
Banking & Finance

AN EIGHTH DISTRICT PERSPECTIVE

FALL 1988

Standby Letters of Credit and Capital Requirements

During the 1980s, the trend toward more stringent capital adequacy standards in bank regulation has constrained asset growth at many of our nation's banks. In other words, banks have attempted to increase their capital-to-asset ratios by restricting the growth of assets listed on their balance sheets. At the same time, however, standby letters of credit (SLCs) and other "off-balance sheet" transactions have experienced tremendous growth. Regulators are concerned that off-balance sheet exposure may increase capital risk even as banks strengthen their capital-to-asset ratios. From a regulatory perspective, the general improvement in capital adequacy positions serves to reduce default risk and to protect the deposit insurance fund. However, default risk and the liability of the deposit insurance system also depend on the degree of asset risk assumed by banks. To the extent that asset risk has increased in recent years, the effects of the higher capital levels may have been offset.

This article looks at one example of off-balance sheet banking, standby letters of credit, and explains how these transactions will be accounted for under the new risk-based capital guidelines.

Standby Letters of Credit

A standby letter of credit is a contractual arrangement involving three parties. The bank, as issuer of the letter of credit, guarantees that the bank's customer will meet an underlying contractual obligation to the beneficiary. The SLC underwrites the beneficiary's risk of loss should the account party fail to repay a debt obligation.

When an SLC is used to back a debt obligation, the bank assumes the default or credit risk of the loans to its customer, and a third party funds the loan. By issuing an SLC, many of the services associated with commercial lending, such as credit risk evaluation, are separated from the actual funding of the loan. Through this separation, a bank can earn fee income without having to put an asset or corresponding liability on its balance sheet.

A Growing Market

As indicated in the table on the following page, the nationwide SLC market has grown rapidly over the last several years, from less than \$50 billion at year-end 1980 to more than \$160 billion in June of this year. At the 36 largest banks in the nation, those with assets more than \$10 billion, SLCs now exceed \$124 billion. Across the nation, more than 2,000 banks had SLCs outstanding as of mid-year, a notable increase from the 177 banks in December 1980.

A similar pattern of growth for SLCs has occurred at banks in the Eighth District. SLCs outstanding as of June 1988 totaled approximately \$1.5 billion, slightly less than 10 times the dollar volume reported in December 1980. In addition, the number of District banks participating in the SLC market has expanded from seven at year-end 1980 to 160 in June of this year.

One reason for the growth in SLCs is that these instruments provide a way for a bank to increase its effective leverage. Currently, banks must hold a fixed amount of capital against all *booked* assets. One way for a bank to avoid this requirement is by issuing a contingent liability such as an SLC, which is not categorized as an asset and, therefore, not subject to capital requirements. Thus, the presence of these *unbooked* liabilities effectively increases capital leverage, creating an incentive for banks to shift toward the fee income generated by SLCs and other off-balance sheet activities that do not absorb capital.

Another explanation for the growth in this market is that SLCs permit banks to separate the credit risk from the interest-rate risk associated with a loan. The bank can underwrite the credit risk while the beneficiary bears the risk of any change in the value of the loan caused by interest rate movements.

Capital Adequacy

Currently, bank regulators place only limited restrictions on banks' SLC activities. They require that banks treat SLCs as loans



Standby Letters of Credit (billions of dollars outstanding)

	June 1988	December 1980
United States		
All banks	\$165.8 (2294) ¹	\$42.6 (177)
\$100-\$300 million ²	2.1 (1376)	0.0
\$300 million-\$1 billion	4.5 (478)	0.2 (19)
\$1-\$10 billion	35.0 (309)	7.1 (134)
>\$10 billion	124.1 (36)	35.3 (18)
Eighth District		
All banks	1.5 (160)	0.2 (7)
\$100-\$300 million	0.1 (113)	0.0
\$300 million-\$1 billion	0.2 (30)	0.0
\$1-\$10 billion	1.2 (13)	0.2 (7)

¹The number in parenthesis represents the number of reporting banks.

²Size categories based on asset size.

SOURCE: FDIC Quarterly Reports of Condition and Income for Insured Commercial Banks, June 1988 and December 1980

for the purposes of evaluating credit quality and calculating loan concentration ratios. However, because of the inherent riskiness of SLCs as well as the greater potential for capital leverage with SLCs than with loans, some form of capital regulation is needed in order to protect the assets of the federal deposit insurance fund.

The Federal Reserve Board has proposed that its current capital regulation be supplemented by risk-based capital guidelines that would take into account the relative riskiness of certain off-balance sheet items. The basic purpose of the new guidelines is to require more bank capital against riskier assets. Therefore, the focus on risk-based standards reflects the concern that simple minimum standards for capital adequacy have not kept pace with possible increases in asset risk.

The guidelines chart a bank's risk profile by establishing a relationship between assets and five general categories of risk, to be weighted at 0, 10, 25, 50 or 100 percent. Each asset is assigned a category depending on its credit risk. Assets in the highest risk category receive a 100 percent weight, meaning they count fully as assets when calculating the risk-adjusted capital ratio. Many of the usual bank assets fall within this group, including commercial and industrial loans, residential real estate loans and consumer loans. Off-balance sheet assets are included in the guidelines on a "credit equivalent" basis; that is, the face amount of the item is multiplied by a conversion factor to arrive at a balance

sheet equivalent amount. The guidelines apply a 100 percent conversion factor to financial guarantees that are effectively a direct extension of credit to the customer, as with standby letters of credit.

After the conversion amount is determined, that amount is multiplied by the asset risk variable to determine capital risk. Under the new risk-based capital guidelines for off-balance sheet items, the same risk weight is assigned to most SLCs as to loans. For example, an off-balance sheet standby letter of credit to support a shopping center development has a conversion rate of 100 percent because it is a credit substitute. The risk capital assessment on such a loan on the balance sheet is also 100 percent; therefore, the entire balance is considered a risk asset. The risk asset ratio is determined by aggregating the risk-weighted asset and off-balance sheet amounts and dividing the total capital by the amount of risk assets.

In order to comply with the new risk-based requirements, a bank with a large portfolio of SLCs might be required either to raise additional capital or to reduce leverage by changing the composition of its asset and off-balance sheet portfolios. The advantage of these guidelines is that they reduce banks' incentive to issue SLCs merely as a means of increasing effective leverage and circumventing capital regulation.

—Lynn M. Barry

This is the final issue of **Banking & Finance - An Eighth District Perspective**. The Bank's three quarterly regional publications will be merged into one regional publication, **Pieces of Eight - An Economic Perspective on the Eighth District**. Our goal is to increase the usefulness of the Bank's analyses of economic activity in the Eighth District. The new format will allow greater flexibility in covering topics and providing data. **Pieces of Eight** will debut February 1989 and will be published quarterly. Current subscribers of our regional publications will automatically receive the new publication.

Banking & Finance—An Eighth District Perspective is a quarterly summary of banking and finance conditions in the area served by the Federal Reserve Bank of St. Louis. Single subscriptions are available free of charge by writing: Research and Public Information Department, Federal Reserve Bank of St. Louis, P.O. Box 442, St. Louis, Missouri 63166. Views expressed are not necessarily official positions of the Federal Reserve System.

EIGHTH DISTRICT BANKING DATA

LARGE WEEKLY REPORTING BANKS¹

	Level III/1988 (\$ millions)	Rates of Change			
		Current Quarter II/1988- III/1988	Current Year III/1987- III/1988	Same Periods Previous Year	
				II/1987- III/1987	III/1986- III/1987
Selected Assets & Liabilities					
Total Loans & Leases	\$20,858	2.6%	6.2%	2.8%	9.7%
Commercial Loans	7,147	7.7	11.2	-2.4	8.6
Consumer Loans	4,374	-15.8	-9.1	9.1	15.8
Real Estate Loans	6,058	12.3	16.0	27.5	24.7
Loans to Financial Institutions	913	32.5	3.8	-52.5	-21.3
All Other Loans	2,364	-6.8	3.0	-10.0	-9.2
Total Securities	4,980	-13.9	6.9	-2.1	13.6
U.S. Treasury & Agency Securities	3,539	-17.6	10.6	-1.1	29.0
Other Securities	1,440	-3.9	-1.4	-4.3	-9.9
Total Deposits	23,881	2.8	5.7	1.3	7.3
Non-Transaction Balances	15,318	6.3	9.0	10.4	8.2
MMDAs	2,718	-5.0	-0.8	-21.6	2.9
\$100,000 CDs	4,826	-0.6	7.4	38.1	19.0
Demand Deposits	5,938	-1.9	-1.9	-16.7	0.4
Other Transaction Balances ²	2,624	-5.9	5.8	1.9	22.3

EIGHTH DISTRICT INTEREST RATES³

	September 1988	August 1988	July 1988	September 1987
NOWs	5.08%	5.09%	5.08%	5.04%
MMDAs	5.50	5.50	5.43	5.38
Time CDS				
92 — 182 days	7.06	6.96	6.73	6.36
1 — 2½ years	7.50	7.52	7.27	7.03
2½ years and over	7.95	7.92	7.76	7.59

All data are not seasonally adjusted.

¹ A sample of commercial banks with total assets greater than \$750 million. Historical data have been revised to incorporate adjustment factors that offset the cumulative effects of mergers and other changes involving weekly reporting banks during 1986. These adjustment factors, which are computed each year, are used to construct a consistent time series for which year-to-year growth rates can be calculated. Adjustment factors are available upon request from the Statistics Section of the Research and Public Information Department. Rates of change are compounded annual rates.

² Includes NOW, ATS and accounts permitting telephone or pre-authorized transfers.

³ Average interest rates paid on new deposits by a sample of Eighth District commercial banks.

QUARTERLY BANK PERFORMANCE RATIOS

	Eighth District			United States		
	II/88	II/87	II/86	II/88	II/87	II/86
Annualized Return on Average Assets						
<\$100 million ¹	1.06%	1.00%	1.09%	.72%	.65%	.76%
\$100 — \$300 million	1.04	.97	1.03	.85	.78	.92
\$300 million — \$1 billion	1.05	.97	.89	.68	.58	.81
\$1 billion — \$10 billion	.84	.45	1.02	.69	.46	.76
>\$10 billion	N.A.	N.A.	N.A.	.64	-2.03	.46
Annualized Return on Average Equity						
<\$100 million	11.62	11.27	12.31	8.17	7.53	8.73
\$100 — \$300 million	12.65	12.08	12.90	10.92	10.25	12.14
\$300 million — \$1 billion	13.24	12.36	11.69	9.83	8.08	11.46
\$1 billion — \$10 billion	12.74	6.94	15.19	10.88	7.35	11.95
>\$10 billion	N.A.	N.A.	N.A.	14.03	-48.88	9.06
Loans as Percent of Deposits						
<\$100 million	57.40	55.62	55.17	59.93	58.41	58.54
\$100 — \$300 million	66.21	64.65	62.64	66.22	64.98	64.44
\$300 million — \$1 billion	71.01	67.89	68.60	75.58	74.56	73.02
\$1 billion — \$10 billion	86.34	83.47	79.54	86.24	83.77	83.30
>\$10 billion	N.A.	N.A.	N.A.	89.21	88.12	89.74
Nonperforming Loans as Percent of Total Loans²						
<\$100 million	2.01	2.52	3.00	2.50	3.08	3.39
\$100 — \$300 million	1.81	2.14	2.31	2.09	2.49	2.62
\$300 million — \$1 billion	1.51	2.15	2.65	2.21	2.52	2.49
\$1 billion — \$10 billion	2.27	2.43	2.02	2.21	2.51	2.25
>\$10 billion	N.A.	N.A.	N.A.	5.01	5.59	3.51
Loan Loss Reserves as Percent of Total Loans						
<\$100 million	1.50	1.51	1.38	1.64	1.64	1.48
\$100 — \$300 million	1.35	1.38	1.30	1.51	1.54	1.37
\$300 million — \$1 billion	1.35	1.44	1.38	1.62	1.67	1.46
\$1 billion — \$10 billion	1.91	1.94	1.44	1.77	1.87	1.54
>\$10 billion	N.A.	N.A.	N.A.	4.17	4.25	1.72
Net Loan Losses as Percent of Total Loans³						
<\$100 million	.18	.30	.38	.35	.48	.57
\$100 — \$300 million	.19	.31	.32	.33	.36	.37
\$300 million — \$1 billion	.19	.33	.28	.39	.41	.37
\$1 billion — \$10 billion	.56	.30	.27	.55	.34	.38
>\$10 billion	N.A.	N.A.	N.A.	.52	.40	.40

¹ Size ranges based on bank assets.

² Includes past due greater than 89 days and nonaccrual.

³ Loan losses are adjusted for recoveries.