FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10498**
December 11, 1991]

INTERNATIONAL RISK-BASED CAPITAL ACCORD

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:

Our Circular No. 10441, dated March 21, 1991, announced a proposal by the Basle Committee on Banking Supervision concerning the inclusion of general loan-loss reserves in the definition of capital under the international risk-based capital accord. Printed below is a joint agency press release — by the Comptroller of the Currency, the FDIC, and the Board of Governors of the Federal Reserve System — announcing the Basle Committee's adoption of the proposal:

> The Basle Committee on Banking Supervision has released the attached amendment to the international risk-based capital accord. The amendment gives greater precision to the inclusion of general loan loss reserves in the definition of capital under the international risk-based capital accord.
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> The U.S. banking agencies regard the amendment as useful and consistent with the risk-based capital guidelines previously adopted by the U.S. agencies in 1989.
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> 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.
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> 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 attached amendment reflects results of these efforts.
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> Since no change in existing U.S. risk-based capital guidelines will result from this amendment, 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 amendment by the Basle Committee. Copies of the enclosure will be furnished to others upon request directed to our Circulars Division (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 may be directed to Manuel J. Schnaidman, Staff Director, Bank Analysis Division (Tel. No. 212-720-6710).

E. GERALD CORRIGAN,
President.

Basle Committee
on
Banking Supervision

<u>Amendment of the Basle capital accord in respect of the inclusion of general provisions/general loan-loss reserves in capital</u>

1. Banking supervisors in the Group of Ten countries, with the approval of their central-bank Governors, have agreed to implement the attached changes to the Basle capital accord of July 1988. The changes affect paragraphs 18-21 of the accord and two sections of Annex 1, paragraph D.

2. The amended text is virtually the same as that contained in the proposals issued on 21st February 1991. The only change made has been to replace the word "future" with other wording in two parts of the text which referred to the fact that general provisions are created against the possibility of future losses. This is because the accounting profession has noted that law and accounting practice in a number of countries prohibits the setting-up of provisions for unidentified losses that relate to unknown conditions which could arise in the future, requiring this to be done by transfer to a separate reserve.

3. It is intended that these amendments be fully implemented by member countries 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.

4. 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:

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(i) that disclosed reserves and equivalent general funds (such as the EC's Fund for general banking risks) are being or are 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.

6th November 1991

Basle Committee
on
Banking Supervision

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 losses not yet identified. Where they do not reflect a known 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 the supervisory process takes due account of 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 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.

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