

**FEDERAL RESERVE BANK
OF NEW YORK**

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RISK-BASED CAPITAL
**Proposals for the Inclusion of General Loan-Loss Reserves
in the Definition of Capital**

*To All State Member Banks, Bank Holding Companies,
and Branches and Agencies of Foreign Banks
in the Second Federal Reserve District, and Others Concerned:*

The following statement was issued jointly by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, announcing the release of a paper by the Basle Committee on Banking Supervision concerning the proposed inclusion of general loan-loss reserves in the definition of capital under the international risk-based capital accord:

The Basle Committee on Banking Supervision has released the attached consultative paper on proposals to give greater precision to the inclusion of general loan-loss reserves in the definition of capital under the international risk-based capital accord.

The U.S. banking agencies regard the proposals as useful and consistent with the risk-based capital guidelines previously adopted by the U.S. agencies in 1989. The enclosed paper is being circulated in the United States for information.

Developed by the Basle Committee and endorsed by the Central Bank Governors of the Group of Ten countries in 1988, the accord serves as the basis for the risk-based capital framework adopted by the U.S. banking agencies and by bank supervisors in other major industrial countries.

When the accord was originally published in 1988, the Basle Supervisors' Committee indicated that work would continue on assuring consistent treatment of loan-loss reserves and provisions eligible for inclusion in the risk-adjusted capital base. The enclosed paper reflects these continuing efforts.

The Committee anticipates that conforming revisions will be incorporated into the language of the Basle accord later this year, after a period of review and consultation by G-10 supervisory authorities.

Since no change in existing U.S. risk-based capital guidelines will result from the current proposals, the allowance for loan and lease losses of U.S. banks will continue to qualify for inclusion in Tier 2 capital under the 1.50 percent limitation until the end of 1992 and the 1.25 percent limitation beginning at year-end 1992.

Enclosed — for member banks, bank holding companies, and branches and agencies of foreign banks in this District — is a copy of the paper issued by the Basle Committee. Copies of the enclosure will be furnished to others upon request directed to the Circulars Division of this Bank (Tel. No. 212-720-5215 or 5216); additionally, single copies may be obtained at this Bank (33 Liberty Street) from the Issues Division on the first floor.

Questions concerning this matter may be directed to Manuel J. Schnaidman, Financial Specialist, Bank Analysis Division (Tel. No. 212-720-6710.)

E. GERALD CORRIGAN,
President.

Basle Committee
on
Banking Supervision

Consultative paper

Proposals for the inclusion of general provisions/
general loan-loss reserves in capital

Introduction

1. In July 1988 the Basle Committee on Banking Supervision, with the endorsement of the central bank Governors of the Group of Ten countries, reached agreement on a framework for measuring capital adequacy and for applying a minimum capital standard to banks engaged in international business. The agreement¹ stated that the national supervisory authorities represented on the Committee² intended to implement the arrangements in their respective countries within a specified timescale. Subsequently a large number of other countries have announced that they intend to implement similar arrangements.

2. The definition of capital in the agreement is structured according to quality. The amount of the highest quality capital (tier 1 or core capital) is unlimited. Capital elements of lesser quality (tier 2 or supplementary capital), which include general provisions and loan-loss reserves, are admitted up to an amount equal to that of core capital (i.e. core capital must comprise at least 50% of the eligible total). Within the

1 International convergence of capital measurement and capital standards.

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

tier 2 elements there is a further constraint in that subordinated debt is limited to 50% of tier 1 capital.³

3. In concluding the July 1988 agreement, particular difficulty was experience in defining general provision or general loan-loss reserves. The final text recognised this problem in the following passage (paragraphs 18-21).

"General provisions or general loan-loss reserves are created against the possibility of future losses. Where they are not ascribed to particular assets and do not reflect a reduction in the valuation of particular assets, these reserves qualify for inclusion in capital and it has been agreed that they should be counted within tier 2. Where, however, provisions have been created against identified losses or in respect of a demonstrable deterioration in the value of particular assets, they are not freely available to meet unidentified losses which may subsequently arise elsewhere in the portfolio and do not possess an essential characteristic of capital. Such specific or earmarked provisions should therefore not be included in the capital base.

The Committee accepts, however, that, in practice, it is not always possible to distinguish clearly between general provisions (or general loan loss reserves) which are genuinely freely available and those provisions which in reality are earmarked against assets already identified as impaired. This partly reflects the present diversity of accounting, supervisory, and, importantly, fiscal policies in respect of provisioning and in respect of national definitions of capital. This means, inevitably, that initially there will be a degree of inconsistency in the characteristics of general provisions or general loan-loss reserves included by different member countries within the framework.

In the light of these uncertainties, the Committee intends during the proposed transitional period (see paragraphs 45 to 50 below) to clarify the distinction made in member countries between those elements which should conceptually be regarded as part of capital and those which should not qualify. The Committee will aim to develop before the end of 1990 firm proposals applicable to all member countries, so as to ensure consistency in the definition of general provisions and general loan-loss reserves eligible for inclusion in the capital base by the time the interim and final minimum target standards fall to be observed.

As a further safeguard, in the event that agreement is not reached on the refined definition of unencumbered resources eligible for inclusion in supplementary capital, where general provisions and general loan-loss reserves may include amounts reflecting lower valuations for assets or latent but unidentified losses present in the balance sheet, the amount of such reserves or provisions that qualify as capital would be phased down so that, at the end of the transitional period, such items would constitute no more than 1.25 percentage points, or exceptionally and

3 These limits are subject to certain concessions in the transitional period up to end-1992.

temporarily up to 2.0 percentage points, of risk assets within the secondary elements."

4. In accordance with the intention expressed in the third paragraph quoted above, the Committee has examined this aspect further and is now presenting proposals which it believes will clarify the definition of capital and significantly improve the quality of the capital employed in the international banking system. The details are set out in the attached annex, which is drafted in the form of a proposed amendment to paragraphs 18-21 of the main text and paragraph D of Annex 1 of the capital agreement.

Criteria for inclusion in capital

5. The conceptual basis for the inclusion of general provisions in capital derives from such reserves being freely available to meet future losses that are currently not identified. In effect, once the operating expenses (before provisioning expenses) and extraordinary expenses of a bank have been met, the remaining income can be used for three purposes. First, provisions can be made with respect to identified deterioration in the value of specific assets. It is generally agreed that such provisions should not be part of capital. Second, provisions can be made with respect to credit risk but where no specific deterioration in value has been identified. Under certain conditions described below, it is appropriate to include such balances in capital, but only in tier 2. The remaining income represents the balance of post-tax profits after all charges and provisions have been made. These funds, because they constitute shareholders' funds, and because losses on impaired assets cannot be charged directly to them without first being charged to the profit and loss account, can appropriately be included in tier 1 capital.

6. Banks in all countries have mechanisms for adjusting the value in their accounts of assets which are identified, for one reason or another, to have lost value. This identification of loss of value may arise from a failure by the borrower to make contractual payments of interest and principal. It may equally stem from a number of other factors influencing the lender to believe that the asset is likely not to be serviced fully in the future. Alternatively, the collateral may have diminished in value to such an extent that the protection it once furnished is no longer adequate. In such circumstances a prudent banker will write down such a loan or make

a specific provision against it. The write-down or provision will be a charge against current earnings. In some cases similar value adjustments may be made to a group or subset of a bank's assets that have been identified as having lost value. Action of this type may be taken because of external factors, such as the deterioration of the credit standing of the country or region in which the assets are located or of the industry in which the borrowers are active. Such adjustments may be made on a disaggregated basis, that is separate write-downs or provisions would be made to each loan in the group or subset. Alternatively, the loans may be carried at their gross value and a generic provision set up for the whole of the group of assets. But such a provision or reserve still reflects a judgement that the value of the particular assets has become impaired.

7. It is the task of senior management, internal auditors, external auditors and supervisors to ensure that this process of review and judgement is carried on in a prudent and timely manner and that the resulting net values adequately reflect any identified deterioration in asset quality. Normally it would be the value of the asset net of provisions for identified deterioration that appears in the balance sheet but, where the asset is still shown gross and the provision held on the liabilities side of the balance sheet, these provisions clearly fall into the first of the three classes enumerated above and should not form part of capital.

8. Banks in most countries also establish what are known as general provisions or loan-loss reserves, which may in certain cases not be publicly disclosed. Where such general loan loss reserves or provisions are not allocated in any way, formally or informally, to an identified deterioration in any asset or group or subset of assets, and are therefore genuinely available to meet losses which are subsequently identified wherever they may occur, these balances fall into the second class and it would be reasonable to include them in capital. However, because additions to such balances are made before a final measure of profit is reached, because losses may be charged directly to such balances and because such balances are often either not disclosed or are shown as a deduction from assets, it was accepted in the capital agreement that such provisions or reserves should only be included in tier 2 capital, although supervisors in some countries have chosen to exclude them altogether.

9. Finally, the residual of profit after tax and dividends is credited to variously named shareholders' equity accounts, e.g. retained earnings, free or general reserves, balance of profit and loss account, etc. Such balances, where they are unambiguously shareholders' funds, properly belong to tier 1. In a few European countries earnings are sometimes retained in an unpublished or hidden reserve. Although such retentions are freely available, because of their lack of transparency they are included in tier 2.

10. In order to facilitate the gradual phasing-out of hidden reserves, the European Community has provided in its Bank Accounts Directive⁴ for a Fund for general banking risks. This account is designed to form part of retained earnings. Amounts can only be transferred to or from the Fund via the post-tax balance on the profit and loss account, i.e. losses cannot be directly charged to the Fund but must be taken through the profit and loss account. Consequently, it has been agreed that balances in such accounts are properly a part of core capital. Funds with the same characteristics in the accounts of non-EC countries will be entitled to the same treatment.

11. The major area where practice has differed in an economic rather than an accounting sense has lain so far in the treatment of the adjustments made by banks in respect of their sovereign claims on countries with severe debt problems. In most countries represented on the Basle Committee, provisions or reserves in respect of such claims are regarded as specific, even if the adjustments are in some cases in respect of a group of countries, rather than in respect of individual borrowers. In some countries, however, such adjustments have not been so regarded on the grounds that the reserves were not linked to a specified group of assets and could therefore be used to meet losses occurring elsewhere. This different treatment is often due to important differences in the tax treatment of these reserves against sovereign borrowers.

4 This Directive, whose full title is "Council Directive of 8th December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions", must be implemented in national legislation by 1st January 1993.

The proposals

12. The attached proposals for amending the capital accord are designed to achieve further convergence in the definition of capital as well as an improvement in the quality of capital. They clarify the terms on which those elements designed to provide against identified deterioration in specified assets, and therefore unavailable to meet other losses wherever they may arise, are to be excluded from capital. Conversely, the proposals recognise the reality that some banks have reserves which have exactly the same quality as retained earnings and allow for the inclusion of such elements in tier 1, subject to certain strict criteria designed to make them indistinguishable from retained earnings. Elements which remain in general provisions/general loan-loss reserves would continue to be eligible as tier 2 capital, on condition that they constitute no more than 1.25 percentage points of risk assets.

Transitional and procedural arrangements

13. The Committee realises that it will be difficult for the above proposals to be fully implemented for all banks by the end of the transitional period envisaged in the 1988 agreement, that is by the end of 1992. It is intended, however, that in all cases they should be fully implemented as soon as possible, and at the latest by the end of 1993. Until that date the existing arrangements will apply, that is to say the limits in paragraph 21 of the 1988 paper will apply in the period between the end of 1990 and the end of 1993.

14. In order to ensure that the proposals are having the desired effect of achieving further convergence and improving the quality of capital, the Committee will keep these arrangements under periodic review. Such a review would include, inter alia, an assessment of the following aspects:

- (i) that the Fund for general banking risks (or other reserves in non-EC countries having the same attributes) is being or is likely to be used in the way anticipated;
- (ii) that the level of the limit on general provisions/general loan-loss reserves in tier 2 capital is appropriate;
- (iii) that differing tax arrangements are adequately catered for.

15. Since the proposals constitute an amendment to the 1988 agreement, a period for consultation with commercial banks and other interested parties is envisaged. This consultative process will be handled at national level in the first instance and the Committee will co-ordinate the comments and responses made to individual member supervisory authorities. The closing date for the receipt of comments will be set by national supervisors, but the Committee intends to issue a final amendment to the 1988 agreement in the second half of 1991.

Basle, February 1991

Basle Committee
on
Banking Supervision

Proposed amendments to the Basle capital accord

A. Replacement for paragraphs 18-21

(iii) **General provisions/general loan-loss reserves**

18. General provisions or general loan-loss reserves are created against the possibility of future losses. Where they do not reflect an identified deterioration in the valuation of particular assets, these reserves qualify for inclusion in tier 2 capital. Where, however, provisions or reserves have been created against identified losses or in respect of an identified deterioration in the value of any asset or group or subsets of assets, they are not freely available to meet unidentified losses which may subsequently arise elsewhere in the portfolio and do not possess an essential characteristic of capital. Such provisions or reserves should therefore not be included in the capital base.

19. The supervisory authorities represented on the Committee undertake to ensure that all assets are appropriately valued to reflect any identified deterioration in value. They will also ensure that general provisions or general loan-loss reserves will only be included in capital if they are not intended to deal with the deterioration of particular assets, whether individual or grouped.

20. This would mean that all elements in general provisions or general loan loss reserves designed to protect a bank from identified deterioration in the quality of specific assets (whether foreign or domestic) should be ineligible for inclusion in capital. In particular, elements that reflect identified deterioration in assets subject to country risk, in real estate lending and in other problem sectors would be excluded from capital.

21. General provisions/general loan-loss reserves that qualify for inclusion in tier 2 under the terms described above do so subject to a limit of 1.25 percentage points of weighted risk assets.

B. Amendments to Paragraph D of Annex 1

Indent (i) (first sentence)

Tier 1: includes only permanent shareholders' equity (issued and fully paid ordinary shares/common stock and perpetual non-cumulative preference shares) and disclosed reserves (created or increased by appropriations of retained earnings or other surplus, e.g. share premiums, retained profit, general reserves and legal reserves). Disclosed reserves also include general funds (such as a Fund for general banking risks in certain EC countries) of the same quality that meet the following criteria:

- allocations to the funds must be made out of post-tax retained earnings or out of pre-tax earnings adjusted for all potential tax liabilities;
- the funds and movements into or out of them must be disclosed separately in the bank's published accounts;
- the funds must be available to a bank to meet losses for unrestricted and immediate use as soon as they occur;
- losses cannot be charged directly to the funds but must be taken through the profit and loss account.

Indent (ii)(c)

General provisions/general loan-loss reserves: provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialise and therefore qualify for inclusion within supplementary elements. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded. Furthermore, general provisions/general loan-loss reserves eligible for inclusion in tier 2 will be limited to a maximum of 1.25 percentage points of weighted risk assets.

C. Amendment to the transitional arrangements (section IV and Annex 4)

The transitional arrangements will remain as specified in the agreement, subject to the extension of the transitional period until end-1993 for the implementation of the arrangements described above.