

**AGREED PROPOSAL OF THE UNITED STATES FEDERAL
BANKING SUPERVISORY AUTHORITIES AND THE
BANK OF ENGLAND ON PRIMARY CAPITAL AND
CAPITAL ADEQUACY ASSESSMENT**

This paper constitutes a system for the measurement of capital adequacy agreed by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation and the Bank of England. The principal objective of the paper is to promote the convergence of supervisory policies on capital adequacy assessments among countries with major banking centers. The proposal outlined below is intended to serve as a basis for consultation with the banking industry and others in the United States and the United Kingdom. The authorities concerned hope that the approach adopted by the United States and the United Kingdom will provide a basis which other countries can follow.

This paper explains the agreed proposal concerning:

- (I) the components of the primary capital base of banking organizations;
- (II) the deductions to be made from primary capital in computing the capital base for the calculation of a risk asset ratio;

(III) the weighting structure of risk assets and off-balance sheet activities; and

(IV) the use for supervisory purposes of a ratio of primary capital to weighted risk assets.

The paper should be read in conjunction with the attached tables which are appropriately cross-referenced.

I. Primary capital

Primary capital represents the highest quality form of capital for banks and banking organizations (hereinafter a reference to banks should generally be taken to include banks, bank holding companies in the United States and banking groups in the United Kingdom). Within this category of capital, quality cannot be regarded as uniform and some components are undoubtedly of a higher quality than others. There are a number of elements that strengthen the balance sheets of banks to some extent, although clearly falling short of primary capital. Into this latter category may fall subordinated debt with a fixed maturity and the excess of market value over book value of some bank assets, notably bank premises and long-term investments. It is not the intention of the supervisors to ignore these items but rather to take some account of them after the basic primary capital to weighted risk asset ratio has been calculated. The supervisory authorities in both countries will therefore

also take account of the ratio of total capital to weighted risk assets, as well as other qualitative factors, in their overall prudential assessment.

The components of the primary capital base represent resources which can be used to meet current losses while leaving banks able to continue operating on a going concern basis. The supervisors agree that this criterion is the most important determinant of the status of primary capital.

Common stock/equity (IA1), although repayable in strictly defined and limited circumstances, clearly meets the criterion as does any premium or surplus arising from the issue of common stock/equity. These, together with reserves in the form of retained earnings (IA2), represent the highest quality form of capital. The minority interest in subsidiaries that are consolidated for supervisory purposes (IA3) is also available to absorb losses.

There are no limits on the amounts of such capital that can be included in a bank's capital base for purposes of measuring capital adequacy. While it could be argued on grounds of uncertainty that it would be desirable to defer inclusion of current year earnings (IA2) until the end of the year in question, the U.S. and U.K. supervisory authorities have decided to include them. A realized profit arising out of the disposal of real property, for example, clearly fully meets the criterion for inclusion in primary capital. It is, however, possible that lending or trading

profits for interim periods during the year may be eroded by later or unidentified losses.

General reserves/general provisions (IA4) for losses resulting from charges to earnings will be included for the present in primary capital. The U.S. and U.K. supervisory authorities are agreed that provisions made against identified losses cannot and should not be regarded as capital. General reserves/general provisions are made against unidentified or potential losses and can therefore be regarded as meeting the criterion. The U.S. and U.K. supervisory authorities have reservations about those general provisions that in reality are earmarked against specific assets or categories of assets and that do not therefore satisfy the criterion of general availability. However, it is not always possible to distinguish such provisions. Therefore, while for the present all general reserves/general provisions are included as primary capital, the supervisory authorities would like to seek comment from banks, the accounting profession and other interested parties on whether such reserves should be phased out of the primary capital base.

Hidden reserves (IA5), in the form of undisclosed retained earnings, do not exist in the United States and presently are permitted only to a limited number of banks in the United Kingdom. The issue has been addressed in the European Community's Bank Accounts Directive and, within its terms, member states have the option to allow banks in their

- 3 -

country to maintain limited hidden reserves. This option will be reviewed five years after the Directive has been implemented. The position of hidden reserves in the United Kingdom will therefore next be considered when the Bank Accounts Directive is implemented. If it is then decided that U.K. banks should not be permitted to maintain hidden reserves, they will be available for transfer to disclosed reserves. Until this occurs, the Bank of England will continue to include them as primary capital.

In addition to the elements to be allowed without limit, the supervisory authorities propose to include in primary capital, but subject to a limit, certain items that give much greater strength to a bank than subordinated debt of a fixed maturity but that have certain drawbacks as compared with common stock and other unlimited components of the primary capital base.

Perpetual preferred shares (IB1a) and instruments perpetual in nature and capable of meeting current losses (IB2), together with long-term dated (limited-life) preferred shares (IB1b), will be included in the primary capital base subject to a limit of 50 percent of the unlimited elements after the deduction of intangible assets. (For example, if the unlimited items total US\$100 million and there are intangibles of US\$10 million, then there will be a limit of US\$45 million applying to qualifying preferred shares and perpetual debt and their equivalents). Perpetual preferred shares and perpetual subordinated debt cannot be

redeemed at the option of the holder and any repayment may occur only with the prior consent of the supervisory authorities. Included here are perpetual subordinated debt and certain instruments that can only be converted into primary capital instruments. The proceeds of such instruments effectively remain available to meet current losses and leave the bank able to continue operating. Long-term dated preferred shares (25 years or more initial maturity) also provide a cushion against current losses. Such shares must be amortized for the purpose of assessing capital adequacy over the last few years of their life.

Since changes are involved in the definition of the capital base, the respective supervisory authorities will continue to include (in the United States) existing mandatory convertible securities which do not meet the new criteria (in the attached tables at IB2 (a), (b), (c)) and (in the United Kingdom) existing revaluation reserves for bank premises.

II. Deductions from primary capital

The U.S. and U.K. supervisors have also agreed to propose that certain deductions should be made from the total of primary capital elements in order to derive the adjusted capital base for purposes of calculating the risk weighted capital ratio. In the United States, all future intangible assets will be deducted; existing allowed intangible assets will be "grandfathered." The Bank of

England reaffirms its present policy of deducting all existing intangible assets (IIA).

Investments in unconsolidated subsidiaries and associated companies including, but not limited to, unconsolidated joint ventures, will also be deducted (IIB). For the United States, this could include certain consolidated subsidiaries as determined by U.S. regulatory authorities. The assets of such companies will not be brought into the calculation of the risk asset ratio.

The Bank of England already deducts bank holdings of other banks' capital instruments (IIC), except for limited concessions to allow some banks to play an active role in market-making in the primary (new issues) and/or secondary markets. This policy will be maintained. The U.S. authorities accept the principle underlying this policy and will monitor bank holdings of capital instruments issued by other banks and may, as appropriate, deduct these items on a case-by-case basis.

III. The risk asset ratio

(a) General

The risk asset ratio is calculated by applying to each broad category of assets or off-balance sheet obligations a weight reflecting the relative riskiness inherent in each. The total of weighted risk assets is then measured in relation to the adjusted capital base to derive

a ratio. The U.S. and U.K. authorities intend to concentrate on the primary capital to total weighted risk asset ratio.

This section describes and explains the simple structure of weights and indicates areas where further work is required to augment the present agreed approach.

It is recognized that it would be possible to establish more weights but this would introduce greater complexity, and more onerous statistical reporting obligations, without any assurance of a significantly more efficient or effective system. The calculation of the ratio represents only one element in the assessment of capital adequacy, although it is a most important one.

The agreed framework consists of broad categories of obligor and, to some extent, of maturity. With certain important exceptions, it reflects credit risk, that is, the risk of borrower or counterparty default. In addition the Bank of England includes the net open foreign exchange position in the risk asset ratio as defined in Foreign Currency Exposure, April 1981. The U.S. authorities are committed to introducing a capital requirement for exchange rate risk. All authorities are firmly committed to the development of an approach that will enable interest rate risk to be incorporated into the framework. Some other risks--for example, of operational failures--are important but cannot readily be captured in a risk asset ratio. The agreed weighting structure takes no account of country

transfer risk. Nor is commercial lending differentiated with respect to credit quality or collateral, except for the strictly limited exception for exposures secured by government securities or cash. These factors will be considered, as now, through the examination/supervisory process.

Five risk weight categories are proposed--0 percent, 10 percent, 25 percent, 50 percent and 100 percent --and the weighting for particular items is discussed below. There are some special institutional features of the U.S. and U.K. markets which require differences in treatment between the two countries; these are indicated in the text which follows.

(b) On-balance sheet

The weightings set out in what follows are based on relative degrees of risk starting from 100 percent for a claim on a non-bank obligor, which can for these purposes be regarded as a standard risk.

(i) Cash and all claims on the domestic central bank

Cash and all claims on the domestic central bank (III 1, 2) are regarded as bearing no significant banking risks and therefore are assigned a weight of 0 percent. The Bank of England will also continue to give a 0 percent weight to government-guaranteed export and

ship-building loans (III 3). As indicated below, the U.S. supervisory agencies place comparable U.S. Government-guaranteed claims in the 25 percent risk category (III 12).

(ii) Short-term claims on domestic national government

Short-term claims (remaining maturity of one year or less) on the domestic national government and on domestic national government agencies (III 4) are assigned a weight of 10 percent. (For the United States, national government agencies are defined as those agencies whose debt obligations are backed by the full faith and credit of the U.S. Government.) While short-term claims on the domestic national government bear no credit risk, such claims could involve a degree of interest rate exposure. Thus, as described below, until a more direct measure of interest rate risk is developed, such claims will be assigned to the 10 percent category.

(iii) U.K. discount houses, gilt-edged market makers and Stock Exchange money brokers

The Bank of England proposes a weighting of 10 percent for short-term (remaining maturity of one year or less) claims on discount houses, gilt-edged market makers and Stock Exchange money brokers. These specialist institutions have an operational relationship with the Bank, including secured borrowing facilities, and are subject to close supervision. They trade predominantly in high quality

liquid assets on which their borrowing is customarily secured. For these reasons, short-term claims on this group involve less risk than short-term claims on banks. This treatment effectively reflects the special institutional structure in the United Kingdom (III 5).

(iv) Short-term claims on domestic depository institutions and foreign banks
(including foreign central banks)

The weighting for short-term claims (remaining maturity of one year or less) on domestic depository institutions and foreign banks and equivalent off-balance sheet exposures (III 6, 7, 11) reflects the lower risk generally of such claims as compared with claims on commercial obligors and longer-term claims on banks. For this reason, a weighting of 25 percent for this category has been proposed. It is acknowledged that short-term claims on some commercial borrowers may involve less risk than similar claims on some banks. It is considered, however, that since depository institutions are supervised and a particularly high quality is inherent in short-term inter-bank claims, the treatment proposed is broadly reasonable. Longer-term claims on depository institutions are regarded as bearing a higher risk that is generally closer in quality to claims on commercial obligors and these will be assigned a weight of 100 percent. The breakpoint at one year is admittedly arbitrary but captures most genuine short-term, inter-bank money market activity.

(v) Longer-term claims on own (domestic)
governments and analogous claims

For U.S. banks, the weighting of long-term claims on the U.S. Government (Treasury), and for U.K. banks, the weighting of long-term claims on HM Government, does not reflect any credit risk but is designed, as a temporary measure, to be a proxy for the significant element of interest rate risk inherent in holdings of longer-term government securities. It is the intention of the U.S. authorities and the Bank of England to develop a more direct measure of interest rate risk. Pending this further work, it has been agreed that government securities with a remaining maturity of more than one year should be weighted at 25 percent (III 9).¹

¹The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) disagreed with splitting such securities according to maturity, even as a temporary measure. Optimally, an adjusted capital standard should incorporate an assessment of a bank's exposure to interest rate risk. Specific assets, however, do not necessarily expose a bank to interest rate risk; rather, interest rate risk reflects the relationship within the portfolio between the interest rate structure of assets and liabilities. Isolating a single asset on a bank's balance sheet and making a maturity distinction in order to incorporate interest rate risk into the capital ratio is inappropriate because it fails to take account of the interest rate exposure arising from other loans and securities, off-balance sheet activities, and a bank's liability structure. In the light of this concern, the OCC and FDIC recommended that banks' exposures to interest rate risk be evaluated case by case during examinations, for purposes of assessing capital adequacy, and that all U.S. Treasury securities and agency securities bearing the full faith and credit of the U.S. Government be placed in the 10 (Footnote Continued)

To be consistent with this approach, claims having an analogous nature are also to be weighted at 25 percent. Thus, for U.S. banks, all long-term claims on U.S. Government agencies (III 9), all claims collateralized by U.S. Government and U.S. Government agency debt or cash (III 10) and claims guaranteed by the U.S. Government or its agencies (III 12) will be assigned to the 25 percent category. For U.K. banks, claims collateralized by domestic national government debt or cash (III 10), most domestic national government guaranteed claims (III 12) and claims on U.K. public corporations and the rest of the public sector (III 9) will be weighted at 25 percent.

For U.S. banks, all claims on U.S. Government-sponsored agencies (that is, agencies that are chartered or established by the Federal Government to carry out a public purpose as specified by the U.S. Congress and whose debt obligations are not guaranteed by the full faith and credit of the U.S. Government) and all claims collateralized by U.S. Government-sponsored agency debt are assigned to the 50 percent category (III 14, 15).

(Footnote Continued)
percent risk category. The other supervisory authorities agree with the logic that interest rate risk should be addressed on a portfolio, rather than an individual asset, basis but believe that until such risk can be monitored and included in capital adequacy requirements in a more systematic fashion, the proposed maturity split represents a reasonable interim step.

Although the credit risk attaching to claims on U.K. local authorities is not the same as claims on HM Government, the Bank of England believes that they should be included in the 25 percent category rather than in the 50 percent category (III 8). The U.S. authorities propose placing general obligation claims on domestic state and local governments in the 50 percent category (III 16).

(vi) Local currency claims on foreign central governments in foreign offices

The treatment of assets in overseas offices of banks raises difficult conceptual and practical questions. It has been agreed, however, that local currency claims on foreign central governments, to the extent funded by local currency liabilities in that country, do not involve any transfer risk. A 25 percent weight will therefore be applied to both short and long-term claims. (III 13)

(vii) Multinational development institutions

All direct claims of U.S. banks on multinational development institutions in which the U.S. Government has shareholder or contributing member status and, similarly, all direct claims of U.K. banks on such institutions in which HM Government has the same status will be given a weight of 50 percent. This reflects the generally high quality of claims on such institutions (III 17).

(viii) Other assets

All assets not mentioned so far will carry a 100 percent weight (III 18, 19, 20, 21, 22). As discussed earlier, the Bank of England also already applies a weight of 100 percent to the net open foreign exchange position (III 23) and will maintain this. The U.S. authorities are committed to introducing a capital requirement for exchange rate risk.

(c) Off-balance sheet

(1) General

The U.S. and U.K. banking supervisory authorities believe that all off-balance sheet items giving rise to credit risk (and in addition, in time, foreign exchange and interest rate risks) should in principle be included in the risk asset ratio. The obligations should receive the risk asset weighting appropriate to the individual obligor. There is, however, an important and difficult question relating to the size of the exposure that should be weighted.

An approach to off-balance sheet items has been devised that endeavors to convert the credit risk of each instrument into a credit equivalent that can be incorporated into the risk asset framework outlined in this paper. It is recognized that the methodology employed will appear simple and approximate but it provides a logical and

consistent basis for the calculation of a ratio that encompasses both on- and off-balance sheet business.

Distinctions are made between contingencies, commitments and interest rate and foreign exchange rate contracts and these are discussed separately.

(ii) Contingencies/contingent items

Obligations in the form of financial guarantees and equivalents (for example, standby letters of credit having the character of guarantees and, in the United Kingdom, acceptances) effectively involve from the date of the assumption of the obligation the same degree of credit risk as outstanding loans (III 24). There is no action that the bank can take to avoid the full credit risk. The supervisory authorities, accordingly, believe that these obligations should be regarded as direct credit substitutes and be weighted for their full amount, that is, the credit conversion factor is 100 percent of the principal amount. The risk asset weighting is then determined by the category of the counterparty and, where appropriate, the maturity.

Some contingencies (III 25), notably commercial letters of credit, performance bonds and performance-related standby letters of credit, involve a lesser credit risk. The key elements in this judgment are that the counterparty has a strong incentive to meet its obligations if it wishes to remain in business (thus giving these claims a somewhat higher ranking in the counterparty's list of priorities than some other claims); the obligations

are often (but not invariably) short-term in maturity; and banks assert that the loss record is favorable. To make allowance for these favorable factors, it is proposed to scale down the nominal exposure by a credit conversion factor of 50 percent, before the exposure is weighted according to the category of the obligor (and where relevant maturity)--for example, the deemed credit risk equivalent of a commercial letter of credit of US\$10 million would be US\$5 million which in turn would be weighted according to obligor and, some cases, maturity.

Contingencies such as indemnities for lost share certificates and bill endorsements will be excluded from the framework as they do not involve a significant credit risk.

(iii) Commitments

Whereas contingencies (as described above) involve the immediate assumption of a credit risk, commitments generally represent an undertaking to assume a credit risk in the future. It is recognized that this distinction is somewhat difficult to make at the margin and that it is the nature of the obligation which matters rather than the name given to the facility.

Some transactions, for example, sale and repurchase agreements and asset sales with recourse, may involve balance sheet entries and as such will attract a weighting for the full face value. Any other obligation or transaction effectively involving an immediate credit

exposure will be treated as if it were on the balance sheet. Where an obligation or transaction clearly has the same effect as a financial guarantee (as, for example, certain asset sales with recourse) it will be treated as such (III 26).

For all other commitments (III 27), it is proposed to take account of maturity in determining the credit conversion factors. In so doing, maturity to some extent serves as a proxy for instrument-type. The category of exposure here giving rise to the greatest concern is the long-term contract that is equivalent in effect to an insurance arrangement in its underlying nature, most notably revolving underwriting facilities. Even if material adverse change clauses are included--and the supervisory authorities do not wish to take any action which will discourage their use--the reality is that the bank is assuming a long-term obligation to provide credit if other lenders are unwilling to do so. At the other end of the maturity spectrum, it is accepted that commitments reviewable--and unconditionally cancellable--at least annually involve less risk and that the credit conversion factor should be much lower. While a bank is at risk from an increase in credit exposures as a result of a higher than average utilization of undrawn lines, the low credit conversion factor reflects the historical stability of the undrawn amount of these lines.

The conversion factors to be applied to these commitments will, therefore, be set as follows in

terms of their original maturity (for these purposes maturity is defined as the earliest possible time at which the bank may unconditionally cancel the commitment):

one year or less - 10 percent

over one year to five years - 25 percent

over five years - 50 percent

For contingencies and commitments, the principal amount is multiplied by the conversion factor and the resulting exposure will carry the appropriate weight for the category of the counterparty (and the maturity).

(iv) Interest rate and foreign exchange rate related transactions

It is the firm intention of the U.S. supervisory authorities and the Bank of England to include the credit equivalent exposure on interest rate and foreign exchange rate related transactions in the risk asset ratio as soon as possible (III 28 and 29). The timing of this step is dependent on reaching final agreement on a method of calculating the credit exposure. As with other off-balance sheet transactions, this will involve estimating a deemed credit equivalent for these instruments that would be incorporated in the general framework on an obligor (and, where appropriate, maturity) basis.

IV. Primary capital to weighted risk asset ratio

The U.S. and U.K. authorities intend to set and publish an agreed minimum level of this ratio to be applied

to all banks supervised by them. In both countries most institutions will be expected to maintain their ratio at a higher level. The precise figure set for individual banks will remain confidential and will be determined in light of each institution's particular circumstances, for example, the quality and diversification of assets, liquidity, management, internal control systems and other relevant factors. These higher levels will be determined as part of the ongoing supervisory process.

I. COMPONENTS OF PRIMARY CAPITAL

A. Funds included without limit.

1. Common stock/equity and premium (United Kingdom), surplus (United States)
2. Retained earnings (including current year earnings)
3. Minority interest in consolidated subsidiaries
4. General reserves for losses resulting from charges to earnings
5. Hidden reserves (comprising undisclosed retained earnings) - not applicable in United States, to be phased out in United Kingdom

B. Funds included with limits - items included in this category must not exceed 50 percent of the total items included in A above less intangible assets.

1. Preferred shares that
 - (a) Do not mature; or
 - (b) Mature on a fixed date and have an original maturity of at least 25 years. (Amount included in primary capital would be discounted for prudential purposes as the instrument approaches maturity.)
2. Subordinated debt that
 - (a) Can only be converted into primary capital instruments;
 - (b) Is available at all times to absorb losses; and

- (c) Provides that interest payments may be deferred if the issuer does not make a profit in the preceding period and/or pay dividends on common and perpetual preferred stock.

This is intended to include perpetual debt.

- Note:
- (a) Existing mandatory convertible securities which do not meet the criteria in IB2 (for U.S. banks) and existing property revaluation reserves (for U.K. banks) are to be "grandfathered."
 - (b) For bank holding companies in the United States, perpetual debt issued by the parent company need not be subordinated. It must, however, be unsecured.

II. ADJUSTMENTS TO CAPITAL FOR PRUDENTIAL PURPOSES

- A. Deduction of all intangible assets. (Existing intangibles currently allowed by U.S. regulatory authorities will be "grandfathered.")
- B. Deduction of investments in unconsolidated subsidiaries and associated companies including, but not limited to, unconsolidated joint ventures. For the United States, this could include certain consolidated subsidiaries as determined by U.S. regulatory authorities; for the United

Kingdom this also includes related securities companies.

- C. Deduction of bank holdings of capital instruments of other banking organizations. (In the United States these would be monitored and deducted on a case-by-case basis.)

III. CATEGORY OF RISK

WEIGHT GIVEN

0 percent

1. Vault cash - domestic and foreign
2. All balances with and claims on domestic central bank
3. Domestic national government guaranteed export and ship-building loans (United Kingdom only)

10 percent

4. For the United States, short-term (remaining maturity of one year or less) claims on the U.S. Government (Treasury) and on U.S. Government agencies (for the United States, national government agencies are defined as those agencies whose debt obligations are backed by the full faith and credit of the U.S. Government). For the United Kingdom, short-term (one year or

less) claims on the United Kingdom and Northern Ireland Governments

5. Short-term (one year or less) claims on discount houses, gilt-edged market makers and Stock Exchange money brokers (United Kingdom only)

25 percent

6. Cash items in process of collection - foreign and domestic
7. Short-term (one year or less) claims on domestic depository institutions and foreign banks
8. All claims on domestic local authorities (United Kingdom only)
9. Long-term (over one year) claims on domestic national government (including, for the United Kingdom, Northern Ireland) and all long-term claims on domestic national government agencies. For the United Kingdom, this includes all claims on U.K. public corporations and on the rest of the public sector.
10. All claims (including repurchase agreements) fully collateralized by domestic national government debt and (for the United States) debt of U.S. Government agencies.

Also all claims collateralized by cash on deposit in the lending institution

11. Federal Reserve Bank stock (United States only)
12. Portions of loans guaranteed by domestic national government or (for the United States) domestic national government agencies
13. All local currency claims on foreign central governments to the extent funded by local currency liabilities in that foreign country

50 percent

14. All claims on domestic national government-sponsored agencies (U.S. Government-sponsored agencies are defined as agencies whose debt obligations are not guaranteed by the full faith and credit of the U.S. Government)
15. All claims (including repurchase agreements) that are fully collateralized by domestic national government-sponsored agency debt (United States only)
16. All general obligation claims on domestic state and local governments (United States only)
17. Claims on multinational development institutions in which the domestic government is a shareholder or contributing member

100 percent

18. Long-term (over one year) claims on domestic depository institutions and foreign banks
19. All claims on foreign governments other than local currency claims on foreign central governments funded by local currency liabilities in that foreign country
20. The customer liability on acceptances outstanding involving standard risk obligors (United States only)
21. Domestic state and local government revenue bonds and industrial development bonds (United States only)
22. All other assets
23. Net open position in foreign exchange (United Kingdom only)

OFF BALANCE SHEET ITEMS

The face amount of these items would be multiplied by the credit conversion factors shown below, and the resulting amount would be slotted in the appropriate risk category depending upon the identity of the obligor and the maturity of the instrument where appropriate.

24. "Direct credit substitutes" (financial guarantees and standby letters of credit serving the same purpose and, in the United

Kingdom, acceptances outstanding) - 100 percent credit conversion factor.

25. "Trading contingencies" (for example, commercial letters of credit, bid and performance bonds and performance standby letters of credit) - 50 percent credit conversion factor.
26. Sale and repurchase agreements and asset sales with recourse, if not already included on the balance sheet - 100 percent credit conversion factor.
27. Other commitments, for example, overdrafts, revolving underwriting facilities (for example, RUFs/NIFs), 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.

Credit conversion factor to be determined

28. Interest rate swaps and other interest rate contracts.
29. Foreign exchange rate contracts.

NOTE 1. Maturity is defined as the earliest possible time at which the bank may unconditionally cancel the commitment.

NOTE 2. Certain off-balance sheet obligations, for example, indemnities for lost share certificates and bill endorsements, or "holders in due course" obligations, would not be included in capital adequacy requirements.

Definition of capital included in the capital base
(To apply at end-1992 - see Annex 4
for transitional arrangements)

A. Capital elements

- Tier 1** (a) Ordinary paid-up share capital/common stock
(b) Disclosed reserves
- Tier 2** (a) Undisclosed reserves
(b) Asset revaluation reserves
(c) General provisions/general loan loss reserves
(d) Hybrid (debt/equity) capital instruments
(e) Subordinated term debt

The sum of Tier 1 and Tier 2 elements will be eligible for inclusion in the capital base, subject to the following limits.

B. Limits and restrictions

- (i) The total of Tier 2 (supplementary) elements will be limited to a maximum of 100 per cent. of the total of Tier 1 elements;
- (ii) subordinated term debt will be limited to a maximum of 50 per cent. of Tier 1 elements;
- (iii) where general provisions/general loan loss reserves include amounts reflecting lower valuations of asset or latent but unidentified losses present in the balance sheet, the amount of such provisions or reserves will be limited to a maximum of 1.25 percentage points, or exceptionally and temporarily up to 2.0 percentage points, of risk assets;¹

¹ This limit would only apply in the event that no agreement is reached on a consistent basis for including unencumbered provisions or reserves in capital (see paragraphs 18 and 19).

- (iv) asset revaluation reserves which take the form of latent gains on unrealised securities (see below) will be subject to a discount of 55 per cent.

C. Deductions from the capital base

From Tier 1: Goodwill

From total

capital: (i) Investments in unconsolidated banking and financial subsidiary companies

N.B. The presumption is that the framework would be applied on a consolidated basis to banking groups.

(ii) Investments in the capital of other banks and financial institutions (at the discretion of national authorities).

D. Definition of capital elements

(i) Tier 1: includes only permanent shareholders' equity (issued and fully paid ordinary shares/common stock) and disclosed reserves (created or increased by appropriations of retained earnings or other surplus, e.g. share premiums, retained profit,² general reserves and legal reserves). In the case of consolidated accounts, this also includes minority interests in the equity of subsidiaries which are less than wholly owned. This basic definition of capital excludes revaluation reserves and preference shares having the characteristics specified below in (d).

(ii) Tier 2: (a) undisclosed reserves are eligible for inclusion within supplementary elements provided these reserves are accepted by the supervisor. Such reserves consist of that part of the accumulated after-tax surplus of retained profits which banks in some countries may be permitted to maintain as an undisclosed reserve. Apart from the fact that the reserve is not identified in the published balance sheet, it should have the same high quality and character as a disclosed capital reserve; as such, it should not be encumbered by any

² Including, at national discretion, allocations to or from reserve during the course of the year from current year's retained profit.

provision or other known liability but should be freely and immediately available to meet unforeseen future losses. This definition of undisclosed reserves excludes hidden values arising from holdings of securities in the balance sheet at below current market prices (see below).

(b) Revaluation reserves arise in two ways. Firstly, in some countries, banks (and other commercial companies) are permitted to revalue fixed assets - normally their own premises, from time to time in line with the change in market values. In some of these countries the amount of such revaluations are determined by law. Revaluations of this kind are reflected on the face of the balance sheet as a revaluation reserve.

Secondly, where formal revaluations are not permitted, hidden values or "latent" revaluation reserves may be present. Of particular importance in some banking systems are hidden values relating to long-term holdings of equity securities where the difference between the historic cost book valuation and the current market price may be substantial.

Both types of revaluation reserve may be included in Tier 2 provided that the assets are prudently valued, fully reflecting the possibility of price fluctuation and forced sale. In the case of "latent" revaluation reserves a discount of 55 per cent. will be applied to reflect the potential volatility of this form of unrealised capital and the notional tax charge on it.

(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 secondary elements. Provisions ascribed to impairment of particular assets or known liabilities should be excluded. Furthermore, where general provisions/general loan loss reserves include amounts reflecting lower valuations of assets or latent but unidentified losses already present in the balance sheet, the amount of such provisions or reserves eligible for inclusion will be limited to a maximum of 1.25

percentage points, or exceptionally and temporarily up to 2.0 percentage points.³

(d) Hybrid (debt/equity) capital instruments. This heading includes a range of instruments which combine characteristics of equity capital and of debt. Their precise specifications differ from country to country, but they should meet the following requirements:

- they are unsecured, subordinated and fully paid-up;
- they are not redeemable at the initiative of the holder or without the prior consent of the supervisory authority;
- they are available to participate in losses without the bank being obliged to cease trading (unlike conventional subordinated debt);
- although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders' equity), it should allow service obligations to be deferred (as with preference shares) where the profitability of the bank would not support payment.

Preference shares, having these characteristics, would be eligible for inclusion in this category. In addition, the following are examples of instruments that may be eligible for inclusion: long-term preferred shares in Canada, titres participatifs and titres subordonnés à durée indéterminée in France, Genussscheine in Germany, perpetual subordinated debt and preference shares in the United Kingdom and mandatory convertible debt instruments in the United States. Debt capital instruments which do not meet these criteria may be eligible for inclusion in item (e).

(e) Subordinated term debt: includes conventional unsecured subordinated debt capital instruments with a fixed term to maturity and limited life redeemable preference shares. Unlike instruments included in item (d), these instruments are not normally available to participate in the losses of a bank which continues trading. For this reason these instruments will be limited to a maximum of 50 per cent. of Tier 1.

³ This limit would apply in the event that no agreement is reached on a consistent basis for including unencumbered provisions or reserves in capital (see paragraphs 18 and 19).

Risk weights by category of on-balance-sheet asset

- 0%
- (a) Cash
 - (b) Balances at and claims on domestic central bank
 - (c) Loans to domestic central governments
 - (d) Securities issued by domestic central governments¹
 - (e) Loans and other assets fully collateralised by cash or domestic central government securities¹ or fully guaranteed by domestic central governments
- 0 or 20%
- (a) Claims on IBRD and regional development banks (at national discretion) (EC countries would treat EC institutions consistently)
- 20%
- (a) Claims on domestic and foreign banks with an original maturity of under 1 year
 - (b) Claims on domestic banks with an original maturity of 1 year and over and loans guaranteed by domestic banks
 - (c) Claims on foreign central governments in local currency financed by local currency liabilities
 - (d) Cash items in process of collection
- 0, 20 or 50%
- (a) Claims on the domestic public sector, excluding central government (at national discretion) and loans guaranteed by such institutions
- 50%
- (a) Loans to owner-occupiers for residential house purchase fully secured by mortgage
- 100%
- (a) Claims on the private sector
 - (b) Cross-border claims on foreign banks with an original maturity of 1 year and over

¹ Some member countries intend to apply weights to securities issued by their domestic central government to take account of investment risk. These weights would, for example, be 10 per cent. for all securities or 10 per cent. for those maturing in under one year and 20 per cent. for those maturing at one year or over.

- (c) Claims on foreign central governments (unless 20 per cent. - see page 1)
- (d) Claims on commercial companies owned by the public sector
- (e) Premises, plant and equipment and other fixed assets
- (f) Real estate and other investments (including non-consolidated investment participations in other companies)
- (g) Capital instruments issued by other banks (unless deducted from capital)
- (h) All other assets

Credit conversion factors for off-balance-sheet items

The framework proposed takes account of the credit risk on off-balance-sheet exposures by applying credit conversion factors to the different types of off-balance-sheet instrument or transaction. These credit conversion factors, which are derived from the estimated size and likely occurrence of the credit exposure, as well as the relative degree of credit risk as identified in the Committee's paper "The management of banks' off-balance-sheet exposures: a supervisory perspective" issued in March 1986, are set out below. The credit conversion factors would be multiplied by the weights applicable to the category of the counterparty for an on-balance-sheet transaction (see Annex 2).

Instruments	Credit conversion factors
1. Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances)	100%
2. Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions)	50%
3. Short-term self-liquidating trade-related contingencies (such as documentary credits collateralised by the underlying shipments)	20%

- | | |
|---|-----------|
| 4. Sale and repurchase agreements and asset sales with recourse, ¹ where the credit risk remains with the bank | 100% |
| 5. Forward purchases, forward forward deposits and partly-paid shares and securities, which represent commitments with certain drawdown | 100% |
| 6. Note issuance facilities and revolving underwriting facilities | 50% |
| 7. Other commitments (e.g. formal standby facilities and credit lines) with an original maturity exceeding one year | 50% |
| 8. Similar commitments with an original maturity of less than one year, or which can be cancelled at any time | 0% |
| 9. Foreign exchange and interest rate related items | see below |

(N.B. Member countries will have some limited discretion to allocate particular instruments into items 1 to 8 above according to the characteristics of the instrument in the national market.)

Foreign exchange and interest rate related contingencies

The treatment of foreign exchange and interest rate related items needs special treatment because banks are not exposed to credit risk for the full face value of their contracts, but only to the potential cost of replacing the cash flow (i.e. on contracts showing positive value) if the counterparty defaults. The credit equivalent amounts will depend inter alia on the maturity of the contract and on the volatility of the rates underlying that type of instrument.

1 These items are to be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.

Despite the wide range of different instruments in the market, the theoretical basis for assessing the credit risk on all of them has been the same. It has consisted of an analysis of the behaviour of matched pairs of swaps under different volatility assumptions. Since exchange rate contracts involve an exchange of principal on maturity, as well as being generally more volatile, higher conversion factors are proposed for those instruments which feature exchange rate risk. Interest rate contracts² are defined to include single-currency interest rate swaps, basis swaps, forward rate agreements, interest rate futures, interest rate options purchased and similar instruments. Exchange rate contracts² include cross-currency interest rate swaps, forward foreign exchange contracts, currency futures, currency options purchased and similar instruments. Exchange rate contracts with an original maturity of 7 days or less are excluded.

Exemptions from capital weighting for foreign exchange and interest rate instruments will be permitted on two grounds. Firstly, instruments traded on exchanges can be excluded where they are subject to daily margining requirements. Secondly, replacement costs which are fully collateralised by cash and government securities may be given the weight of the underlying security (in most cases nil). The Committee considered the justification for permitting netting of swaps and similar contracts, but concluded that netting would not be permitted until it had been firmly established by reasoned legal opinion that such contracts are offsettable. However, the matter is still under review. Options purchased over the counter are included with the same conversion factors as other instruments, but this view may be amended in the light of further study and comments from market practitioners.

The current exposure method

A majority of G-10 supervisory authorities are of the view that the best way to assess the credit risk on these items is to ask banks to

2 Excluding instruments traded on exchanges (see following paragraph).

calculate the current replacement cost by marking contracts to market, thus capturing the current exposure without any need for estimation, and then adding a factor (the "add-on") to reflect the potential future exposure over the remaining life of the contract. It is proposed that, in order to calculate the "credit equivalent amount" of its off-balance-sheet interest rate and foreign exchange rate instruments, a bank would sum:

- the total replacement cost (obtained by "marking to market") of all its contracts with positive value and
- an amount for potential future credit exposure calculated on the basis of the total notional principal amount of its book, split by residual maturity as follows:

Residual maturity	Interest Rate Contracts	Exchange Rate Contracts
Less than one year	nil	1.0%
One year and over	0.5%	5.0%

No potential credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

In deciding on the appropriate "add-ons", the Committee has made use of the volatility analysis carried out by the Bank of England and the US Federal Regulatory Agencies, which was published in March 1987 as a supplement to the risk-based capital proposals jointly put out by the authorities from those two countries (code references 1015E and 1361d). Following comments on these proposals, several changes have been made in the way in which the "add-ons" were calculated in the US/UK papers. These include:

- there is now a recognition of par and non-par instruments (i.e. in-the-money, at-the-money or out-of-the-money) in the proposals. This has the effect of reducing the numbers since risks are considered on a portfolio basis;
- a lower confidence limit has been used;
- cash flows are now discounted (at an annual rate of 5 per cent.);

the recommended method of calculating the "add-ons" is significantly less complex, both in that it omits a year-by-year maturity breakdown and in that the potential exposure factor is not applied to each contract singly, but to the total notional principal of each bank's portfolio whether or not the contracts have a positive current exposure. As such, some precision has been lost since it is necessary to introduce an assumption about the pattern of banks' portfolios, including the rates at which contracts have been entered into and their average maturity spread, but it is believed that the formula represents an acceptable balance between the need to capture the risk and to avoid unnecessary complexity.

The original exposure method

Some G-10 supervisors believe that this two-step approach, incorporating a "mark to market" element, is too complex in comparison with the remainder of the proposed capital framework. They favour a simpler method whereby the potential credit exposure is estimated against each type of contract and a notional capital weight allotted, no matter what the market value of the contract might be at a particular reporting date. It has therefore been agreed that tests should be undertaken to establish a credit risk conversion approach which is compatible with the "current exposure" method detailed above.³ In deciding on what those notional credit conversion factors should be, it is agreed that a somewhat more cautious bias is justified since the current exposure is not being calculated on a regular basis.

In order to arrive at the credit equivalent amount using this original exposure method, a bank would simply apply one of two sets of conversion factors to the notional principal amounts of each instrument

3 Some national authorities may permit individual banks to choose which method to adopt, it being understood that banks would not be permitted to switch between the two.

according to the nature of the instrument and its maturity. The following conversion factors are put forward as a basis for consultation:

Maturity ⁴	Interest Rate Contracts	Exchange Rate Contracts
Less than one year	0.5%	2.0%
One year and less than 2 years	1.0%	6.0% (i.e. 2% + 4%)
For each additional year	1.0%	4.0%

It is emphasised that the conversion factors proposed above are regarded as provisional and may be subject to amendment as a result of representations from market practitioners or of changes in the volatility of exchange rates and interest rates.

The Committee envisages that the credit equivalent amounts, whether calculated according to the current or the original exposure method, would be weighted within the framework according to the category of counterparty but most members consider that such transactions should bear a maximum weight of 50 per cent. on the grounds that most counterparties in these markets, particularly for long-term contracts, tend to be first-class names.

4 Most member countries are in favour of basing the calculation on original maturity on the grounds that, if contracts are not being marked to market, it is necessary to take account of movements in rates from the time that each contract was entered into. Moreover, the exposure on most foreign exchange contracts is at its greatest in the final year of their life when principal is about to be exchanged. Other member countries, however, favour using residual maturity on the grounds that the potential incidence of losses occurring on any particular contract is a function of the length of time remaining before the contract matures, i.e. its residual maturity. Comments on this matter are invited.

Transitional arrangements

	Initial	End-1990	End-1992
1. Minimum standard	The level prevailing at end-1987	7.25%	8.0%
2. Measurement formula	Core elements plus 100%	Core elements plus 100% (3.625% plus 3.625%)	Core elements plus 100% (4% plus 4%)
3. Supplementary elements included in core	Maximum 25% of total core	Maximum 10% of total core (i.e. 0.36%)	None
4. Limit on general loan loss reserves in supplementary elements ¹	No limit	1.5 percentage points, or exceptionally up to 2.0 percentage points	1.25 percentage points, or exceptionally and temporarily up to 2.0 percentage points
5. Limit on term subordinated debt in supplementary elements	No limit (at discretion)	No limit (at discretion)	Maximum of 50% of Tier 1
6. Deduction for goodwill	Deducted from tier 1 (at discretion)	Deducted from tier 1 (at discretion)	Deducted from Tier 1

N.B. The Committee as a whole has not endorsed any precise minimum standard figure at this stage. The figures given in the table are those proposed by the ten member countries wishing to introduce indicative levels as a basis for consultation on the framework.

¹ This limit would only apply in the event that no agreement is reached on a consistent basis for including unencumbered provisions or reserves in capital (see paragraphs 18 and 19).