also be exempt from any deduction from primary capital.

#### Proposed Weights for Assets and Off-Balance Sheet Activities

Although the January 1986 proposal did not contemplate any changes in the manner in which primary capital is defined for purposes of a risk-based ratio, both the January 1986 proposal and this revised proposal provide that primary capital, as determined, be compared with a banking organization's total assets weighted for risk considerations in order to determine a risk-based capital, or risk asset, ratio. Under this revised proposal, each of a banking organization's assets is assigned to one of five 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 and interest rate risk.

This revised proposal and the proposed U.S./U.K. Agreement on which it is based contain some significant modifications to the January 1986 proposal, some of which have already been briefly mentioned above. First, a "credit equivalent" approach is used in weighting the risks of off-balance sheet activities. Under this approach, the face amount of an off-balance sheet item is multiplied by a credit conversion factor, and the resulting amount is assigned to the appropriate risk category depending upon the identity of the obligor and, in certain cases, the maturity of the instrument.

Second, the revised proposal explicitly includes commitments to extend credit to consumers within the category of commitments for which a capital requirement is being proposed. As discussed more fully below, such consumer credit lines would be multiplied by a credit conversion factor to reach a credit equivalent amount. That amount would then be included in a bank's asset figure in accordance with the risk categories discussed below. The explicit inclusion of consumer credit lines as commitments represents a change from the Board's January 1986 proposal.

Third, although the revised proposal does not explicitly recognize general forms of collateral or guarantees in calculating asset risk, the proposal recognizes collateral in the form of cash and U.S. Treasury, Government agency and Government-sponsored agency securities, and guarantees by the U.S. Government and Government agencies. (The definitions of Government agencies

<sup>4</sup> The definitions of unconsolidated subsidiaries, associated companies, and joint ventures are contained in the instructions to the Bank Report of Condition and the consolidated Bank Holding Company FR Y-9 Report.

and Government-sponsored agencies are discussed below.) Thus, the proposal includes in the 25 percent risk category claims fully collateralized by cash on deposit in the lending institution or by U.S. Government or Government agency securities, and portions of claims guaranteed by the U.S. Government or U.S. Government agencies. Claims collateralized by U.S. Government-sponsored agency debt are assigned to the 50 percent weight category. The Board's proposal thus recognizes the risk-reducing effects of collateral in the form of U.S. Government securities and cash, but does not explicitly take account of any other form of collateral, guarantees or credit enhancements. However, all forms of collateral and guarantees are considered by examiners in evaluating asset quality and are taken into account in making an overall assessment of capital adequacy.

Fourth, this proposal does not explicitly incorporate transfer risk distinctions among foreign countries in assigning assets and off-balance sheet items to risk categories. The Board's January 1986 proposal placed short-term claims on U.S. banks in a lower risk category than similar claims on foreign banks. The Board's earlier proposal also further distinguished between claims on banks and governments in industrial versus non-industrial countries, based on the IMF and World Bank's list of industrial market economies. This revised proposal treats claims on all banks, foreign and domestic, in an equivalent fashion and places in the standard risk category claims on *all* foreign governments that involve transfer risk.

Although the proposed risk-based capital ratio thus does not take account of transfer risk distinctions among foreign countries, transfer risk will continue to be monitored closely in the examination process, and banks with large exposures to high-risk countries will be required to maintain capital positions above the minimum ratios. Evaluation of transfer risk on an individual basis is consistent with the requirements of section 904 of ILSA, 12 U.S.C. 3903 (a), (b), which provides that federal banking agencies shall establish examination and supervisory procedures to assure that such foreign country exposure and transfer risk are taken into account in evaluating the capital adequacy of banking institutions.

In incorporating explicit distinctions among foreign countries in its January 1986 proposal, the Board had hoped that the use of an appropriate list or simple, objective criteria to account for transfer risk would be more practical than

country-by-country evaluations that would require frequent updating and publication. However, the Board removed explicit transfer risk distinctions among foreign countries for several reasons. The list of industrialized countries compiled by the IMF, while perhaps more acceptable than possible alternatives, is not based upon prudential criteria or transfer risk considerations. Moreover, it is difficult to develop simple, objective criteria that effectively distinguish countries with high and low degrees of transfer risk. Finally, the treatment of country risk contained in the Board's January 1986 proposal could be viewed as different from the typical approach used in the risk-based capital measures of other countries, which assign a low risk weight to claims on their own governments or groups of affiliated governments, while assigning claims on all other governments to the equivalent of a standard risk category. Thus, the January 1986 proposal might have conflicted with the Board's stated goal of converging United States capital policies with those of other industrial countries.

While the revised proposal does not incorporate explicit transfer risk distinctions among foreign countries, transfer risk considerations are not totally absent from the proposal. Thus, as described below, local currency claims on foreign central governments are placed in a relatively low (25 percent) risk category *to the extent* the bank has local currency liabilities booked in offices located in the foreign country. The reason for this is that such claims constitute national government obligations that do not involve transfer risk. All foreign government obligations that involve transfer risk (that is, all other claims on foreign governments) are assigned to the standard (100 percent) risk category.

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 and in the proposed U.S./U.K. Agreement. Generally, unless otherwise specified, short-term assets are defined as claims with a remaining maturity of one year or less; long-term assets are defined as claims with a remaining maturity of more than one year. The following tables provide a summary of major risk-based asset and off-balance sheet items as they pertain to state member banks and bank holding companies, and an illustration of how the proposed risk-based capital ratio would be calculated.

Table 1

Summary of Risk Weights and Major Risk Categories for State Member Banks and Bank Holding Companies

*0 percent*

Cash—domestic and foreign  
Claims on Federal Reserve Banks

*10 percent*

Short-term (one year or less) claims on  
U.S. Government and its Agencies

*25 percent*

Cash items in process of collection  
Short-term claims on domestic  
depository institutions and foreign  
banks, including foreign central banks  
Long-term claims on U.S. Government  
and its Agencies  
Claims (including repurchase  
agreements) collateralized by cash or  
U.S. Government or Agency debt  
Claims guaranteed by the U.S.  
Government or its Agencies  
Local currency claims on foreign central  
governments to the extent that bank  
has local currency liabilities  
Federal Reserve Bank stock

*50 percent*

Claims on U.S. Government-sponsored  
Agencies  
Claims (including repurchase  
agreements) collateralized by U.S.  
Government-sponsored Agency debt  
General obligation claims on states,  
counties and municipalities  
Claims on multinational development  
institutions in which U.S. is a  
shareholder or contributing member

*100 percent*

All other assets not specified above,  
including:

Claims on private entities and  
individuals  
Long-term claims on domestic and  
foreign banks  
All other claims on foreign governments  
and private obligors

Table 2

Summary of Off-Balance Sheet Items and Conversion Factors for State Member Banks and Bank Holding Companies

*Direct credit substitutes* (financial guarantees and standby letters of credit serving the same purpose)—100 percent credit conversion factor.

*Trade-related contingencies* (commercial letters of credit, bid and performance bonds and performance standby letters of credit)—50 percent credit conversion factor.

*Sale and repurchase agreements and asset sales with recourse*, if not already included on the balance sheet—100 percent credit conversion factor.

*Other commitments*, including overdraft facilities, revolving underwriting facilities (RUFs/NIFs), underwriting commitments, commercial and consumer credit lines. The credit conversion factors are:

10 percent—one year and less original maturity<sup>1</sup>

25 percent—over one to five years original maturity

50 percent—over five years original maturity

**Credit Conversion Factor To Be Determined**

Interest rate swaps and other interest rate contracts.

Foreign exchange rate contracts.

**Table 3**

The following table illustrates the calculation of the risk-based capital ratio, as proposed in the U.S./U.K. Agreement. This example assumes a banking organization with \$100,000 in total assets, \$50,000 in certain off-balance sheet credit equivalent amounts, and \$7,000 in adjusted primary capital as defined by the proposal.

Risk category	On-balance sheet and credit equivalent amounts	Risk weight	Weighted risk assets and off-balance sheet items
0 Percent .....	\$5,000	×	0
10 Percent .....	10,000	×	0.10
25 Percent .....	30,000	×	0.25
50 Percent .....	20,000	×	0.50
100 Percent .....	85,000	×	1.00
Total (including \$100,000 in total assets and \$50,000 in credit equivalent off-balance sheet items, as derived in the example below) .....	150,000		103,500
Adjusted primary capital .....	7,000		
Risk-based capital ratio (as proposed) .....	7,000	=	6.8%
	103,500		

The following table illustrates the calculation of the "credit equivalent" value of selected off-balance sheet items by multiplying the principal amount by the appropriate "credit conversion factor." Each credit equivalent value would subsequently be assigned to one of the five risk categories (in the table

<sup>1</sup> Maturity is defined as the stated maturity date or the earliest possible time at which the bank may unconditionally cancel the commitment, if the latter comes first.

above) depending on the identity of the obligor.

Off-balance sheet item	Principal amount	Credit conversion factor	On-balance sheet credit equivalent amount
Standby letter of credit (financial guarantees).....	\$40,000	×	1.00 = \$40,000
Commitment with original maturity of three years.....	20,000	×	0.25 = 5,000
Commercial letter of credit.....	10,000	×	0.50 = 5,000
Total.....	70,000		50,000

**a. Category I: Zero Weight**

For U.S. banking organizations, this category includes vault cash (domestic and foreign) and balances with and claims on Federal Reserve Banks, excluding Federal Reserve Bank stock.

**b. Category II: 10 Percent**

This category includes short-term claims on the U.S. Government and U.S. Government agencies, that is, federal agencies whose debt obligations are explicitly guaranteed by the full faith and credit of the U.S. Government. The placement of such claims in a 10 percent category is based on the view that although short-term claims on the U.S. Government bear no credit risk, such claims could involve some interest rate exposure. Moreover, such claims normally are highly liquid.

**c. Category III: 25 Percent**

This category includes short-term interbank claims and assets that normally have little or no risk of default and a significant degree of liquidity. The specific items included in this category are: Short-term claims (including demand deposits) on domestic depository institutions<sup>5</sup> and all foreign banks<sup>6</sup> (including foreign central

<sup>5</sup> Domestic (U.S.) depository institutions are defined to include both the U.S. and foreign branches of banks and depository institutions chartered and headquartered in the U.S. The term includes U.S. chartered banks and depository institutions owned by foreigners, but excludes U.S. branches and agencies of foreign banks. In addition to banks, domestic depository institutions include mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, and international banking facilities of domestic banks and depository institutions.

<sup>6</sup> Foreign banks are defined as organizations that are organized under laws of a foreign country; engage in the business of banking; are recognized as banks by the bank supervisory or monetary authorities of the country of their organization or principal banking operations; receive deposits to a substantial extent in the regular course of business; and have the power to accept demand deposits. Claims on foreign banks are defined to include

banks);<sup>7</sup> cash items in the process of collection, both foreign and domestic; claims (including repurchase agreements) fully collateralized by cash on deposit in the lending institution or U.S. Government or U.S. Government agency debt; portions of loans guaranteed by the U.S. Government or U.S. Government agencies; local currency claims on foreign central governments<sup>8</sup> to the extent that a bank has local currency liabilities booked in that foreign country; and long-term claims on the U.S. Government and U.S. Government agencies.

Several elements of this category differ from those included in the Board's January 1986 proposal. As noted above, treatment of claims on foreign banks differs from the Board's original proposal in that foreign banks are assigned to the same risk category as U.S. banks, and no distinction is made among foreign banks based upon country of origin. The decision to include in this category short-term claims with maturities of one year or less on all banks reflects comments in response to the Board's January 1986 proposal that the inclusion in a low-risk category of only claims with maturities of three months or less would discourage intermediate-term lending and could have a negative impact on interbank funding markets.

The assignment of short-term claims on all banks, foreign and domestic, to the 25 percent category reflects a recognition of the importance of facilitating the smooth and efficient functioning of the interbank funding markets and a desire to avoid discouraging banks from holding liquid interbank claims. This treatment also reflects a recognition of the fact that national governments generally have established supervisory frameworks to promote the stability of their banking systems.

In general, as already indicated, the revised proposal does not explicitly recognize collateral or guarantees. However, the revised proposal includes

claims on the U.S. branches and agencies of the foreign banks.

<sup>7</sup> Short-term claims are included in this category regardless of the form of the instrument, that is, this category includes federal funds sold, certificates of deposit, Eurocurrency placements, repurchase agreements, and bankers acceptances for which the account party is a domestic depository institution or a foreign bank.

<sup>8</sup> Foreign governments are defined to include the central government and its ministries, departments, and agencies; they do not include state, provincial or local governments in foreign countries or government-owned enterprises. In addition, claims on foreign governments do not include claims on non-governmental entities guaranteed by foreign governments.

in Category III claims fully collateralized by cash on deposit in the lending institution or by U.S. Government or Government agency securities, and portions of claims guaranteed by the U.S. Government or U.S. Government agencies. As noted below, claims on U.S. Government-sponsored agencies (as defined below), and claims collateralized by U.S. Government-sponsored agency debt, are assigned to the 50 percent category. The Board's revised proposal thus recognizes the risk-reducing effects of collateral in the form of U.S. Government securities and cash.

The framework does not explicitly take account of any other form of collateral, guarantees or so-called credit enhancements. Thus, collateral in the form of foreign government debt, bank securities, or domestic local government debt, or guarantees issued by foreign or domestic local governments or banks, do not affect the assignment of claims to risk categories. In addition, the risk-based proposal does not explicitly recognize guarantees in the form of the sale of risk participations in bankers acceptances or standby letters of credit, or credit enhancements in the form of standby letters of credit backing outstanding loans or investments. This latter treatment differs to some degree from the Board's January 1986 proposal which recognized explicitly the sale of risk participations in bankers acceptances. The main reasons for this change were to bring the proposed treatment of these particular items into line with the proposal's general approach to guarantees and to coordinate the Federal Reserve's proposal with the views of the other regulatory authorities.

The regulatory authorities do not wish to discourage legitimate arrangements designed to reduce credit exposure. Thus, collateral and guarantees are currently and will continue to be considered by examiners in evaluating asset quality and are taken into account, along with other relevant factors, in making an overall assessment of capital adequacy. The presence of guarantees and collateral, if prudently administered and controlled, may mean that an organization can operate with lower levels of capital (although still at or above the minimums) than would otherwise be required if the organization had not taken steps to limit its credit exposure.

Nonetheless, there are several reasons for this very limited recognition of collateral and guarantees. First, recognition of collateral more broadly would significantly complicate the ratio

and could greatly expand any reporting requirements established to monitor the risk-based measure. Second, the existence of collateral may not always preclude losses since legal or operational problems could arise affecting a bank's control over or access to underlying collateral. Third, guarantees are only as good as the strength of the guarantor; thus, explicit recognition of guarantees beyond what is contained in the proposal would suggest the need to make individual credit judgments on guarantors, judgments that would appear to be better left to the on-site examination. Finally, guarantees vary in content, and may contain clauses or conditions that could limit the protection provided to the lender under certain circumstances. All of these factors suggest that the effect of collateral and guarantees on bank exposure are more appropriately evaluated in the course of the on-site supervisory examination.

The Board's January 1986 proposal assigned trading account assets to the 30 percent risk category. The revised proposal does not incorporate this approach; rather, all assets, including trading account assets, are assigned directly to the appropriate risk category depending upon the identity of the obligor and, if applicable, the maturity of the instrument. Many of the assets currently in bank trading accounts, such as U.S. Government and agency securities, short-term obligations of banks, and general obligation municipal securities are assigned weights of 25 or 50 percent, well below the 100 percent weight that is implicit in the Board's existing capital-to-total assets guidelines. Nonetheless, the Board recognizes that as banking organizations become involved in trading a wider range of non-government securities, it may be desirable to recognize explicitly the different risks inherent in trading account assets that are readily marketable and marked to market on a frequent basis. Thus, the Board seeks comment on how the risks associated with trading account assets might be assessed and how such assets might be treated in a risk-based capital framework.

The inclusion in Category III of local currency claims on foreign central governments to the extent a bank has local currency liabilities booked in that foreign country recognizes that such claims are debt obligations of national governments that do not involve transfer risk. All other claims on foreign governments are assigned to the 100 percent category.

The proposed U.S./U.K. Agreement assigns short-term domestic central government securities to the 10 percent category and long-term central government securities to the 25 percent category. This maturity break is intended to recognize an element of interest rate risk in long-term government securities, as well as the liquidity inherent in short-term securities, pending the development of a more direct and comprehensive approach to assessing overall interest rate risk. Nonetheless, it has been argued that since domestic central government securities bear no credit risk, both short- and long-term securities should be assigned to the same risk category, perhaps the 0 or 10 percent category. While the risk-based capital ratio is intended to focus primarily on credit risk, the 0 percent category seems inappropriate in view of the fact that even a government securities portfolio involves some operational and interest rate risks. On the other hand, placing long-term Government securities in the 10 percent category could understate the potential for interest rate exposure. Thus, in the absence of a more comprehensive measure of interest rate risk, the Board is proposing to incorporate the maturity break for U.S. Government securities as set forth in the proposed U.S./U.K. Agreement. The Board recognizes the importance of a consistent approach to interest rate risk and seeks public comment on this issue.

#### *d. Category IV: 50 Percent*

This category includes assets that have more credit risk than the assets categorized above, but generally less credit risk than the standard commercial bank loan portfolio. This category includes claims on U.S. Government-sponsored agencies, that is, agencies originally established or chartered by the federal government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government. It also includes claims fully collateralized by U.S. Government-sponsored agency debt and direct claims on multinational development banks in which the U.S. government is a shareholder or contributing member. The latter would include, among other institutions, the World Bank and the Inter-American Development Bank. Category IV also includes general obligation claims on domestic state and local governments.

If a claim is secured by two forms of collateral that are recognized explicitly in the proposal but placed in different risk categories, such as U.S. Government

debt and U.S. Government-sponsored agency debt, the claim would be assigned to the higher of the two risk categories, provided that the claim is fully collateralized. Any claim that is not fully secured, based upon current market value, would be placed in the risk category appropriate for an unsecured claim to the obligor.

*e. Category V (Standard Risk): 100 Percent*

All assets not included in the categories above are assigned to this category. If it appears that a claim could be assigned to more than one category, for example, a long-term claim on a bank (100 percent) secured by U.S. Government debt (25 percent), the claim should be assigned to the lower of the two risk categories.

The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category. Such assets include: long-term claims on domestic depository institutions and foreign banks; all other claims on foreign central governments (including local currency claims on foreign central governments that exceed local currency liabilities in that foreign country), that is, claims on foreign governments that entail transfer risk; and all other assets including commercial and industrial loans and lease financing receivables, residential real estate and consumer loans, corporate securities and commercial paper, all other claims on foreign private obligors, and investments in fixed assets and premises. This category also includes loans to nondepository financial institutions, such as insurance companies, mortgage companies, and finance companies, as well as loans to depository and nondepository financial institution holding companies, including bank holding companies. This category also includes domestic tax-exempt state and local government revenue and industrial development bonds.

*f. Off-Balance Sheet Items*

As noted above, the Board's January 1986 proposal assigned both assets and certain off-balance sheet items directly to an appropriate risk category. By contrast, this proposal follows the treatment outlined in the proposed U.S./U.K. Agreement, that is, a two-step credit equivalent approach to determining off-balance sheet risk. The face amount of an off-balance sheet item is multiplied by a credit conversion factor (see Table 2 above) and the resulting amount is assigned to the appropriate risk category depending upon the identity of the obligor and, in certain cases, on the maturity of the

instrument.<sup>9</sup> The Board believes that the proposed credit equivalent approach provides supervisors greater flexibility for factoring new off-balance sheet instruments into a risk-based capital calculation.

The proposed U.S./U.K. Agreement applies a 100 percent conversion factor to direct credit substitutes, defined to include financial guarantees and standby letters of credit backing outstanding financial claims of the account party. These direct credit substitutes would include standby letters of credit, or other equivalent irrevocable obligations or surety arrangements, that "back" or guarantee repayment of commercial paper, tax-exempt securities, or other commercial or individual loans or debt obligations. In addition, sale and repurchase agreements and asset sales with recourse (to the extent not already included on a financial institution's balance sheet) are converted at 100 percent of their face amount.<sup>10</sup>

Conversion of these items at the 100 percent level reflects the view that the credit risk associated with these items is broadly equivalent to the risks associated with on-balance sheet items. By issuing such instruments, a bank has the same credit risk with respect to a customer that it would have if it made a direct extension of credit to the customer. This treatment of standby letters of credit is also consistent with the fact that such exposures are generally covered by statutory limits on loans to a single borrower, warrant the same credit review and approval process as traditional loans, and are treated and analyzed like loans by bank examiners and supervisors.

The Agreement proposes that trade-related contingencies be converted at 50 percent. Such trade-related contingencies include commercial letters of credit and performance standby letters of credit. The latter includes obligations backing the performance of nonfinancial or commercial contracts or undertakings. To the extent permitted by law or regulation, performance standby letters of credit would include arrangements backing, among other things, subcontractors' and suppliers' performance, labor and materials

<sup>9</sup> Credit equivalent amounts of off-balance items that are secured by recognized collateral (that is, cash or debt of the U.S. Government, Government agencies or Government-sponsored agencies) are assigned, as with on-balance sheet exposures, to the appropriate risk category based upon the nature of the collateral.

<sup>10</sup> A bank's purchases of risk participations in bankers acceptances are also included and converted at 100 percent and assigned to the appropriate category depending upon the identity of the account party.

contracts, and construction bids. The conversion of trade-related contingencies at the 50 percent level is based on the view that the counterparty involved in such contingencies has a strong incentive to meet its obligations if it wishes to continue to conduct its day-to-day commercial business. Moreover, such trade-related contingent obligations are often short-term, and banks have maintained that their loss record on these instruments is favorable.

The credit conversion factors proposed for other commitments, including overdraft facilities, revolving credit facilities, note issuance facilities, and commercial and consumer commitments, are tied to the *original* maturity of the commitment. Maturity in this regard is defined by the earliest possible point in time that the bank can, at its option, *unconditionally* cancel its commitment to a borrower. As is apparent from the above discussion, maturity is generally not a factor in assigning loans to risk categories because once a direct loan has been made the funds are disbursed to the borrower, the bank is fully exposed on the entire amount of the loan, and deterioration of a loan with a short stated maturity can, nonetheless, result in a long-term exposure for the lender. However, with respect to a loan commitment, the longer the term of the commitment the greater the risk since there is a greater likelihood the borrower's financial circumstances or condition may change during the period the commitment is outstanding. Thus, under the proposal, commitments with an original maturity of one year or less would be converted at 10 percent; those with an original maturity of over one year and up to and including five years would be converted at 25 percent; and those with an original maturity of more than five years would be converted at 50 percent.

The Board's January 1986 proposal aggregated commitments and assigned them directly to the 30 percent asset risk category. Thus, the U.S./U.K. proposal places a lower weight on short- and intermediate-term commitments and a higher weight on long-term commitments than incorporated in the Board's January 1986 proposal. In addition, the Board's January 1986 proposal did not explicitly include obligations in the form of credit card and consumer commitments, which include home equity lines and mortgage commitments, in the risk categories, as this proposal does. The Board is seeking comment on the proposed definition and treatment of commitments, particularly the inclusion of commitments to consumers in the form of credit card

lines, home equity lines and mortgage commitments.

Commitments, for risk-based capital purposes, are defined as any arrangements that legally obligate a banking organization to purchase loans or securities, or extend credit in the form of loans or leases, participations in loans and leases, overdraft facilities, revolving credit or underwriting facilities, or similar transactions. Generally, commitments involve a written contract or agreement, or a commitment fee or some other form of consideration. For the purpose of calculating the risk asset ratio, the definition includes, as noted above, commitments that obligate the banking organization to extend credit to consumers or individuals in the form of retail credit cards, check credit and overdraft facilities, home equity and mortgage lines, and other similar arrangements.

Commitments are to be included in the risk asset ratio regardless of whether they contain "material adverse change" clauses or other provisions that are intended to relieve the bank of its funding obligation under certain conditions. However, lending arrangements that are unconditionally cancelable at any time at the option of the bank would not be deemed to be commitments for risk asset purposes, *provided that* the bank, in fact, makes a separate credit decision based upon the borrower's current financial condition before each drawing under the lending facility. Arrangements under which a banking organization agrees to extend credit for a specified period, even if unconditionally cancelable at any time, would constitute commitments for risk-based capital purposes if the bank does *not* make an individual decision based upon the borrower's financial condition at the time each extension of credit or drawing under the lending facility is made. As already noted, the proposed definition is intended to include the unused portion of credit card lines.

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

In the case of commitments structured as syndications, the risk asset

framework includes only the banking organization's proportional share of such commitments. In addition, only the unused portion of commitments are treated as off-balance sheet items. Amounts that are already drawn and outstanding under a commitment appear on the balance sheet and such amounts, therefore, should not also be included as commitments for purposes of computing the risk asset ratio.

The definition of the maturity of commitments in connection with revolving credit facilities raises a number of questions. Such arrangements typically entail (i) a commitment period during which the borrower has access to a revolving credit facility, and (ii) conversion of the outstanding balance to a term loan at a specified future date. Thus, the maturity of such commitments could be defined in terms of the duration of the revolving credit facility only, or in terms of the combined period of the revolving credit facility and the term loan. The Board seeks public comment on the appropriate manner by which to define the maturity of these types of commitments, as well as on the broader issue of the definition of commitments incorporated in this proposal.

#### Administration of a Risk-Based Capital Measure

As the current Guidelines emphasize with respect to primary and total capital ratios, the proposed risk-based ratio would be used as a guideline in the assessment of capital adequacy. The Board wishes to emphasize that the introduction of a risk-based capital ratio 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.

The proposed U.S./U.K. Agreement upon which the Board's proposal is based provides that banking authorities will emphasize the risk-based capital ratio. However, the Agreement leaves each banking agency free to use other capital ratios in assessing capital adequacy. In this regard, the Board intends to use the risk-based capital ratio in tandem with current capital-to-total-assets ratios. This means that individual banking organizations would still be subject to an overall constraint on total leverage (although the revised definition of capital proposed in the risk-based capital measure would apply to the leverage ratios as well as to the risk-based capital ratio), with the proposed risk-based capital ratio 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.

Under the tandem operation of the risk-based capital and capital-to-total assets (leverage) ratios, banking organizations in strong financial condition and with risk-based capital ratios well above the risk-based minimum might be allowed to reduce their ratios of primary and total capital to total assets (that is, increase their leverage) closer to the existing 5.5 percent and 6.0 percent supervisory minimums. This would be permitted only to the extent that such banking organizations did not face significant risks, such as excessive loan concentrations or problem loans, significant interest rate exposure, or other financial, managerial or operational deficiencies, and only to the extent that reductions in ratios of capital to total assets were carried out in a manner consistent with sound banking practices. Normally, as long as the total leverage constraints are in place, banking organizations would not be permitted to reduce their capital-to-total assets ratios below the supervisory minimums.

The use of the risk-based capital ratio in tandem with existing supervisory guidelines would not result in inconsistent supervisory treatment since most banking organizations have capital-to-total assets ratios above the current supervisory minimums. Thus, the proposed risk-based capital ratio and current supervisory guidelines will complement each other by providing a framework for evaluating capital in relation to risk as well as overall leverage. As experience is gained in the application of the risk-based ratio, the Board may consider whether the existing capital-to-total assets ratios should be reduced, phased out or eliminated. In this regard, the Board seeks public comment on whether, in the long run, some form of total leverage constraint should be retained and what factors should be considered in making this determination.

As is the case under the Board's current Guidelines, this proposal envisions that risk-based 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 applies to both large and small institutions.

The proposed U.S./U.K. Agreement indicates the intention to establish a minimum ratio of adjusted primary capital to total assets weighted for risk for U.S. and U.K. banking organizations. However, as stated in the proposed Agreement, most banking institutions would generally be expected to operate above the minimum risk-based capital level. Supervisors would be able to establish risk-based capital ratios or guidelines above the minimum standard for individual banking institutions. In addition, the Board is requesting comment on whether it should adopt zones or benchmarks above the minimum acceptable risk-based capital ratio. Such zones or benchmarks would be used to designate risk-based capital ratios that would be considered adequate, barring other significant financial, managerial, supervisory or operating problems. If risk-based ratio zones were to be established, such zones would replace the zones in the Board's current Guidelines for total capital to total assets in order to avoid confusion and excessive complexity.

The proposed U.S./U.K. Agreement does not specify at this time the actual minimum risk-based ratio, nor is the Board proposing at this time any specific benchmarks or zones above the minimum. Instead, it would appear to be more appropriate to encourage respondents to focus on the underlying policy considerations and the proposed definitions and framework of this proposal, rather than on where the minimum risk-based capital level should be set.

Banking organizations will be able to comply with the risk-based capital measure in several ways, some of which do not require raising new external capital. For example, an organization can moderate its growth and/or increase its earnings retention. More importantly, however, within a risk-sensitive capital framework, an organization can raise its capital ratio by reducing its risk profile. 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. If an individual banking organization is required to raise additional capital in order to comply with the risk-based capital guidelines, the organization would be asked to submit a plan, acceptable to the Federal Reserve, that includes a program for achieving compliance with the required ratios within a reasonable period of time.

#### Issues for Further Consideration

Since the issuance of the Board's supplemental adjusted capital proposal in January 1986, the Board has received public comment on the proposal and the concept of a risk-based capital measure in general. The Federal Reserve staff has worked with the staffs of the FDIC and OCC to maintain uniform capital standards for all federally supervised banking organizations in the United States. In addition, the staffs of the Federal Reserve, FDIC and OCC have coordinated with the staff of the Bank of England to develop the agreement that provides the basis for this revised proposal. Nevertheless, significant questions remain and the Board is seeking comments in the specific areas described below.

1. The proposed U.S./U.K. Agreement, upon which the Board's proposal is based, provides that banking authorities will emphasize the risk-based capital ratio. However, the Agreement leaves each banking agency free to use other capital ratios in assessing capital adequacy. In this regard, the Board intends to use the risk-based capital ratio in tandem with current capital ratios. The Board seeks comment on whether the risk-based capital ratio should eventually replace the existing capital-to-total assets ratios. Stated differently, should some form of total leverage constraint be retained? What factors should be considered in making this determination? In addition, should the proposed redefinition of primary capital apply, as is now proposed, to the Board's current capital Guidelines as well as to a risk-based capital measure, or should the proposed redefinition apply only to the proposed risk-based capital measure?

2. The proposed U.S./U.K. Agreement states that the regulatory authorities intend to establish a minimum level of primary capital to weighted risk assets, although most institutions will be expected to operate above the minimum. Should the Board supplement the proposed minimum risk-based capital ratio with the use of zones above the minimum acceptable ratio—similar to but replacing the zones currently incorporated in the Board's existing Capital Guidelines—for the purpose of measuring appropriate or adequate levels of risk-based capital?

3. While the proposed U.S./U.K. Agreement focuses on primary capital, it indicates that the regulatory authorities will consider other measures of capital adequacy. In addition to the Board's proposed ratio of primary capital to weighted risk assets, should the Board establish a minimum ratio of *total*

capital (defined as primary capital plus secondary capital) to weighted risk assets for U.S. banking organizations?

4. The U.S./U.K. Agreement proposes capital requirements for commitments, including commitments to extend credit to consumers in the form of credit card lines, home equity lines, mortgage commitments, and overdraft facilities. How should commitments be defined for risk-based capital purposes? Should the Board consider commitments to consumers to be different, in terms of risk exposure, from commitments to commercial borrowers? What is the most appropriate way to treat commitments to consumers in light of the supervisory objective of relating capital to risks assumed by banks?

5. Adoption of the proposed U.S./U.K. Agreement would modify the criteria for including certain non-common equity instruments in primary capital. Are the criteria for defining limited forms of primary capital and the limitations that apply to these instruments reasonable? Are the criteria consistent with the concepts of loss absorption capacity and permanence, two major characteristics that determine the quality of capital instruments? How will such criteria affect the ability of organizations to raise primary capital in the form of preferred stock and perpetual debt? What is the most appropriate way to discount limited-life preferred stock with an original maturity of 25 years or more for prudential purposes as it approaches maturity?

6. The proposed U.S./U.K. Agreement defines primary capital to include general reserves for losses resulting from charges to earnings (that is, the valuation reserve for losses on loans and leases). The proposal also states, however, that specific reserves for identified losses should not be included in primary capital since such reserves are not generally available to absorb estimated, but unidentified, losses. Given the practical difficulty of distinguishing between specific and general reserves, the proposed Agreement provides that the banking agencies will seek comment on whether loan loss reserves should be phased out of primary capital.

Valuation reserves have historically been included in U.S. bank capital because they are deemed to be available to absorb estimated or anticipated (but not identified) losses inherent in the loan portfolio. However, it could be argued that such reserves should be excluded from primary capital to the extent that such reserves actually reflect known or identified losses, or to the extent that banks are reluctant to charge

off loans because such action would reduce their primary capital ratios. This argument reflects the view that the capital base exists to absorb unidentified losses and should not be inflated by the presence of a high volume of known or identified problem loans.

7. The proposed Agreement provides that intangible assets be deducted from primary capital for the purposes of calculating the risk-based capital ratio, but proposes to grandfather intangibles acquired before the final adoption of the risk-based capital framework. Two approaches to grandfathering are possible: (1) Intangibles could be grandfathered for their useful lives; or (2) they could be grandfathered for a specific period, such as 10 years, if such a period is shorter than the useful life. By what method should the Board grandfather intangible assets for purposes of deducting intangible assets from capital in calculating supervisory capital ratios?

8. Should the Board revise the definition of adjusted primary capital for the purpose of calculating daylight overdraft limits to be consistent with the definition of capital proposed by the U.S./U.K. Agreement?

9. Should risk-based capital ratios be calculated from period-end or average data?

10. As discussed above, should the risks associated with trading account assets be incorporated explicitly into the risk-based capital ratio, and, if so, how might this be done? What would be the rationale in terms of risk exposure for assigning trading account assets a different weight than the weight assigned to the same assets held for investment purposes? If assets held in trading accounts are to be given a different weight than if they are held as investments, how should trading account assets be specifically defined and delimited to distinguish them from assets held for investment purposes?

11. The Board's proposal incorporates a maturity break for U.S. Government securities as a proxy for dealing with an element of interest rate exposure. However, the U.S./U.K. Agreement acknowledges that interest rate risk is best dealt with in a more comprehensive fashion. What alternatives exist for addressing interest rate risk in a more comprehensive manner within the risk asset framework?

#### 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 state member banks would presumably be required to revise their reporting procedures to permit supervisory monitoring of risk-based capital ratios, the major aspects of this proposal would generally apply only to bank holding companies with assets of \$150 million or more.

In addition, this proposal is designed primarily to take account of those practices, such as the increased use of off-balance sheet risk and the decline in the holdings of low-risk, liquid assets, which have been engaged in primarily by certain larger banking organizations. Moreover, rather than requiring all banking organizations to raise additional capital, this proposal is directed at institutions whose capital positions are less than fully adequate in relation to their risk profiles. While some additional reporting requirements would be imposed by this proposal, the Board will attempt to minimize the additional requirements, to use existing forms and collected data where possible, and to eliminate or reduce existing reporting requirements to offset to the extent possible any additional reporting burden.

#### List of Subjects in 12 CFR Part 225

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

#### PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

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

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

2. The Board proposes to revise Appendix A to 12 CFR Part 225 as follows:

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

The Board of Governors of the Federal Reserve System has adopted minimum capital ratios and guidelines to provide a framework for assessing the adequacy of the capital of bank holding companies and state member banks (collectively "banking organizations"). The guidelines generally apply to all state member banks and bank holding companies regardless of size and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board of Governors will review the guidelines from time to time for possible adjustments commensurate with changes in

the economy, financial markets, and banking practices.

The guidelines include a ratio that relates adjusted primary capital to assets and certain off-balance sheet items weighted for risk considerations (risk-based capital ratio) and ratios that relate adjusted primary capital and total capital to total assets. The definitions of adjusted primary capital and total capital and the procedures for calculating the risk-based capital ratio and the adjusted primary and total capital-to-total assets ratios (primary capital and total capital ratios) are set forth in the definitional sections of these guidelines.

#### I. Appropriate Capital Levels

The Board has established minimum levels of capital for bank holding companies and state member banks, including a minimum risk-based capital ratio of — percent, a minimum primary capital ratio of 5.5 percent and a minimum total capital ratio of 6.0 percent. Since no capital ratio takes account of all risk factors, banking organizations are generally expected to operate above these minimum capital levels and maintain capital positions that are consistent with the organizations' overall risk exposure.

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

	Total capital ratio (percent)
Zone 1.....	Above 7.0
Zone 2.....	6.0 to 7.0
Zone 3.....	Below 6.0

The capital guidelines apply to both banks and bank holding companies on a consolidated basis.<sup>1</sup> Some banking organizations are engaged in significant nonbanking activities that typically require capital ratios higher than those of commercial banks alone. The Board believes that, as a matter of both safety and soundness and competitive equity, the degree of leverage common in banking should not automatically extend to nonbanking activities. Thus, nonbank subsidiaries of a banking organization should maintain levels of capital consistent with the levels that have been established by industry norms or standards, by Federal or state regulatory agencies for similar firms that are not affiliated with banking organizations, or that may be established by the Board after taking into account risk factors of a particular industry. The assessment of an organization's

<sup>1</sup>The guidelines will apply to bank holding companies with less than \$150 million in consolidated assets on a bank-only basis unless (1) the holding company or any nonbank subsidiary is engaged directly or indirectly in any nonbank activity involving significant leverage or (2) the holding company or any nonbank subsidiary has outstanding significant debt held by the general public. Debt held by the general public is defined to mean debt held by parties other than financial institutions, officers, directors, and principal shareholders of the banking organization or their related interests.

consolidated capital adequacy must take into account the amount and nature of all nonbank activities, and an institution's consolidated capital position should at least equal the sum of the capital requirements of the organization's bank and nonbank subsidiaries as well as those of the parent company.

## II. Supervisory Action

The nature and intensity of supervisory action will be determined by an organization's compliance with minimum supervisory ratios and its overall financial condition. Banks and bank holding companies with risk-based capital ratios below the — percent minimum or 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.

An organization's compliance with minimum risk-based and primary capital ratios and the zone in which the 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 risk-based and primary capital ratios are acceptable to the Federal Reserve and are above the supervisory minimums.

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

—Pay particular attention to the risk-based capital ratio and to financial factors, such as asset quality, asset concentrations, liquidity, 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 that 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.

Institutions with risk-based capital ratios below the minimum supervisory ratio will also be subject to these Zone 3 enforcement actions, even though their primary and total capital ratios comply with supervisory minimums.

While the risk-based capital ratio establishes a general framework for assessing the capital of an individual banking

organization in relation to risks, the ratio measures only certain types of risk in a general and relatively broad manner. The Board will 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 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 assess capital adequacy by (1) calculating and assessing the risk-based capital ratio, together with the primary and total capital ratios, (2) evaluating all other risk factors and, in particular, (3) taking into account the *level* and *severity* of classified assets.

The Board has determined that it will deduct all intangible assets from primary capital for the purpose of determining compliance with minimum supervisory capital guidelines, except that intangibles included in capital prior to the adoption of these risk-based guidelines will continue to be treated as primary capital to the degree and in the amount that the Board included such intangibles in primary capital previously under its guidelines. While the Board has "grandfathered" intangibles acquired prior to the adoption of these risk-based capital guidelines, the Federal Reserve will continue to monitor the level and quality of all intangible assets and may consider tangible as well as stated capital ratios in assessing an organization's capital adequacy. Banking organizations experiencing substantial growth, either internally or through acquisitions, should maintain strong capital positions above minimum supervisory ratios without significant reliance on intangibles, particularly goodwill.

## III. Definition of capital to be used in determining capital adequacy of bank holding companies and State member banks

### A. Primary Capital Components

Primary capital consists of two classes of capital funds: "Base primary capital," that is, capital funds treated as primary capital without limit, and "limited primary capital," that is, primary capital funds that are limited to a specified percentage of base primary capital. The types of capital that would be considered to be base primary capital and limited primary capital are discussed below.

1. *Base primary capital: Capital funds that are treated as primary capital without a percentage limitation.* The components of base primary capital are:

- Common stock,
- Surplus (relating to common stock),
- Undivided profits or retained earnings,
- Allowance for possible loan and lease losses (exclusive of reserves allocated for

identified losses, such as transfer risk reserves), and

—Minority interest in the equity accounts of consolidated subsidiaries.

2. *Limited Primary Capital: Capital funds that are treated as primary capital subject to a percentage limitation (set forth below).* The components of limited primary capital are:

—Perpetual preferred stock<sup>2</sup> and limited-life preferred stock with an original maturity of at least 25 years,<sup>3</sup>

—Debt that is unsecured and subordinated (in the case of a bank) to deposits, that may only be converted into or redeemed by equity or equity equivalents, and that meets the additional criteria set forth below for inclusion in primary capital, and

—Mandatory convertible securities that were issued before the risk-based capital ratio was adopted by the Board and that meet the "grandfather" conditions set forth below.

Limited primary capital is considered to be primary capital to the extent that on a combined basis it does not exceed 50 percent of the amount that results from subtracting from base primary capital *all* intangible assets, including those intangible assets that are otherwise considered "grandfathered" intangible assets as discussed below. Existing limited primary capital instruments in excess of this limitation will be "grandfathered" and, therefore, included in primary capital, provided that such limited primary capital instruments were issued prior to the final adoption of the risk-based capital ratio and only to the extent that such limited primary capital instruments (1) complied with the Board's definition of primary capital prior to adoption of the risk-based capital ratio and (2) do not exceed the amounts eligible for treatment as primary capital prior to adoption of the risk-based capital ratio. If the grandfathering provision causes the aggregate amount of limited primary capital instruments to exceed the 50 percent limitation, new limited primary capital instruments will not be included as primary capital until the new limited primary capital, together with the grandfathered instruments comply with the limitation on limited primary capital.

3. *Restrictions on treatment of 25-year limited-life preferred stock as primary capital.* Limited-life preferred stock with an original maturity of 25 years or more is to be discounted for the purpose of calculating limited primary capital as it approaches maturity. This discounting process is necessary because as limited-life preferred stock approaches maturity it must either be redeemed or refunded, thereby becoming more like a current liability and less like a component of capital. For capital assessment purposes, the original outstanding balance is to be discounted by 20 percent each year

<sup>2</sup> Perpetual preferred stock is defined as preferred stock that does not have a stated maturity date and may not be redeemed at the option of the holder of the instrument.

<sup>3</sup> The maturity of limited-life preferred stock is defined as the stated maturity date or the earliest point in time at which the instrument can be redeemed at the option of the holder, if the latter comes first.

during the instrument's last five years before maturity. The amount of outstanding limited-life preferred stock that is not included in limited primary capital as a result of this discounting process would be included in secondary capital, provided it meets the general criteria for inclusion in secondary capital.

4. *Criteria for including debt instruments in primary capital.* The Board has established criteria for including debt instruments in primary capital. These criteria are designed to ensure that such debt instruments (a) are permanent; (b) provide strength and loss absorption capacity and, when serious losses occur, permit the organization to continue to operate as a going concern; and (c) provide the issuer with the option, under certain conditions, to defer interest payments during periods of serious financial adversity.

The criteria for state member banks and bank holding companies are:

(i) The instruments must be subordinated to deposits or, if issued by bank holding companies, unsecured.

(ii) The instruments can only be converted into or redeemed with equity or equity equivalents. This means that (a) the instruments cannot provide the holder with any right to demand repayment of principal (even in the event of non-payment of interest), except in the event of bankruptcy, insolvency or reorganization; and (b) the issuer cannot voluntarily redeem the securities without the approval of the Federal Reserve, except that securities may be simultaneously replaced by a like amount of capital instruments that qualify as primary capital.

(iii) The instruments must be available to absorb losses when necessary to allow the organization to continue to operate as a going concern. Thus, the instruments must convert automatically to common or preferred stock that qualifies as primary capital in the event that the issuer's retained earnings and surplus accounts become negative.

(iv) The instruments must provide the option for the issuer to defer (they may also allow the issuer to reduce or eliminate) cash interest payments if the issuer does not report a profit in the preceding period (defined as combined profits for the most recent four quarters) and/or the issuer eliminates cash dividends on common and preferred stock. This provision is intended to provide the issuer with the option of mitigating the burden associated with interest payments during a period of severe financial stress.

Any debt instrument meeting these criteria, so long as the debt instrument does not contain other provisions inconsistent with safe and sound banking practices, would qualify as primary capital. Mandatory convertible securities, formerly defined as capital by the Federal Reserve, are not included in primary capital if issued after the date of adoption of the risk-based capital measure, unless such instruments also satisfy the criteria set forth above. Mandatory convertible instruments that provide for conversion to equity and deferment of interest in accordance with the criteria specified above qualify as primary capital. Moreover, mandatory convertible securities issued before the date that the risk-based

capital ratio was adopted by the Board and that qualified for inclusion in primary capital would be "grandfathered" as limited primary capital under the risk-based capital guidelines. However, only the amount of such mandatory convertible securities that were included in primary capital under the previous limitations would be grandfathered.

#### B. Adjustments to Primary Capital

Adjusted primary capital is calculated by adding base primary capital and limited primary capital, and then deducting all intangible assets (except "grandfathered" intangible assets as discussed below), equity investments in unconsolidated subsidiaries and associated companies, and investments in certain consolidated subsidiaries as discussed below. Amounts deducted from primary capital are also to be excluded from total assets and weighted risk assets in the calculation of capital ratios.

1. *Intangible assets.* In considering the treatment of intangible assets for the purpose of assessing capital adequacy, the Federal Reserve recognizes that the determination of the future benefits and useful lives of intangible assets may involve a degree of uncertainty that is not normally associated with other banking assets. Supervisory concern over intangible assets derives from this uncertainty and from the possibility that, in the event an organization experiences financial difficulties, such assets may not provide the degree of support generally associated with other assets. For this reason, the Federal Reserve intends to deduct all intangible assets from primary capital for the purpose of assessing capital adequacy, except that intangibles acquired before the date of the adoption of the risk-based capital ratio will be "grandfathered" to the extent the intangibles were included in primary capital under previous supervisory guidelines.

Such intangible assets, generally including all intangibles for bank holding companies and intangibles excepting goodwill for state member banks, are grandfathered for a limited period of time, not to exceed the assets' useful lives. Intangible assets acquired after the date of final adoption of the risk-based ratio are to be deducted from primary capital. It should be noted that specific intangible assets are to be grandfathered; existing dollar amounts of intangibles are not grandfathered. Moreover, while goodwill, along with all other intangibles acquired after the ratio is adopted, would be deducted from primary capital for the purpose of assessing capital adequacy, the Board may on a case-by-case basis exempt from this deduction goodwill and other intangibles acquired in connection with a supervisory merger with a failing institution.

2. *Unconsolidated subsidiaries and joint ventures.* Equity investments in all unconsolidated subsidiaries and associated companies, including joint ventures,<sup>4</sup> are to

<sup>4</sup> The definitions of unconsolidated subsidiaries, associated companies, and joint ventures are contained in the instructions to the Bank Report of Condition and the consolidated Bank Holding Company FR Y-9 Report.

be deducted from primary capital, the numerator, as well as from the denominator of the risk-based ratio and both of the capital-to-total assets ratios. The assets of unconsolidated subsidiaries and associated companies are not fully reflected in a banking organization's consolidated total assets, and such assets, therefore, are the equivalent of off-balance sheet assets. Although such assets are not explicitly taken into account in calculating a banking organization's capital ratio, they nonetheless expose the organization to risk. For this reason, it is appropriate to view the equity capital invested in these entities as primarily supporting the risks inherent in these off-balance sheet assets, and not generally available to support risks elsewhere in the organization. Thus, the equity capital supporting these activities is to be deducted from an organization's consolidated primary capital. The Federal Reserve, however, will continue to evaluate on a case-by-case basis the capital adequacy of these entities and their potential impact on the consolidated organization.

3. *Certain consolidated subsidiaries.* The Board will evaluate the activities of consolidated subsidiaries in order to determine whether such activities present such significant additional risk as to warrant the protection of additional capital or whether the Board should deduct investments in such activities from primary capital. The Board reserves the right to require additional capital protection through amendments to these Guidelines (or other regulations) for all subsidiaries engaged in certain activities, or on a case-by-case basis in light of prudential considerations. The Board may also deduct investments in other consolidated subsidiaries if such a step is warranted in light of the nature of the risks involved or the regulatory framework to which the subsidiaries are subjected. In general, if investments in certain consolidated subsidiaries are deducted from primary capital, their assets will also be excluded in the calculation of capital ratios.

4. *Capital instruments of other banking organizations.* The Federal Reserve will monitor banking organizations' holdings of capital instruments issued by other commercial banking organizations and may, as set forth below, require the deduction from primary capital of holdings of primary capital instruments issued by other banking organizations. Such deductions would generally be made in the case of reciprocal or other formal or informal arrangements in which banking organizations swap primary capital instruments in order to raise their capital ratios without in reality raising new capital funds. Deductions would not be made in the case of legitimate interstate "stake out" investments that comply with the Board's Policy Statement on Nonvoting Equity Investments, 12 CFR 225.143; nor would they be made in the case of capital instruments taken in satisfaction of debts previously contracted.

#### C. Secondary Capital Components

The components of secondary capital are:

—Limited-life preferred stock with an original maturity of at least seven years but less than 25 years (including related surplus).

—Portions of 25-year limited-life preferred stock that no longer count as primary capital as a result of the discounting process, and

—Limited primary capital instruments that do not qualify as primary capital because they exceed the percentage limitation (excepting those that are grandfathered).

—Bank subordinated notes and debentures and unsecured long-term debt of the parent company and its nonbank subsidiaries.

The secondary components must meet the following conditions to qualify as capital:

—The instrument must have an original weighted-average maturity of at least seven years.

—The instrument must be unsecured.

—The instrument must clearly state on its face that it is not a deposit and is not insured by a federal agency.

—Bank debt instruments must be subordinated to deposits.

—For banks only, the aggregate amount of secondary capital components qualifying as capital may not exceed 50 percent of the amount of the bank's adjusted primary capital.

As secondary capital components approach maturity, the banking organization must plan to redeem or replace the instruments while maintaining an adequate overall capital position. Thus, the remaining maturity of secondary capital components will be an important consideration in assessing the adequacy of total capital.

#### D. Restrictions Relating to Capital Components

To qualify as primary or secondary capital, a capital instrument should not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices. Examples of such terms are those regarded as unduly interfering with the ability of the bank or holding company to conduct normal banking operations, those interfering with the bank holding company's ability to serve as a source of strength to its subsidiary banks, or those resulting in significantly higher dividends or interest payments in the event of a deterioration in the financial condition of the issuer.

#### IV. Capital Ratios

The risk-based capital ratio and the ratios of adjusted primary and total capital to total assets are computed as follows:

Risk-based capital ratio:

Adjusted Primary Capital

—divided by—

Risk-weighted assets and off-balance sheet items + Allowance for loan and lease losses (exclusive of reserves for identified losses, such as allocated transfer risk reserves)—Appropriate adjustments

Primary capital ratio:

Adjusted primary capital

—divided by—

Total assets + Allowance for loan and lease losses (exclusive of reserves for identified losses, such as allocated transfer risk reserves)—Appropriate adjustments

Total capital ratio:

Adjusted primary capital + Secondary capital

—divided by—

Total assets + Allowance for loan and lease losses (exclusive of reserves for identified losses, such as allocated transfer risk reserves)—Appropriate adjustments

Generally, average total assets will be used in calculating the ratios of adjusted primary capital and total capital to total assets. All other components of these ratios will be based upon period-end balances. The risk-based capital ratio will be calculated from period-end figures, although the Board is studying whether the ratio should be calculated on the basis of average data.

#### V. Method of Computing Risk-Weighted Assets and Off-Balance Sheet Items To Be Used In The Risk-Based Capital Ratio

The assets and off-balance sheet items of state member banks and bank holding companies are assigned to one of five categories broadly weighted according to risk. The aggregate dollar value of the assets in each category is multiplied by the weight assigned to that category. The resulting weighted values from each of the five risk categories are added together and this sum is the risk-weighted assets total that, as adjusted, comprises the denominator of the risk-based capital ratio.

Off-balance sheet risks are weighted by a "credit equivalent" approach. The face amount of each type of off-balance sheet item is multiplied by a specific credit conversion factor appropriate to convert the type of off-balance sheet item to an on-balance sheet risk equivalent. The converted value is then placed in the appropriate risk category, depending on the identity of the obligor and, in certain cases, the maturity of the instrument.

The Board has set forth in Table 1 a listing of the risk categories, a summary of the types of assets to be included in each category, and the weight assigned to each category, i.e., 0 percent, 10 percent, 25 percent, 50 percent and 100 percent. A brief explanation of the components of each category follows. Thereafter, in Table 2, the Board has set forth the conversion factors for various types of off-balance sheet items and a description of how various types of off-balance sheet items are converted.

**Table 1—Summary of Risk Weights and Major Risk Categories for State Member Banks and Bank Holding Companies**

#### 0 percent

Cash—domestic and foreign.  
Claims on Federal Reserve Banks.

#### 10 percent

Short-term (one year or less) claims on U.S. Government and its Agencies.

#### 25 percent

Cash items in process of collection.

Short-term claims on domestic depository institutions and foreign banks, including foreign central banks.

Long-term claims on U.S. Government and its Agencies.

Claims (including repurchase agreements) collateralized by cash or U.S. Government or Agency debt.

Claims guaranteed by the U.S. Government or its Agencies.

Local currency claims on foreign central governments to the extent that bank has local currency liabilities.

Federal Reserve Bank stock.

#### 50 percent

Claims on U.S. Government-sponsored Agencies.

Claims (including repurchase agreements) collateralized by U.S. Government-sponsored Agency debt.

General obligation claims on states, counties and municipalities.

Claims on multinational development institutions in which U.S. is a shareholder or contributing member.

#### 100 percent

All other assets not specified above, including:

Claims on private entities and individuals.  
Long-term claims on domestic and foreign banks.

All other claims on foreign governments and private obligors.

#### a. Category I: Zero Weight

This category includes vault cash (domestic and foreign) and balances with and claims on Federal Reserve Banks, excluding Federal Reserve Bank stock.

#### b. Category II: 10 Percent

This category includes highly liquid claims that bear no credit risk but could involve some interest rate exposure, such as short-term claims (one year or less) on the U.S. Government and U.S. Government agencies, that is, federal agencies whose debt obligations are explicitly guaranteed by the full faith and credit of the U.S. Government.

#### c. Category III: 25 Percent

This category includes short-term interbank claims and assets that normally have little or no risk of default and a significant degree of liquidity. The specific items included in this category are: short-term claims (including demand deposits) on domestic depository institutions<sup>6</sup> and all

<sup>6</sup> Domestic (U.S.) depository institutions include both the U.S. and foreign branches of banks and depository institutions chartered and headquartered in the U.S. The term includes U.S. chartered banks and depository institutions owned by foreigners, but excludes U.S. branches and agencies of foreign banks. In addition to banks, domestic depository institutions include mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, and international banking facilities of domestic banks and depository institutions.

foreign banks<sup>6</sup> (including foreign central banks),<sup>7</sup> cash items in the process of collection, both foreign and domestic; claims (including repurchase agreements) fully collateralized by cash or U.S. Government or U.S. Government agency debt; portions of loans guaranteed by the U.S. Government or U.S. Government agencies; local currency claims on foreign central governments<sup>8</sup> to the extent that a bank has local currency liabilities booked in that foreign country; and long-term claims (over one year) on the U.S. Government and U.S. Government agencies.

**d. Category IV: 50 Percent**

This category includes assets that have more credit risk than the assets categorized above, but generally less credit risk than the standard commercial bank loan portfolio. This category includes claims on U.S. Government-sponsored agencies, that is, agencies originally established or chartered by the federal government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government. It also includes claims fully collateralized by U.S. Government-sponsored agency debt and direct claims on multinational development banks in which the U.S. government is a shareholder or contributing member. Category IV also includes general obligation claims on domestic state and local governments.

If a claim is secured by two forms of collateral that are recognized explicitly in the proposal but placed in different risk categories, such as U.S. Government debt and U.S. Government-sponsored agency debt, the claim would be assigned to the higher of the two risk categories, provided that the claim is fully collateralized. Any claim that is not fully secured, based upon current market value, would be placed in the risk category appropriate for an unsecured claim to the obligor.

**e. Category V (Standard Risk): 100 Percent**

All assets not included in the categories above are assigned to this category. If a claim could be assigned to more than one category, for example, a long-term claim on a bank (100

percent) secured by U.S. Government debt (25 percent), the claim should be assigned to the lower of the two risk categories.

The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category. Such assets include: Long-term claims (over one year) on domestic depository institutions and foreign banks; all other claims on foreign central governments (including local currency claims on foreign central governments that exceed local currency liabilities in that foreign country), that is, claims on foreign governments that entail some degree of transfer risk; and all other assets, including commercial and industrial loans and lease financing receivables, residential real estate and consumer loans, corporate securities and commercial paper, all other claims on foreign private obligors, and investments in fixed assets and premises. This category also includes loans to nondepository financial institutions, such as insurance companies, mortgage companies, and finance companies, as well as loans to depository and nondepository financial institution holding companies, including bank holding companies. This category also includes domestic tax-exempt state and local government revenue and industrial development bonds.

**Table 2—Summary of Off-Balance Sheet Items and Conversion Factors for State Member Banks and Bank Holding Companies**

*Direct credit substitutes* (standby letters of credit that guarantee commercial paper, tax-exempt obligations or any other debt obligation, financial guarantees, and any other equivalent arrangements, including purchases of risk participations)—100 percent credit conversion factor.

*Sale and repurchase agreements and asset sales with recourse*, if not already included on the balance sheet—100 percent credit conversion factor.

*Trade-related contingencies* (commercial letters of credit, bid and performance bonds and standby letters of credit that guarantee performance of a commercial contract)—50 percent credit conversion factor.

*Other commitments*, including overdraft facilities, revolving underwriting and note issuance facilities (RUFs/NIFs), underwriting commitments, and other binding commitments to extend funds to firms or individuals. The credit conversion factors are:

10 percent—one year and less original maturity<sup>9</sup>

25 percent—over one to five years original maturity

50 percent—over five years original maturity.

Off-balance sheet items whose conversion factors are not being established at this time:

Interest rate swaps and other interest rate contracts

Foreign exchange rate contracts.

The face amount of an off-balance sheet item is multiplied by a credit conversion

<sup>9</sup> Maturity is defined as the stated maturity date or the earliest possible time at which the bank may unconditionally, at its option, cancel the commitment, if the latter comes first.

factor (see Table 2 above) and the resulting amount is assigned to the appropriate risk category depending upon the identity of the obligor and, in certain cases, on the maturity of the instrument.<sup>10</sup>

A 100 percent conversion factor applies to direct credit substitutes, including financial guarantees and standby letters of credit backing outstanding financial claims of the account party. These direct credit substitutes would include standby letters of credit, or other equivalent irrevocable obligations or surety arrangements, that "back" or guarantee repayment of commercial paper, tax-exempt securities, or other commercial or individual loans or debt obligations. In addition, sale and repurchase agreements and asset sales with recourse (to the extent not already included on a financial institution's balance sheet) are converted at 100 percent of their face amount.<sup>11</sup>

Trade-related contingencies are to be converted at 50 percent. Such trade-related contingencies include commercial letters of credit and performance standby letters of credit. The latter includes obligations backing the performance of nonfinancial or commercial contracts or undertakings. To the extent permitted by law or regulation, performance standby letters of credit would include arrangements backing, among other things, subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

The credit conversion factors for other commitments, including overdraft facilities, revolving credit facilities, note issuance facilities, and commercial and consumer commitments, are tied to the *original* maturity of the commitment. Maturity in this regard is defined by the earliest possible point in time that the bank can, at its option, *unconditionally* cancel its commitment to a borrower. The longer the term of a loan commitment the greater the risk since there is a greater likelihood the borrower's financial circumstances or condition may change during the period the commitment is outstanding. Thus, under these guidelines, commitments with an original maturity of one year or less would be converted at 10 percent; those with an original maturity of more than one year and up to and including five years would be converted at 25 percent; and those with an original maturity of more than five years would be converted at 50 percent.

Commitments, for risk-based capital purposes, are defined as any arrangements that legally obligate a banking organization to purchase loans or securities, or extend credit in the form of loans or leases,

<sup>10</sup> Credit equivalent amounts of off-balance items that are secured by recognized collateral (that is, cash or debt of the U.S. Government, Government agencies or Government-sponsored agencies) are assigned, as with on-balance sheet exposures, to the appropriate risk category depending upon the nature of the collateral and, if appropriate, the maturity of the instrument.

<sup>11</sup> A bank's purchases of risk participations in bankers acceptances are also included and converted at 100 percent and assigned to the appropriate category depending upon the identity of the account party.

<sup>6</sup> Foreign banks are organizations that are organized under laws of a foreign country; engage in the business of banking; are recognized as banks by the bank supervisory or monetary authorities of the country of their organization or principal banking operations; received deposits to a substantial extent in the regular course of business; and have the power to accept demand deposits. Claims on foreign banks include claims on the U.S. branches and agencies of the foreign banks.

<sup>7</sup> Short-term claims are included in this category regardless of the form of the instrument, that is, this category includes federal funds sold, certificates of deposit, Eurocurrency placements, repurchase agreements, and bankers acceptances for which the account party is a domestic depository institutions or a foreign bank.

<sup>8</sup> Foreign governments include the central government and its ministries, departments, and agencies; they do not include state, provincial or local governments in foreign countries or government-owned enterprises. In addition, claims on foreign governments do not include claims on non-governmental entities guaranteed by foreign governments.

participations in loans and leases, overdraft facilities, revolving credit or underwriting facilities, or similar transactions. Generally, commitments involve a written contract or agreement, or a commitment fee or some other form of consideration. For the purpose of calculating the risk-based capital ratio, the definition includes commitments that obligate the banking organization to extend credit to consumers or individuals in the form of retail credit cards, check credit and overdraft facilities, home equity and mortgage lines, and other similar arrangements.

The existence of a "material adverse change" clause or similar provisions does not by itself suggest that a lending arrangement is not a commitment. However, lending arrangements that are unconditionally cancelable at any time at the option of the bank would not be deemed to be commitments for risk asset purposes, provided that the bank, in fact, makes a separate credit decision based upon the borrower's current financial condition before each drawing under the lending facility. Unused credit card lines are to be included in the definition of commitments.

In the case of commitments structured as syndications, the risk asset framework includes only the banking organization's proportional share of such commitments. In addition, only the unused portion of commitments are treated as off-balance sheet items. Amounts that are already drawn and outstanding under a commitment appear on the balance sheet and such amounts, therefore, should not also be included as commitments for purposes of computing the risk-based capital asset ratio.

Board of Governors of the Federal Reserve System, February 12, 1987.

William W. Wiles,  
Secretary of the Board.

**Attachment—Agreed Proposal of the United States Federal Banking Supervisory Authorities and the Bank of England on Primary Capital and Capital Adequacy Assessment**

Note.—This attachment is not for publication in the Code of Federal Regulations.

This paper constitutes a system for the measurement of capital adequacy agreed by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation and the Bank of England. The principal objective of the paper is to promote the convergence of supervisory policies on capital adequacy assessments among countries with major banking centers. The proposal outlined below is intended to serve as a basis for consultation with the banking industry and others in the United States and the United Kingdom. The authorities concerned hope that the approach adopted by the United States and the United Kingdom will provide a basis which other countries can follow.

This paper explains the agreed proposal concerning:

(I) The components of the primary capital base of banking organizations;

(II) The deductions to be made from primary capital in computing the capital base for the calculation of a risk asset ratio;

(III) The weighting structure of risk assets and off-balance sheet activities; and

(IV) The use for supervisory purposes of a ratio of primary capital to weighted risk assets.

The paper should be read in conjunction with the attached tables which are appropriately cross-referenced.

**I. Primary Capital**

Primary capital represents the highest quality form of capital for banks and banking organizations (hereinafter a reference to banks should generally be taken to include banks, bank holding companies in the United States and banking groups in the United Kingdom). Within this category of capital, quality cannot be regarded as uniform and some components are undoubtedly of a higher quality than others. There are a number of elements that strengthen the balance sheets of banks to some extent, although clearly falling short of primary capital. Into this latter category may fall subordinated debt with a fixed maturity and the excess of market value over book value of some bank assets, notably bank premises and long-term investments. It is not the intention of the supervisors to ignore these items but rather to take some account of them after the basic primary capital to weighted risk asset ratio has been calculated. The supervisory authorities in both countries will therefore also take account of the ratio of total capital to weighted risk assets, as well as other qualitative factors, in their overall prudential assessment.

The components of the primary capital base represent resources which can be used to meet current losses while leaving banks able to continue operating on a going concern basis. The supervisors agree that this criterion is the most important determinant of the status of primary capital.

*Common stock/equity* (IA1), although repayable in strictly defined and limited circumstances, clearly meets the criterion as does any premium or surplus arising from the issue of common stock/equity. These, together with reserves in the form of *retained earnings* (IA2), represent the highest quality form of capital. *The minority interest in subsidiaries that are consolidated for supervisory purposes* (IA3) is also available to absorb losses.

There are no limits on the amounts of such capital that can be included in a bank's capital base for purposes of measuring capital adequacy. While it could be argued on grounds of uncertainty that it would be desirable to defer inclusion of *current year earnings* (IA2) until the end of the year in question, the U.S. and U.K. supervisory authorities have decided to include them. A realized profit arising out of the disposal of real property, for example, clearly fully meets the criterion for inclusion in primary capital. It is, however, possible that lending or trading profits for interim periods during the year may be eroded by later or unidentified losses.

*General reserves/general provisions* (IA4) for losses resulting from charges to earnings will be included for the present in primary capital. The U.S. and U.K. supervisory authorities are agreed that provisions made against identified losses cannot and should not be regarded as capital. *General reserves/general provisions* are made against unidentified or potential losses and can therefore be regarded as meeting the criterion. The U.S. and U.K. supervisory authorities have reservations about those general provisions that in reality are earmarked against specific assets or categories of assets and that do not therefore satisfy the criterion of general availability. However, it is not always possible to distinguish such provisions. Therefore, while for the present all general reserves/general provisions are included as primary capital, the supervisory authorities would like to seek comment from banks, the accounting profession and other interested parties on whether such reserves should be phased out of the primary capital base.

*Hidden reserves* (IA5), in the form of undisclosed retained earnings, do not exist in the United States and presently are permitted only to a limited number of banks in the United Kingdom. The issue has been addressed in the European Community's Bank Accounts Directive and, within its terms, member states have the option to allow banks in their country to maintain limited hidden reserves. This option will be reviewed five years after the Directive has been implemented. The position of hidden reserves in the United Kingdom will therefore next be considered when the Bank Accounts Directive is implemented. If it is then decided that U.K. banks should not be permitted to maintain hidden reserves, they will be available for transfer to disclosed reserves. Until this occurs, the Bank of

England will continue to include them as primary capital.

In addition to the elements to be allowed without limit, the supervisory authorities propose to include in primary capital, but subject to a limit, certain items that give much greater strength to a bank than subordinated debt of a fixed maturity but that have certain drawbacks as compared with common stock and other unlimited components of the primary capital base.

*Perpetual preferred shares (IB1a) and instruments perpetual in nature and capable of meeting current losses (IB2), together with long-term dated (limited-life) preferred shares (IB1b),* will be included in the primary capital base subject to a limit of 50 percent of the unlimited elements after the deduction of intangible assets. (For example, if the unlimited items total US\$100 million and there are intangibles of US\$10 million, then there will be a limit of US\$45 million applying to qualifying preferred shares and perpetual debt and their equivalents). Perpetual preferred shares and perpetual subordinated debt cannot be redeemed at the option of the holder and any repayment may occur only with the prior consent of the supervisory authorities. Included here are perpetual subordinated debt and certain instruments that can only be converted into primary capital instruments. The proceeds of such instruments effectively remain available to meet current losses and leave the bank able to continue operating. Long-term dated preferred shares (25 years or more initial maturity) also provide a cushion against current losses. Such shares must be amortized for the purpose of assessing capital adequacy over the last few years of their life.

Since changes are involved in the definition of the capital base, the respective supervisory authorities will continue to include (in the United States) existing mandatory convertible securities which do not meet the new criteria (in the attached tables at IB2 (a), (b), (c)) and (in the United Kingdom) existing revaluation reserves for bank premises.

## II. Deductions From Primary Capital

The U.S. and U.K. supervisors have also agreed to propose that certain deductions should be made from the total of primary capital elements in order to derive the adjusted capital base for purposes of calculating the risk weighted capital ratio. In the United States, all future *intangible assets* will be deducted; existing allowed intangible assets will be "grandfathered." The Bank of England reaffirms its present

policy of deducting all existing intangible assets (IIA).

*Investments in unconsolidated subsidiaries and associated companies* including, but not limited to, unconsolidated joint ventures, will also be deducted (IIB). For the United States, this could include certain consolidated subsidiaries as determined by U.S. regulatory authorities. The assets of such companies will not be brought into the calculation of the risk asset ratio.

The Bank of England already deducts *bank holdings of other banks' capital instruments (IIC)*, except for limited concessions to allow some banks to play an active role in market-making in the primary (new issues) and/or secondary markets. This policy will be maintained. The U.S. authorities accept the principle underlying this policy and will monitor bank holdings of capital instruments issued by other banks and may, as appropriate, deduct these items on a case-by-case basis.

## III. The Risk Asset Ratio

### (a) General

The risk asset ratio is calculated by applying to each broad category of assets or off-balance sheet obligations a weight reflecting the relative riskiness inherent in each. The total of weighted risk assets is then measured in relation to the adjusted capital base to derive a ratio. The U.S. and U.K. authorities intend to concentrate on the primary capital to total weighted risk asset ratio.

This section describes and explains the simple structure of weights and indicates areas where further work is required to augment the present agreed approach.

It is recognized that it would be possible to establish more weights but this would introduce greater complexity, and more onerous statistical reporting obligations, without any assurance of a significantly more efficient or effective system. The calculation of the ratio represents only one element in the assessment of capital adequacy, although it is a most important one.

The agreed framework consists of broad categories of obligor and, to some extent, of maturity. With certain important exceptions, it reflects credit risk, that is, the risk of borrower or counterparty default. In addition the Bank of England includes the net open foreign exchange position in the risk asset ratio as defined in Foreign Currency Exposure, April 1981. The U.S. authorities are committed to introducing a capital requirement for exchange rate risk. All authorities are firmly committed to the development of an approach that will enable interest rate

risk to be incorporated into the framework. Some other risks—for example, of operational failures—are important but cannot readily be captured in a risk asset ratio. The agreed weighting structure takes no account of country transfer risk. Nor is commercial lending differentiated with respect to credit quality or collateral, except for the strictly limited exception for exposures secured by government securities or cash. These factors will be considered, as now, through the examination/supervisory process.

Five risk weight categories are proposed—0 percent, 10 percent, 25 percent, 50 percent and 100 percent—and the weighting for particular items is discussed below. There are some special institutional features of the U.S. and U.K. markets which require differences in treatment between the two countries; these are indicated in the text which follows.

### (b) On-balance Sheet

The weightings set out in what follows are based on relative degrees of risk starting from 100 percent for a claim on a non-bank obligor, which can for these purposes be regarded as a standard risk.

#### (i) Cash and All Claims on the Domestic Central Bank

Cash and all claims on the domestic central bank (III 1, 2) are regarded as bearing no significant banking risks and therefore are assigned a weight of 0 percent. The Bank of England will also continue to give a 0 percent weight to government-guaranteed export and ship-building loans (III 3). As indicated below, the U.S. supervisory agencies place comparable U.S. Government-guaranteed claims in the 25 percent risk category (III 12).

#### (ii) Short-term Claims on Domestic National Government

Short-term claims (remaining maturity of one year or less) on the domestic national government and on domestic national government agencies (III 4) are assigned a weight of 10 percent. (For the United States, national government agencies are defined as those agencies whose debt obligations are backed by the full faith and credit of the U.S. Government.) While short-term claims on the domestic national government bear no credit risk, such claims could involve a degree of interest rate exposure. Thus, as described below, until a more direct measure of interest rate risk is developed, such claims will be assigned to the 10 percent category.

(iii) U.K. Discount Houses, Gilt-edged Market Makers and Stock Exchange Money Brokers

The Bank of England proposes a weighting of 10 percent for short-term (remaining maturity of one year or less) claims on discount houses, gilt-edged market makers and Stock Exchange money brokers. These specialist institutions have an operational relationship with the Bank, including secured borrowing facilities, and are subject to close supervision. They trade predominantly in high quality liquid assets on which their borrowing is customarily secured. For these reasons, short-term claims on this group involve less risk than short-term claims on banks. This treatment effectively reflects the special institutional structure in the United Kingdom (III 5).

(iv) Short-term Claims on Domestic Depository Institutions and Foreign Banks (Including Foreign Central Banks)

The weighting for short-term claims (remaining maturity of one year or less) on domestic depository institutions and foreign banks and equivalent off-balance sheet exposures (III 6, 7, 11) reflects the lower risk generally of such claims as compared with claims on commercial obligors and longer-term claims on banks. For this reason, a weighting of 25 percent for this category has been proposed. It is acknowledged that short-term claims on some commercial borrowers may involve less risk than similar claims on some banks. It is considered, however, that since depository institutions are supervised and a particularly high quality is inherent in short-term inter-bank claims, the treatment proposed is broadly reasonable. Longer-term claims on depository institutions are regarded as bearing a higher risk that is generally closer in quality to claims on commercial obligors and these will be assigned a weight of 100 percent. The breakpoint at one year is admittedly arbitrary but captures most genuine short-term, inter-bank money market activity.

(v) Longer-term Claims on Own (Domestic) Governments and Analogous Claims

For U.S. banks, the weighting of long-term claims on the U.S. Government (Treasury), and for U.K. banks, the weighting of long-term claims on HM Government, does not reflect any credit risk but is designed, as a temporary measure, to be a proxy for the significant element of interest rate risk inherent in holdings of longer-term government securities. It is the intention

of the U.S. authorities and the Bank of England to develop a more direct measure of interest rate risk. Pending this further work, it has been agreed that government securities with a remaining maturity of more than one year should be weighted at 25 percent (III 9).<sup>1</sup>

To be consistent with this approach, claims having an analogous nature are also to be weighted at 25 percent. Thus, for U.S. banks, all long-term claims on U.S. Government agencies (III 9), all claims collateralized by U.S. Government and U.S. Government agency debt or cash (III 10) and claims guaranteed by the U.S. Government or its agencies (III 12) will be assigned to the 25 percent category. For U.K. banks, claims collateralized by domestic national government debt or cash (III 10), most domestic national government guaranteed claims (III 12) and claims on U.K. public corporations and the rest of the public sector (III 9) will be weighted at 25 percent.

For U.S. banks, all claims on U.S. Government-sponsored agencies (that is, agencies that are chartered or established by the Federal Government to carry out a public purpose as specified by the U.S. Congress and whose debt obligations are not guaranteed by the full faith and credit of the U.S. Government) and all claims collateralized by U.S. Government-sponsored agency debt are assigned to the 50 percent category (III 14, 15).

Although the credit risk attaching to claims on U.K. local authorities is not the same as claims on HM Government, the Bank of England believes that they should be included in the 25 percent

<sup>1</sup> The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) disagreed with splitting such securities according to maturity, even as a temporary measure. Optimally, an adjusted capital standard should incorporate an assessment of a bank's exposure to interest rate risk. Specific assets, however, do not necessarily expose a bank to interest rate risk; rather, interest rate risk reflects the relationship within the portfolio between the interest rate structure of assets and liabilities. Isolating a single asset on a bank's balance sheet and making a maturity distinction in order to incorporate interest rate risk into the capital ratio is inappropriate because it fails to take account of the interest rate exposure arising from other loans and securities, off-balance sheet activities, and a bank's liability structure. In the light of this concern, the OCC and FDIC recommended that banks' exposures to interest rate risk be evaluated case by case during examinations, for purposes of assessing capital adequacy, and that all U.S. Treasury securities and agency securities bearing the full faith and credit of the U.S. Government be placed in the 10 percent risk category. The other supervisory authorities agree with the logic that interest rate risk should be addressed on a portfolio, rather than an individual asset, basis but believe that until such risk can be monitored and included in capital adequacy requirements in a more systematic fashion, the proposed maturity split represents a reasonable interim step.

category rather than in the 50 percent category (III 8). The U.S. authorities propose placing general obligation claims on domestic state and local governments in the 50 percent category (III 16).

(vi) Local Currency Claims on Foreign Central Governments in Foreign Offices

The treatment of assets in overseas offices of banks raises difficult conceptual and practical questions. It has been agreed, however, that local currency claims on foreign central governments, to the extent funded by local currency liabilities in that country, do not involve any transfer risk. A 25 percent weight will therefore be applied to both short and long-term claims. (III 13)

(vii) Multinational Development Institutions

All direct claims of U.S. banks on multinational development institutions in which the U.S. Government has shareholder or contributing member status and, similarly, all direct claims of U.K. banks on such institutions in which HM Government has the same status will be given a weight of 50 percent. This reflects the generally high quality of claims on such institutions (III 17).

(viii) Other Assets

All assets not mentioned so far will carry a 100 percent weight (III 18, 19, 20, 21, 22). As discussed earlier, the Bank of England also already applies a weight of 100 percent to the net open foreign exchange position (III 23) and will maintain this. The U.S. authorities are committed to introducing a capital requirement for exchange rate risk.

(c) Off-Balance Sheet

(i) General

The U.S. and U.K. banking supervisory authorities believe that all off-balance sheet items giving rise to credit risk (and in addition, in time, foreign exchange and interest rate risks) should in principle be included in the risk asset ratio. The obligations should receive the risk asset weighting appropriate to the individual obligor. There is, however, an important and difficult question relating to the size of the exposure that should be weighted.

An approach to off-balance sheet items has been devised that endeavors to convert the credit risk of each instrument into a credit equivalent that can be incorporated into the risk asset framework outlined in this paper. It is recognized that the methodology employed will appear simple and approximate but it provides a logical

and consistent basis for the calculation of a ratio that encompasses both on- and off-balance sheet business.

Distinctions are made between contingencies, commitments and interest rate and foreign exchange rate contracts and these are discussed separately.

#### (ii) Contingencies/Contingent Items

Obligations in the form of financial guarantees and equivalents (for example, standby letters of credit having the character of guarantees and, in the United Kingdom, acceptances) effectively involve from the date of the assumption of the obligation the same degree of credit risk as outstanding loans (III 24). There is no action that the bank can take to avoid the full credit risk. The supervisory authorities, accordingly, believe that these obligations should be regarded as direct credit substitutes and be weighted for their full amount, that is, the credit conversion factor is 100 percent of the principal amount. The risk asset weighting is then determined by the category of the counterparty and, where appropriate, the maturity.

Some contingencies (III 25), notably commercial letters of credit, performance bonds and performance-related standby letters of credit, involve a lesser credit risk. The key elements in this judgment are that the counterparty has a strong incentive to meet its obligations if it wishes to remain in business (thus giving these claims a somewhat higher ranking in the counterparty's list of priorities than some other claims); the obligations are often (but not invariably) short-term in maturity; and banks assert that the loss record is favorable. To make allowance for these favorable factors, it is proposed to scale down the nominal exposure by a credit conversion factor of 50 percent, before the exposure is weighted according to the category of the obligor (and where relevant maturity)—for example, the deemed credit risk equivalent of a commercial letter of credit of US\$10 million would be US\$5 million which in turn would be weighted according to obligor and, some cases, maturity.

Contingencies such as indemnities for lost share certificates and bill endorsements will be excluded from the framework as they do not involve a significant credit risk.

#### (iii) Commitments

Whereas contingencies (as described above) involve the immediate assumption of a credit risk, commitments generally represent an undertaking to assume a credit risk in the future. It is recognized that this

distinction is somewhat difficult to make at the margin and that it is the nature of the obligation which matters rather than the name given to the facility.

Some transactions, for example, sale and repurchase agreements and asset sales with recourse, may involve balance sheet entries and as such will attract a weighting for the full face value. Any other obligation or transaction effectively involving an immediate credit exposure will be treated as if it were on the balance sheet. Where an obligation or transaction clearly has the same effect as a financial guarantee (as, for example, certain asset sales with recourse) it will be treated as such (III 26).

For all other commitments (III 27), it is proposed to take account of maturity in determining the credit conversion factors. In so doing, maturity to some extent serves as a proxy for instrument-type. The category of exposure here giving rise to the greatest concern is the long-term contract that is equivalent in effect to an insurance arrangement in its underlying nature, most notably revolving underwriting facilities. Even if material adverse change clauses are included—and the supervisory authorities do not wish to take any action which will discourage their use—the reality is that the bank is assuming a long-term obligation to provide credit if other lenders are unwilling to do so. At the other end of the maturity spectrum, it is accepted that commitments reviewable—and unconditionally cancellable—at least annually involve less risk and that the credit conversion factor should be much lower. While a bank is at risk from an increase in credit exposures as a result of a higher than average utilization of undrawn lines, the low credit conversion factor reflects the historical stability of the undrawn amount of these lines.

The conversion factors to be applied to these commitments will, therefore, be set as follows in terms of their *original* maturity (for these purposes maturity is defined as the earliest possible time at which the bank may unconditionally cancel the commitment):

One year or less—10 percent  
Over one year to five years—25 percent  
Over five years—50 percent

For contingencies and commitments, the principal amount is multiplied by the conversion factor and the resulting exposure will carry the appropriate weight for the category of the counterparty (and the maturity).

#### (iv) Interest Rate and Foreign Exchange Rate Related Transactions

It is the firm intention of the U.S. supervisory authorities and the Bank of England to include the credit equivalent exposure on interest rate and foreign exchange rate related transactions in the risk asset ratio as soon as possible (III 28 and 29). The timing of this step is dependent on reaching final agreement on a method of calculating the credit exposure. As with other off-balance sheet transactions, this will involve estimating a deemed credit equivalent for these instruments that would be incorporated in the general framework on an obligor (and, where appropriate, maturity) basis.

#### IV. Primary Capital to Weighted Risk Asset Ratio

The U.S. and U.K. authorities intend to set and publish an agreed minimum level of this ratio to be applied to all banks supervised by them. In both countries most institutions will be expected to maintain their ratio at a higher level. The precise figure set for individual banks will remain confidential and will be determined in light of each institution's particular circumstances, for example, the quality and diversification of assets, liquidity, management, internal control systems and other relevant factors. These higher levels will be determined as part of the ongoing supervisory process.

##### I. Components of Primary Capital

###### A. Funds Included Without Limit

1. Common stock/equity and premium (United Kingdom), surplus (United States).
2. Retained earnings (including current year earnings).
3. Minority interest in consolidated subsidiaries.
4. General reserves for losses resulting from charges to earnings.
5. Hidden reserves (comprising undisclosed retained earnings)—not applicable in United States, to be phased out in United Kingdom.

###### B. Funds Included With Limits—Items Included in This Category Must Not Exceed 50 Percent of the Total Items Included in A Above Less Intangible Assets

1. Preferred shares that:
  - (a) Do not mature; or
  - (b) Mature on a fixed date and have an original maturity of at least 25 years. (Amount included in primary capital would be discounted for prudential purposes as the instrument approaches maturity.)

2. Subordinated debt that:
- (a) Can only be converted into primary capital instruments;
  - (b) Is available at all times to absorb losses; and
  - (c) Provides that interest payments may be deferred if the issuer does not make a profit in the preceding period and/or pay dividends on common and perpetual preferred stock.

This is intended to include perpetual debt.

**Note.**—(a) Existing mandatory convertible securities which do not meet the criteria in IB2 (for U.S. banks) and existing property revaluation reserves (for U.K. banks) are to be "grandfathered."

(b) For bank holding companies in the United States, perpetual debt issued by the parent company need not be subordinated. It must, however, be unsecured.

## II. Adjustments to Capital for Prudential Purposes

A. Deduction of all intangible assets. (Existing intangibles currently allowed by U.S. regulatory authorities will be "grandfathered.")

B. Deduction of investments in unconsolidated subsidiaries and associated companies including, but not limited to, unconsolidated joint ventures. For the United States, this could include certain consolidated subsidiaries as determined by U.S. regulatory authorities; for the United Kingdom this also includes related securities companies.

C. Deduction of bank holdings of capital instruments of other banking organizations. (In the United States these would be monitored and deducted on a case-by-case basis.)

### Category of Risk

#### Weight Given

0 percent

1. Vault cash—domestic and foreign.
2. All balances with and claims on domestic central bank.
3. Domestic national government guaranteed export and ship-building loans (United Kingdom only).

10 percent

4. For the United States, short-term (remaining maturity of one year or less) claims on the U.S. Government (Treasury) and on U.S. Government agencies (for the United States, national government agencies are defined as those agencies whose debt obligations are backed by the full faith and credit of the U.S. Government). For the United Kingdom, short-term (one year or less) claims on the United Kingdom and Northern Ireland Governments.
5. Short-term (one year or less) claims on discount houses, gilt-edged market

makers and Stock Exchange money brokers (United Kingdom only).

25 percent

6. Cash items in process of collection—foreign and domestic.

7. Short-term (one year or less) claims on domestic depository institutions and foreign banks.

8. All claims on domestic local authorities (United Kingdom only).

9. Long-term (over one year) claims on domestic national government (including, for the United Kingdom, Northern Ireland) and all long-term claims on domestic national government agencies. For the United Kingdom, this includes all claims on U.K. public corporations and on the rest of the public sector.

10. All claims (including repurchase agreements) fully collateralized by domestic national government debt and (for the United States) debt of U.S. Government agencies.

Also all claims collateralized by cash on deposit in the lending institution.

11. Federal Reserve Bank stock (United States only).

12. Portions of loans guaranteed by domestic national government or (for the United States) domestic national government agencies.

13. All local currency claims on foreign central governments to the extent funded by local currency liabilities in that foreign country.

50 percent

14. All claims on domestic national government-sponsored agencies (U.S. Government-sponsored agencies are defined as agencies whose debt obligations are not guaranteed by the full faith and credit of the U.S. Government).

15. All claims (including repurchase agreements) that are fully collateralized by domestic national government-sponsored agency debt (United States only).

16. All general obligation claims on domestic state and local governments (United States only).

17. Claims on multinational development institutions in which the domestic government is a shareholder or contributing member.

100 Percent

18. Long-term (over one year) claims on domestic depository institutions and foreign banks.

19. All claims on foreign governments other than local currency claims on foreign central governments funded by local currency liabilities in that foreign country.

20. The customer liability on acceptances outstanding involving standard risk obligors (United States only).

21. Domestic state and local government revenue bonds and industrial development bonds (United States only).

22. All other assets.

23. Net open position in foreign exchange (United Kingdom only).

### Off Balance Sheet Items

The face amount of these items would be multiplied by the credit conversion factors shown below, and the resulting amount would be slotted in the appropriate risk category depending upon the identity of the obligor and the maturity of the instrument where appropriate.

24. "Direct credit substitutes" (financial guarantees and standby letters of credit serving the same purpose and, in the United Kingdom, acceptances outstanding)—100 percent credit conversion factor.

25. "Trading contingencies" (for example, commercial letters of credit, bid and performance bonds and performance standby letters of credit)—50 percent credit conversion factor.

26. Sale and repurchase agreements and asset sales with recourse, if not already included on the balance sheet—100 percent credit conversion factor.

27. Other commitments, for example, overdrafts, revolving underwriting facilities (for example, RUFs/NIFs), underwriting commitments, commercial and consumer credit lines. The credit conversion factors are:

10 percent—one year and less original maturity.

25 percent—over one to five years original maturity.

50 percent—over five years original maturity.

### Credit Conversion Factor To Be Determined

28. Interest rate swaps and other interest rate contracts.

29. Foreign exchange rate contracts.

**Note.**—1. Maturity is defined as the earliest possible time at which the bank may unconditionally cancel the commitment.

2. Certain off-balance sheet obligations, for example, indemnities for lost share certificates and bill endorsements, or "holders in due course" obligations, would not be included in capital adequacy requirements.

[FR Doc. 87-3309 Filed 2-18-87; 8:45 am]

BILLING CODE 6210-01-M