FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10836**
March 26, 1996]

CAPITAL ADEQUACY GUIDELINES

Amendments Regarding Country Transfer Risk

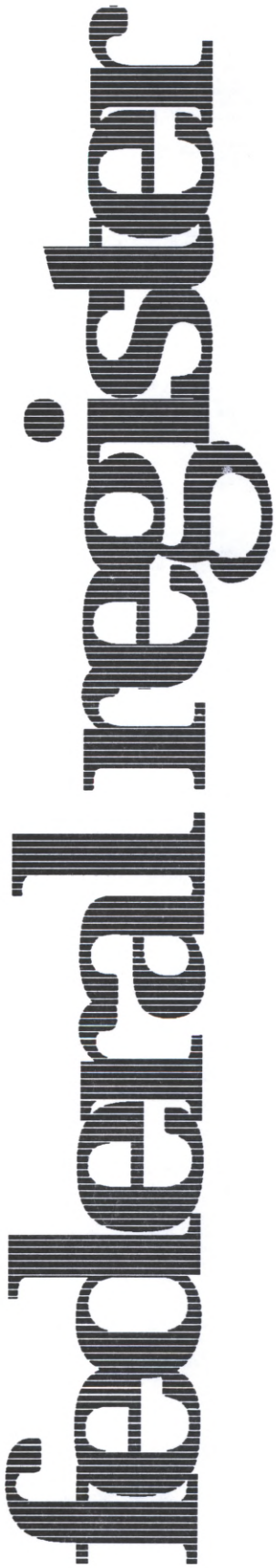
To All State Member Banks and Bank Holding Companies
in the Second Federal Reserve District, and Others Concerned:

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation have jointly amended their respective capital adequacy guidelines in order to conform those guidelines to a change in the Basle Accord on risk-based capital that was adopted by the Basle Committee on Banking Supervision on April 15, 1995.

Enclosed — for State member banks and bank holding companies, and others who maintain sets of the Board's regulations — is the text of the Board's amendments to its Capital Adequacy Guidelines, as published in the *Federal Register* of December 20, 1995. Copies will be furnished to others on request directed to our Circulars Division (FAX Tel. No. 212-720-6767). For those who have access to the Internet, the U.S. Government Printing Office now makes the *Federal Register* available on the Internet; the reference address is http://www.access.gpo.gov/.

Questions concerning these guidelines may be directed, at this Bank, to Kausar Hamdani, Assistant Vice President, Bank Analysis Function (Tel. No. 212-750-8258).

WILLIAM J. MCDONOUGH,
President.



Wednesday
December 20, 1995

CAPITAL ADEQUACY GUIDELINES

Amendments
Effective April 1, 1996

Part VI

Federal Reserve System
12 CFR Parts 208 and 225

Capital; Capital Adequacy Guidelines; Joint Final Rule

66041

Printed in New York, from *Federal Register*; Internet address
http://www.access.gpo.gov/

CAG 125/96

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 95–28]

RIN 1557–AB14

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–0849]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AB54

Capital; Capital Adequacy Guidelines

AGENCIES: Office of the Comptroller of the Currency (OCC), Treasury; Board of Governors of the Federal Reserve System (Board); and Federal Deposit Insurance Corporation (FDIC).

ACTION: Joint final rule.

SUMMARY: The OCC, Board, and the FDIC (Agencies) are amending their respective risk-based capital guidelines to modify the definition of the OECD-based group of countries. The amendment excludes from the OECD-based group of countries any country that has rescheduled its external sovereign debt within the previous five years. The amendment also clarifies that the OECD-based group of countries includes all countries that are members of the OECD, regardless of their date of entry into the OECD. The effect of the amendment would be to increase the amount of capital that banks are required to hold against claims on the governments and banks of an OECD country, in the event that the country were to reschedule its external sovereign debt. This action is being taken to conform with a change in the Basle Accord on risk-based capital that was adopted by the Basle Committee on Banking Supervision (Basle Committee) on April 15, 1995.

EFFECTIVE DATE: April 1, 1996.

FOR FURTHER INFORMATION CONTACT: *OCC:* Geoffrey White, Senior International Economic Advisor, International Banking and Finance Department, (202) 874–5235; Saumya Bhavsar, Attorney, Legislative and Regulatory Activities Division, (202) 874–5090; Ronald Shimabukuro, Senior Attorney, Legislative and Regulatory Activities Division, (202) 874–5090; or Roger Tufts, Senior Economic Advisor, Office of the Chief National Bank Examiner, (202) 874–5070; Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

Board: Roger Cole, Deputy Associate Director, (202) 452–2618; Norah Barger, Manager, (202) 452–2402; Robert Motyka, Supervisory Financial Analyst, (202) 452–3621; Division of Banking Supervision and Regulation; or Greg Baer, Managing Senior Counsel, Legal Division, (202) 452–3236; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. For the hearing impaired *only*, Telecommunication Device for the Deaf, Dorothea Thompson, (202) 452–3544.

FDIC: For supervisory purposes, Stephen G. Pfeifer, Examination Specialist, Accounting Section, Division of Supervision, (202) 898–8904; for legal purposes, Dirck A. Hargraves, Attorney, Legal Division, (202) 898–7049; Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

SUPPLEMENTARY INFORMATION:

I. Background

In 1988, the central bank governors of the Group of Ten (G–10) countries endorsed a framework for international risk-based capital guidelines entitled "International Convergence of Capital Measurement and Capital Standards" (commonly referred to as the Basle Accord).[1] Under the framework, risk-weighted assets are calculated by assigning assets and off-balance-sheet items to broad categories based primarily on their credit risk: that is, the risk that a banking organization will incur a loss due to an obligor or counterparty default on a transaction. Risk weights range from zero percent, for assets with minimal credit risk (such as U.S. Treasury securities), to 100 percent, which is the risk weight that applies to most private sector claims, including commercial loans. In 1989, the Agencies adopted risk-based capital guidelines implementing the Basle Accord for the banking organizations they supervise.

While the Basle Accord focuses primarily on credit risk, it also incorporates country transfer risk considerations. Transfer risk generally refers to the possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraints on, the availability of needed foreign exchange in the country of the obligor.

In addressing transfer risk, the Basle Committee members examined several methods for assigning obligations of foreign countries to the various risk categories. Ultimately, the Basle Committee decided to use a defined group of countries considered to be of high credit standing as the basis for differentiating claims on foreign governments and banks. For this purpose, the Basle Committee determined this group to be the full members of the Organization for Economic Cooperation and Development (OECD), as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow.[2] These countries, referred to in the Agencies' risk-based capital guidelines as the OECD-based group of countries, encompass most of the world's major industrial countries, including all members of the G–10 and the European Union.

Under both the Basle Accord and the Agencies' risk-based capital guidelines, claims on the governments and banks of the OECD-based group of countries generally receive lower risk weights than corresponding claims on the governments and banks of non-OECD countries. Specifically, the Agencies' guidelines provide for the following treatment:

- Direct claims on, and the portions of claims that are directly and unconditionally guaranteed by, OECD-based central governments (including central banks) are assigned to the zero percent risk weight category. Corresponding claims on the central government of a country outside the OECD-based group are assigned to the zero percent risk weight category only to the extent that the claims are denominated in the local currency and the bank has local currency liabilities in that country.
- Claims conditionally guaranteed by OECD-based central governments and

[1] The Basle Accord was proposed by the Basle Committee, which comprises representatives of the central banks and supervisory authorities from the G–10 countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.

[2] The OECD is an international organization of countries which are committed to market-oriented economic policies, including the promotion of private enterprise and free market prices; liberal trade policies; and the absence of exchange controls. Full members of the OECD at the time the Basle Accord was endorsed included Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. In May 1994, Mexico was accepted as a full member of the OECD. In addition, Saudi Arabia has concluded special lending arrangements associated with the IMF's General Arrangements to Borrow.

claims collateralized by securities issued or guaranteed by OECD-based central governments generally are assigned to the 20 percent risk weight category. The same types of claims on non-OECD countries are assigned to the 100 percent risk category.

- Long-term claims on non-OECD banks are assigned to the 100 percent risk category, rather than to the 20 percent risk category accorded to long-term claims on OECD banks. (Short-term claims on all banks are assigned to the 20 percent risk weight category.)
- General obligation bonds that are obligations of states or other political subdivisions of the OECD-based group of countries are assigned to the 20 percent risk category. Revenue bonds of such political subdivisions are assigned to the 50 percent risk category. General obligation and revenue bonds of political subdivisions of non-OECD countries are assigned to the 100 percent risk category.

Recently, the OECD has taken steps to expand its membership. In light of these steps, the Basle Committee was urged to clarify an ambiguity in the Basle Accord as to whether the OECD members qualifying for the lower risk weights include only those members that were members of the OECD when the Basle Accord was endorsed in 1988, or all members, regardless of their date of entry into the OECD. The Basle Committee also reviewed the overall appropriateness of the criteria the Basle Accord uses to determine whether claims on a foreign government or bank qualify for placement in a lower risk category. As part of this review, the Basle Committee reassessed whether membership in the OECD (or the conclusion of special lending arrangements with the IMF) would, by itself, be sufficient to ensure that only countries with relatively low transfer risk would qualify for lower risk weight treatment.

On July 15, 1994, the Basle Committee clarified that the reference in the Basle Accord to OECD members applies to all current members of the organization. The Basle Committee also stated its intention, subject to national consultation, to amend the definition of the OECD-based group of countries in the Basle Accord in order to exclude from lower risk weight treatment any country within the OECD-based group of countries that had rescheduled its external sovereign debt within the previous five years. The Basle Committee adopted this change in the definition of the OECD-based group of countries on April 15, 1995.

On October 14, 1994, the Board and the OCC published a joint notice of proposed rulemaking (59 FR 52100) to make corresponding changes in the definition of the OECD-based group of countries in their risk-based capital guidelines. The FDIC published a similar proposal on February 15, 1995 (60 FR 8582). Under the Agencies' proposals, the OECD-based group of countries would continue to include countries that are full members of the OECD, regardless of entry date, as well as countries that have concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow, but would exclude any country within this group that had rescheduled its external sovereign debt within the previous five years. The purpose of the proposed modification was to clarify that membership in the OECD-based group of countries must coincide with relatively low transfer risk in order for a country to qualify for the lower risk-weight treatment.

Under the proposals, reschedulings of external sovereign debt generally would include renegotiations of terms arising from a country's inability or unwillingness to meet its external debt service obligations. The proposals further provided that renegotiations of debt in the normal course of business generally would not indicate transfer risk of the kind that would preclude an OECD-based country from qualifying for lower risk weight treatment.

The Agencies invited comment on all aspects of the proposal.

II. Comments Received

The OCC and the Board together received two public comments on their proposal. (The FDIC did not receive any comments.) One commenter was a regional banking organization that generally supported the proposal. The other was a clearinghouse that opposed the proposal.

The banking organization agreed that OECD membership alone is not sufficient to ensure that only countries with relatively low transfer risk qualify for lower risk weight treatment, and it supported the additional criterion as providing a good indication of a higher level of transfer risk. The banking organization suggested that the definition should be further revised to exclude newly-formed countries, whose willingness and ability to meet their debt obligations were unproven, for a period of five years. The Agencies did not adopt this suggestion, because the process of admitting countries to the OECD is lengthy enough that the five-year waiting period recommended by the commenter would have little practical effect.

The clearinghouse viewed the current criteria as adequate and commented that adding another criterion would increase the complexity of and confusion about the risk-based capital guidelines. Although the Agencies agree with the commenter on the need to minimize the complexity of the risk-based capital guidelines, the Agencies do not believe that this rule will increase their complexity significantly, particularly since reschedulings by OECD countries tend to be extremely rare. Until a rescheduling occurs, the change in the definition will not have any effect on the assignment of assets to risk-weight categories, and thus will have little or no effect on banks.

III. Final Rule

After carefully considering the comments received and deliberating further on the issues involved, the Agencies are adopting a final rule that amends the definition of the OECD-based group of countries in their risk-based capital guidelines substantially as proposed.

Under the final rule, the OECD-based group of countries continues to include countries that are full members of the OECD, regardless of entry date, as well as countries that have concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow, but excludes any country within this group that has rescheduled its external sovereign debt within the previous five years.

For purposes of this final rule, an event of rescheduling of external sovereign debt generally would include renegotiations of terms arising from a country's inability or unwillingness to meet its external debt service obligations. Renegotiations of debt in the normal course of business generally do not indicate transfer risk of the kind that would preclude an OECD-based country from qualifying for lower risk weight treatment. One example of such a routine renegotiation would be a renegotiation to allow the borrower to take advantage of a change in market conditions, such as a decline in interest rates.

This distinction between renegotiations arising from a country's inability or unwillingness to meet its external debt service obligations and renegotiations that reflect a change in market conditions was discussed in the preambles of the Agencies' notices of proposed rulemaking but was not included in the regulatory text. In order to clarify the meaning of the final rule, the Agencies are including language to this effect in the text of the final rule.

IV. Regulatory Flexibility Act Analysis

The Agencies hereby certify that this final rule will not have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations), in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). The impact on institutions regulated by the Agencies, regardless of their size, will be minimal. In addition, because the risk-based capital guidelines generally do not apply to bank holding companies with consolidated assets of less than $150 million, this proposal will not affect such companies. Accordingly, no regulatory flexibility analysis is required.

V. Paperwork Reduction Act and Regulatory Burden

The Agencies have determined that this final rule will not increase the regulatory paperwork burden of banking organizations pursuant to the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*).

Section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Pub. L. 103–325, 108 Stat. 2160) provides that the Agencies must consider the administrative burdens and benefits of any new regulations that impose additional requirements on insured depository institutions. Section 302 also requires such a rule to take effect on the first day of the calendar quarter following final publication of the rule, unless the agency, for good cause, determines an earlier effective date is appropriate. This final rule is effective on April 1, 1996.

VI. OCC Statement on Executive Order 12866

The OCC has determined that this final rule is not a significant regulatory action, as that term is defined by Executive Order 12866.

VII. OCC Statement on Unfunded Mandates Act of 1995

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104–4 (Unfunded Mandates Act), signed into law on March 22, 1995, requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC has determined that this final rule will not result in expenditures by State, local, and tribal governments, or by the private sector, of $100 million or more in any one year. Accordingly, the OCC has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

List of Subjects

12 CFR Part 3

Administrative practice and procedure, Capital, National banks, Reporting and recordkeeping requirements, Risk.

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Flood insurance, Mortgages, Reporting and recordkeeping requirements, Securities.

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 325

Bank deposit insurance, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.

Authority and Issuance

FEDERAL RESERVE SYSTEM

12 CFR CHAPTER II

For the reasons set forth in the joint preamble, the Board of Governors of the Federal Reserve System amends 12 CFR parts 208 and 225 as set forth below:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for part 208 continues to read as follows:

Authority: 12 U.S.C. 36, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1823(j), 1828(o), 1831o, 1831p–1, 3105, 3310, 3331–3351, and 3906–3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o–4(c)(5), 78q, 78q–1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4102a, 4104a, 4104b, 4106, 4128.

2. Appendix A to part 208 is amended by revising footnote 22 in section III.B.1. to read as follows:

Appendix A to Part 208—Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure

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III. * * *

B. * * *

1. * * *[22]* * *

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[22]The OECD-based group of countries comprises all full members of the

[1] As of November 1995, the OECD included the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States; and Saudi Arabia had concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow.

Organization for Economic Cooperation and Development (OECD) regardless of entry date, as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow, but excludes any country that has rescheduled its external sovereign debt within the previous five years. As of November 1995, the OECD included the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States; and Saudi Arabia had concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow. A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal course of business, such as a renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

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PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

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

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p–1, 1843(c)(8), 1844(b), 1927(l), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. Appendix A to part 225 is amended by revising footnote 25 in section III.B.1. to read as follows:

Appendix A to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure

III. * * *
B. * * *
1. * * *[25] * * *

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[25]The OECD-based group of countries comprises all full members of the Organization for Economic Cooperation and Development (OECD) regardless of entry date, as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow, but excludes any country that has rescheduled its external sovereign debt within the previous five years. As of November 1995, the OECD included the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States; and Saudi Arabia had concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow. A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal course of business, such as a renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

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By the order of the Board of Governors of the Federal Reserve System, November 13, 1995.

William W. Wiles,

Secretary of the Board.