Joint News Release

Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board

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The U.S. bank regulatory agencies and the Bank of England have agreed to request public comment on a proposed risk-based capital framework for banks and bank holding companies that has been developed jointly by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Bank of England.

The proposal is the result of discussions between the U.S. bank regulatory agencies and the Bank of England, and represents an important step toward bringing together the assessment of capital adequacy and the establishment of minimum capital standards on an international basis, especially in view of the increasing trend toward global banking competition.

Specific goals of the proposal include:

- making regulatory capital requirements more sensitive to differences in the risk of banking institutions;
- assessing a capital requirement against certain off-balance sheet exposures;
- recognizing that holding low risk, relatively liquid assets requires less capital; and
- moving the capital adequacy policies of the U.S. and other major industrial countries into closer alignment.

The U.S./U.K. proposal encompasses a common definition of primary capital and risk categories. The framework is intended to ensure that banking organizations that take on additional risks support these activities with additional capital. The primary capital of U.S. banking organizations would include without limit, as it does now, common stockholders' equity, the general

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reserve for loan losses, and minority interest in the equity accounts of consolidated subsidiaries.

The definition of primary capital would also include the following components on a limited basis: perpetual preferred stock, long-term (25 years or more original maturity) limited-life preferred stock, and certain debt instruments (including perpetual debt) with provisions that ensure their permanence and ability to absorb losses. Finally, the U.S./U.K. proposal provides for certain deductions from primary capital to calculate adjusted primary capital and assess capital adequacy.

The proposal establishes five risk categories for the purpose of calculating weighted risk assets. The categories are assigned weights of 0, 10, 25, 50, and 100 percent. The proposed measure would achieve convergence between U.S. and U.K. supervisory authorities with respect to capital requirements for major categories of assets and off-balance sheet items. Included among these categories are:

- cash and claims on domestic central bank,
- claims on domestic depository institutions,
- claims on foreign banks, including foreign central banks,
- claims on domestic central government and claims collateralized by central government debt,
- claims on foreign governments; and
- claims on private sector entities.

Weights assigned to off-balance sheet items are determined through a conversion formula that translates off-balance sheet exposures into a rough on-balance sheet equivalent.

(next page)

The conversion factors for off-balance sheet items are summarized as follows:

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 revolving underwriting facilities, 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

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

Calculation

The weighted risk asset base equals the sum of the aggregate dollar value of the assets and the converted off-balance sheet items in each category multiplied by the weight assigned to that category. The risk asset ratio is then calculated by dividing primary capital by the weighted risk asset base, as follows:

Adjusted Primary Capital ÷ Weighted Risk Asset Base

= Risk Asset Ratio

The U.S./U.K. proposal provides that the banking authorities will establish a common minimum risk asset ratio for banking organizations under their supervision, although such a minimum is not being established at this time. Most institutions will be expected to maintain their ratios above this minimum.

For practical reasons the proposed capital measure is not intended to capture all of the risks faced by banking institutions. Instead, the primary focus is on credit risk. The U.S./U.K. proposal indicates a commitment on the part of the agencies to develop techniques for factoring interest rate swap and foreign exchange trading risks into the ratio in the future. The proposal also reflects an intention to develop a more direct measure of overall interest rate risk.

In assessing capital adequacy, the U.S./U.K. proposal indicates that the banking authorities will emphasize the risk asset ratio. However, the authorities will retain flexibility to continue to utilize other measures of capital adequacy, including capital to total asset ratios.

All parties recognize that the calculation of a risk asset or other capital ratio is but <u>one step</u> in the evaluation of capital and that many other factors must be taken into account before an overall determination of capital adequacy can be made. These factors include the quality and diversity 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.

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