

BANK FOR INTERNATIONAL SETTLEMENTS

**Committee on Banking Regulations
and
Supervisory Practices**

December 1987

Consultative paper

**Proposals for international convergence of capital measurement and
capital standards**

Introduction

1. The Basle Committee on Banking Regulations and Supervisory Practices¹ has, for several years, been working to achieve a strengthening in the capital resources of international banks in order to help strengthen the stability of the international banking system. At the same time, achieving some convergence of capital adequacy standards in national supervisory régimes has been increasingly realised to be a desirable objective in order to remove an important source of competitive inequality for banks operating internationally. Accordingly, the Committee was charged by the G-10 central-bank Governors to try to achieve a common approach among its members to measuring banks' capital adequacy and establishing minimum standards for banks undertaking significant cross-border business. This paper sets out the conclusions of the Committee's discussions (reflecting as appropriate important minority views) in the form of a proposal for a common framework of capital adequacy

1 The Committee comprises representatives of the central banks and supervisory authorities of the Group of Ten countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States) and Luxembourg.

measurement and a common minimum target capital standard to be achieved and maintained by banks operating internationally.²

2. The proposals of the Committee described in this paper have been presented to Governors and have been accepted and endorsed by them as a basis for wider consultations with commercial banks and other interested parties. National authorities will be setting in train consultations with national banking associations in G-10 countries. These consultations are to be concluded within six months, when the Committee will review the national discussions and report the outcome to the Governors. The Committee is also circulating the paper to supervisory authorities in countries outside the G-10 for their comments with a view to encouraging a worldwide standard for international banks.

3. Parallel discussions are also under way between member countries of the European Community with the object of agreeing on a common approach towards the definition of capital and a solvency ratio to be applied to credit institutions in the Community. Seven members of the Committee are also members of the European Community. It is therefore highly desirable that the proposals which emerge from Brussels and from Basle should be as compatible and consistent as possible. With this objective, close contact has been maintained between the Committee in Basle and those responsible for taking this work forward in the European Community in Brussels. The European Commission's proposals are expected to apply to credit institutions generally, whereas the Committee framework is designed more specifically with banks undertaking international business in mind. Nonetheless, it would be the Committee's hope that the proposals being developed in Basle and in Brussels will turn out in most important respects to be similar or at least mutually compatible.

4. In developing the framework described in this document the Committee has sought to arrive at a set of recommendations which are both conceptually sound and at the same time pay due regard to particular

2 The majority of the member countries of the Committee accept the package of proposals as a whole. However, on a few features of the framework, one or two countries hold dissenting views and these are indicated in the text.

features of the present supervisory and accounting systems in individual member countries. It believes that this objective has been achieved. The framework provides for a transitional period so that the existing circumstances in different countries can be handled pragmatically and in ways that allow time for adjustment. The framework envisages countries retaining certain aspects of their national systems during a period of transition of five years at the end of which time a common framework can be applied.

5. In certain limited respects (notably as regards the risk weightings) the framework has been designed to allow some divergence in national approaches during, and to a lesser extent also after, the transition period. The impact of such discrepancies on the overall ratios is likely to be only marginal, however, and is not considered to compromise the basic objectives.

6. It should be stressed that the proposed framework is designed to establish minimum levels for internationally active banks, National authorities will, of course, be free to adopt arrangements that require higher levels.

7. It should also be emphasised that capital, though important, is one of a number of factors to be weighed in assessing the strength of banks. The framework of measurement in this document is mainly directed towards assessing capital in relation to credit risk (the risk of counterparty failure) but other risks, notably interest rate risk and the investment risk on securities, need to be taken into account by supervisors in assessing capital adequacy. The Committee is examining possible approaches in relation to these risks. Furthermore, capital ratios, judged in isolation, may provide a misleading guide to relative strength. Much also depends on the quality of a bank's assets and, importantly, the level of provisions a bank may be holding outside its capital against assets of doubtful value. Recognising the close relationship between capital and provisions, the Committee will continue to monitor provisioning policies by banks in member countries and will seek to promote convergence of policies in this field as in other regulatory matters. In assessing progress by banks in member countries towards meeting the proposed capital standards, the Committee will therefore take careful account of any differences in

existing policies and procedures among countries' banks for setting the level of provisions and in the form in which such provisions are constituted.

8. The objective of these proposals is to achieve convergence in supervisory regulation and standards of capital adequacy but the Committee is aware that differences between countries in the fiscal treatment and accounting presentation for tax purposes of certain classes of provision for losses and capital reserve derived from retained earnings may to some extent distort the comparability of the real or apparent capital positions of international banks. Convergence in tax régimes, though desirable, lies beyond the responsibility of the Committee and tax considerations are not addressed in these proposals. However, the Committee would wish to keep these matters under review to the extent that they affect the comparability of the capital adequacy of different countries' banking systems.

9. This paper is divided into four sections. The first two describe the framework: Section I the constituents of capital and Section II the risk weighting system. Section III deals with the target or standard ratio; and Section IV with transitional and implementing arrangements.

I. THE CONSTITUENTS OF CAPITAL

(a) Core capital (basic equity)

10. The Committee considers that the key element of capital on which the main emphasis should be placed in any framework is equity capital³ and disclosed reserves. This key element of capital is the only element common to all countries' banking systems; it is wholly visible in the published accounts and is the basis on which most market judgements of capital adequacy are made; and it has a crucial bearing on profit margins and a bank's ability to compete. This emphasis on equity capital and disclosed reserves reflects the importance the Committee attaches to

3 Issued and fully paid ordinary shares/common stock (i.e. excluding preferred stock).

securing a progressive enhancement in the quality, as well as the level, of the total capital resources maintained by major banks.

11. Notwithstanding this emphasis, the member countries of the Committee also consider that there are a number of other important and legitimate constituents of a bank's capital base which may be included within any international system of measurement (subject to certain conditions set out in sub-section (b) below). One member country, however, takes the view that in the context of the Committee's work to improve the quality of banks' capital, an international definition of capital should effectively be confined to core capital elements.

12. With this qualification on the part of one member country, the Committee has concluded that capital should be defined in two tiers, for supervisory purposes, in a way which will have the effect of requiring at least 50 per cent. of a bank's capital base to consist of a core element comprised of equity capital and published reserves from post-tax retained earnings (tier 1). The other elements of capital (supplementary capital) will be admitted into tier 2 up to an amount equal to that of the core capital. These supplementary capital elements and the particular conditions attaching to their inclusion in the capital base are set out below and in more detail in Annex 1. Each of these elements may be included or not included by national authorities at their discretion in the light of their national accounting and supervisory regulations.

(b) Supplementary capital

(i) Undisclosed reserves

13. Unpublished or hidden reserves may be constituted in various ways according to differing legal and accounting régimes in member countries. Under this heading are included only reserves which, though unpublished, have been passed through the profit and loss account and which are accepted by the bank's supervisory authorities. They may be inherently of the same intrinsic quality as published retained earnings, but, in the context of an internationally agreed minimum standard, their lack of transparency argues for excluding them from the core equity capital element.

(ii) Revaluation reserves

14. Some countries, under their national regulatory or accounting arrangements, allow certain assets to be revalued to reflect their current value, or something closer to their current value than historic cost, and the resultant revaluation reserves to be included in the capital base. Such revaluations can arise in two ways:

- (a) from a formal revaluation carried through to the balance sheet of fixed assets (normally banks' own premises); or
- (b) from a notional addition to capital of hidden values which arise from the practice of holding securities in the balance sheet valued at historic cost.

Such reserves may be included within supplementary capital provided that the assets are considered by the supervisory authority to be prudently valued, fully reflecting the possibility of price fluctuations and forced sale.

15. Alternative (b) is relevant to those banks whose balance sheets traditionally include very substantial amounts of equities held in their portfolio at historic cost but which can be, and on occasions are, realised at current prices and used to offset losses. These "latent" revaluation reserves, the Committee considers, can be included among supplementary elements of capital since they can be used to absorb losses on a going-concern basis. The Committee agreed, therefore, that latent revaluation reserves should be included in supplementary capital, provided they are subject to a substantial discount in order to reflect concerns both about market volatility and about the tax charge which would arise were such gains to be realised. A discount of 55 per cent. on the difference between the historic cost book value and market value is agreed to be appropriate in the light of these considerations.

(iii) General provisions/general loan loss reserves

16. General provisions or general loan-loss reserves are created against the possibility of future losses. Where they are not ascribed to particular assets and do not reflect a reduction in the valuation of particular assets, these reserves qualify for inclusion in capital and it has been agreed that they should be counted within tier 2. Where, however,

provisions have been created against identified losses or in respect of a demonstrable deterioration in the value of particular assets, they are not freely available to meet unidentified losses which may subsequently arise elsewhere in the portfolio and do not possess an essential characteristic of capital. Such specific or earmarked provisions should therefore not be included in the capital base.

17. The Committee accepts, however, that, in practice, it is not always possible to distinguish clearly between general provisions (or general loan loss reserves) which are genuinely freely available and those provisions which in reality are earmarked against assets already identified as impaired. This partly reflects the present diversity of accounting, supervisory, and, importantly, fiscal policies in respect of provisioning and in respect of national definitions of capital. This means, inevitably, that initially there will be a degree of inconsistency in the characteristics of general provisions or general loan-loss reserves included by different member countries within the framework.

18. In the light of these uncertainties, the Committee intends during the proposed transitional period (see paragraphs 45 to 50 below) to clarify the distinction made in member countries between those elements which should conceptually be regarded as part of capital and those which should not qualify. The Committee will aim to develop before the end of 1990 firm proposals applicable to all member countries, so as to ensure consistency in the definition of general provisions and general loan-loss reserves eligible for inclusion in the capital base by the time the interim and final minimum target standards fall to be observed.

19. As a further safeguard, in the event that agreement is not reached on the refined definition of unencumbered resources eligible for inclusion in supplementary capital, where general provisions and general loan-loss reserves may include amounts reflecting lower valuations for assets or latent but unidentified losses present in the balance sheet, the amount of such reserves or provisions that qualify as capital would be phased down so that, at the end of the transitional period and thereafter, such items would constitute no more than 1.25 percentage points, or exceptionally and temporarily up to 2.0 percentage points, of risk assets within the secondary elements.

(iv) Hybrid debt capital instruments

20. In this category fall a number of capital instruments which combine certain characteristics of equity and certain characteristics of debt. Each of these have particular features which can be considered to affect their quality as capital. It has been agreed that, where these instruments have close similarities to equity, in particular when they are able to support losses on an on-going basis without triggering liquidation, they may be included in supplementary capital. In addition to preference shares carrying a fixed charge, the following instruments, for example, may qualify for inclusion: long-term preferred shares in Canada, titres participatifs and titres subordonnés à durée indéterminée in France, Genussscheine in Germany, perpetual debt instruments in the United Kingdom and mandatory convertible debt instruments in the United States. The qualifying criteria for such instruments are set out in Annex 1.

(v) Subordinated term debt

21. The Committee is agreed that subordinated term debt instruments have significant deficiencies as constituents of capital in view of their fixed maturity and inability to absorb losses except in a liquidation. These deficiencies justify an additional restriction on the amount of such debt capital which is eligible for inclusion within the capital base. Consequently, it has been concluded that subordinated term debt instruments may be included within the supplementary elements of capital but only to a maximum of 50 per cent. of the core capital element.

(c) Deductions from capital

22. It has been concluded that the following deductions should be made from the capital base for the purpose of calculating the risk-weighted capital ratio. The deductions would consist of:

- (i) goodwill, as a deduction from tier 1 capital elements;
- (ii) investments in subsidiaries engaged in banking and financial activities which are not consolidated in national systems. The normal practice will be to consolidate subsidiaries for the purpose of assessing the capital adequacy of banking groups. Where this is not done, deduction is essential to prevent the

multiple use of the same capital resources in different parts of the group. The deduction for such investments would be made against the total capital base. The assets representing the investments in subsidiary companies whose capital had been deducted from that of the parent would not be included in total assets for the purposes of computing the ratio.

23. The Committee carefully considered the possibility of requiring deduction of banks' holdings of capital issued by other banks or deposit-taking institutions, whether in the form of equity or of other capital instruments. Several G-10 supervisory authorities currently require such a deduction to be made in order to discourage the banking system as a whole from creating cross-holdings of capital, rather than drawing capital from outside investors. The Committee is very conscious that such double-gearing (or "double-leveraging") can have systemic dangers for the banking system by making it more vulnerable to the rapid transmission of problems from one institution to another and some members consider these dangers justify a policy of full deduction of such holdings.

24. Despite these concerns, however, the Committee as a whole is not presently in favour of a general policy of deducting all holdings of other banks' capital, on the grounds that to do so could impede certain significant and desirable changes taking place in the structure of domestic banking systems.

25. The Committee has nonetheless agreed that:

- (a) individual supervisory authorities should be free at their discretion to apply a policy of deduction, either for all holdings of other banks' capital, or for holdings which exceed material limits in relation to the holding bank's capital or the issuing bank's capital, or on a case-by-case basis;
- (b) where no deduction is applied, banks' holdings of other banks' capital instruments will bear a weight of 100 per cent.;
- (c) in applying these policies, member countries consider that reciprocal cross-holdings of bank capital designed artificially to inflate the capital position of the banks concerned should not be permitted;

- (d) the Committee will closely monitor the problem of double-gearing in the international banking system and does not preclude the possibility of introducing constraints at a later date. For this purpose, it proposes that supervisory authorities should ensure that adequate statistics are made available to enable them and the Committee to monitor the development of banks' holdings of other banks' equity and debt instruments which rank as capital under the present agreement.

II. THE RISK WEIGHTS

26. The Committee believes that a weighted risk ratio in which capital is related to different categories of asset or off-balance-sheet exposure, weighted according to broad categories of relative riskiness, is the preferred method for assessing the capital adequacy of banks. This is not to say that other methods of capital measurement are not also useful, but they are considered by the Committee to be supplementary to the risk weight approach. The Committee believes that a risk ratio has the following advantages over the simpler gearing ratio approach:

- (i) it provides a fairer basis for making international comparisons between banking systems whose structures may differ;
- (ii) it allows off-balance-sheet exposures to be incorporated more easily into the measure;
- (iii) it does not deter banks from holding liquid or other assets which carry low risk.

27. The framework of weights has been kept as simple as possible and only five weights are used - 0, 10, 20, 50 and 100 per cent. There are inevitably some broad-brush judgements in deciding which weight should apply to different types of asset and the weightings should not be regarded as a substitute for commercial judgement for purposes of market pricing of the different instruments.

28. The weighting structure is set out in detail in Annex 2. There are five aspects of the structure to which attention is particularly drawn.

(i) Categories of risk captured in the framework

29. There are many different kinds of risks against which banks' managements need to guard. For most banks the major risk is credit risk, that is to say the risk of counterparty failure, but there are many other kinds of risk - for example, investment risk, interest rate risk, exchange rate risk, concentration risk. The central focus of this framework is credit risk and, as a further aspect of credit risk, country transfer risk. In addition, individual supervisory authorities have discretion to build in certain other types of risk. Some countries, for example, will wish to retain a weighting for open foreign exchange positions or for some aspects of investment risk. No standardisation has been attempted in the treatment of these other kinds of risk in the framework at the present stage.

30. The Committee considered the desirability of seeking to incorporate additional weightings to reflect the investment risk in holdings of fixed rate domestic government securities - one manifestation of interest rate risk which is of course present across the whole range of a bank's activities, on and off the balance sheet. For the present, it was concluded that individual supervisory authorities should be free to apply either a zero or a low weight to claims on the domestic government (e.g. 10 per cent. for all securities or 10 per cent. for those maturing in under one year and 20 per cent. for one year and over). All members agreed, however, that interest rate risk generally required further study and that if, in due course, further work made it possible to develop a satisfactory method of measurement for this aspect of risk for the business as a whole, consideration should be given to applying some appropriate control alongside this credit risk framework. Work is already under way to explore the possibilities in this regard.

(ii) Country transfer risk

31. After careful assessment of various alternative approaches, the Committee concluded that there was no wholly satisfactory method for incorporating country transfer risk into the weighting system. The two basic alternatives are:

- (a) a simple differentiation between, on the one hand, claims on the domestic public sector (central government and official sector

institutions) and, on the other hand, cross-border claims on the public sectors of all foreign countries. In principle, a similar differentiation can also be made between claims on domestic banks and foreign banks. Low weights would be applied to such domestic claims, reflecting the absence of transfer risk, and high weights to foreign claims since, depending on the location of the claim, transfer risk is present to a greater or lesser extent in all such claims; or

- (b) an approach involving the selection of specific countries with high credit standing in some defined grouping and the application of low weights to cross-border claims on the public sectors (and banks) of those countries. Similar claims on other countries outside this preferential zone would attract high weights.

32. The approach outlined in (b) above has some conceptual advantage in prudential terms as a measure of relative transfer risk since the potential incidence of payments problems varies greatly among different countries. Against this, however, must be weighed the difficulty of determining in a fair and defensible manner the countries eligible to be included in the preferential grouping. The Committee has considered the possibility of devising objective yardsticks of creditworthiness but, at this stage and until further research has been completed, feels that this is not a practical approach for an international standard for general application and could present serious administrative complications. It has been concluded, therefore, that, if an approach in line with method (b) were to be followed, the best solution would be either for member countries as a whole to adopt the criterion of membership of some existing grouping of industrialised countries, or to allow discretion to individual national supervisory authorities to select a grouping of countries which in their view merits preferential treatment.

33. The arguments for and against the approach outlined in (a) above - the simple domestic/foreign differentiation - are essentially the reverse of those described for the other method. This approach would be easy to apply, does not require any process of country selection but is less satisfactory as a method of capturing relative country risk. In

addition, however, there are further considerations which point towards this approach. Firstly, the method is already followed in several existing national systems (although two member countries of the European Community apply an approach similar to that outlined in (b) and treat certain categories of claim on institutions in other member countries of the European Community in the same way as equivalent domestic claims). Secondly, the actual incidence of payments problems, although not the potential incidence, would be dealt with through banks' provisioning which to some extent diminishes the need for differentiation between countries in the risk weighting system. Thirdly, in limiting a low weight to claims on the domestic central governments and official sector, the system would in practice capture and appropriately reflect the great bulk of the high-quality liquid assets held in most banking systems.

34. The Committee has considered the balance of these arguments and most member countries of the Committee concluded that in present circumstances they would favour alternative (a)⁴ and thus applying a zero weight (or a low weight if the national supervisory authority elects to incorporate interest rate risk) to claims on the domestic central government and a low weight to claims on domestic official-sector entities⁵ [see (iii) below]. All claims on foreign public-sector bodies would attract a standard 100 per cent. weight, with two exceptions. Firstly, some alleviation is appropriate for local currency claims booked in banks' foreign offices⁶

4 Two member countries would prefer method (b), i.e. to adopt a defined grouping of industrialised countries.

5 Those member countries of the European Community whose systems of measurement treat certain categories of claim on institutions in other member countries of the Community in the same way as similar domestic claims would continue to apply this approach.

6 Branches and, in the case of consolidated accounts, subsidiaries located outside the territory of the parent bank. Where such foreign subsidiaries are located in other G-10 member countries, for the purpose of meeting local capital adequacy requirements the subsidiary would be treated in the same way as other domestic banks. The application of the framework to foreign branches and subsidiaries raises some practical difficulties and comments are invited particularly on this aspect of the framework.

which are funded by local currency liabilities. A 20 per cent. weight would apply to such claims on central governments in such circumstances (but not to other official-sector entities). Secondly, where individual countries' banking systems are closely integrated with that of a neighbouring country and it is customary for banks to manage their liquidity by holding securities issued by the central government of the neighbouring country funded by liabilities denominated in the same currency, the Committee considers that a low weighting for such cross-border claims on foreign central governments may also be justified. Such an arrangement in these special and exceptional circumstances would be at the discretion of the national supervisory authority.

35. As regards the treatment of interbank claims, it is proposed that in order to preserve the efficiency and liquidity of the international interbank market there should be no differentiation between claims on domestic banks and claims on foreign banks. However, the Committee draws a distinction between, on the one hand, short-term placements with other banks which is an accepted method of managing liquidity in the interbank market and carries a perception of low risk and, on the other, longer-term cross-border loans to foreign banks which are often associated with particular transactions and carry greater transfer and/or credit risks. A 20 per cent. weight is therefore proposed for claims on all banks, domestic and foreign, with an original maturity of under one year; longer-term claims on domestic banks would be weighted at 20 per cent; and longer-term cross-border claims on foreign banks would be weighted at 100 per cent.⁷

36. In addressing the relative merits of the different approaches to country transfer risk described in the previous paragraphs, a further additional factor to be borne in mind is that, in the parallel discussions in the European Community, the Member States (which include seven countries represented on the Committee) are likely within the next year or two to have accepted in Community legislation the principle that all claims

7 One member country is in favour of applying a 100 per cent. weight to all claims on foreign banks, irrespective of maturity.

on banks, central governments and the official sector within European Community countries should be treated in the same way as claims on domestic institutions. This means that when, in due course, the proposed system of solvency ratios is introduced in the European Community incorporating this principle, there would be some asymmetry in the approach applied to domestic and foreign claims by G-10 countries which are not members of the Community vis-à-vis that applied by Community countries. This asymmetry may not be of great practical importance since the incidence of cross-border claims on the central governments and the official sector and long-term claims on banks located in the Community is negligible compared with the totality of banks' operations and any inconsistency in weighting will not have a measurable effect on banks' overall capital ratios. But non-EC members of the Committee, nonetheless, find this feature of the framework unattractive and possibly placing them at some competitive disadvantage. Notwithstanding these concerns, the Committee has concluded that, initially, the domestic/all foreign split when applied to cross-border exposure can be accepted. In due course, however, when proposed common solvency ratios become legally binding for EC members of the G-10, this approach may have to be reassessed with a view to reducing such asymmetry or competitive inequalities as may arise.

37. In issuing these proposals, the Committee invites particular comment in the course of the consultative process on the approach to transfer risk described in paragraphs 31 to 36.

(iii) Claims on non-central government, public sector entities

38. The Committee concluded that it was not possible to settle on any common weights which should apply to all claims on domestic public-sector entities below the level of central government (states, local authorities, public corporations, etc.), in view of the special character and varying creditworthiness of these institutions and public bodies in different member countries. For example, in different countries some of these institutions may have the capacity to raise tax revenue or issue liquid securities in ways analogous to central government but other institutions may be more analogous to private-sector corporations. The Committee therefore opted for an alternative solution of allowing discretion to each national supervisory authority to determine the appropriate

weighting factors for the official-sector institutions within that country. In order to preserve a degree of convergence in the application of discretion, the Committee agreed that the weights ascribed in this way should be 0, 20 or 50 per cent. Commercial companies owned by the public sector, however, would attract a uniform weight of 100 per cent. in order to avoid competitive inequality vis-à-vis similar private-sector commercial enterprises.

(iv) Collateral and guarantees

39. The framework recognises the importance of collateral in reducing credit risk, but only to a limited extent. In view of the varying practices among banks in different countries for taking collateral and different experiences of the stability of physical or financial collateral values, it has not been found possible to develop a basis for recognising collateral generally in the weighting system. The proposed more limited recognition of collateral would apply to loans secured against cash or against domestic central-government securities which would attract the weight given to the collateral (i.e. a zero or a low weight). Loans to private individuals for residential house purchases have a very low record of loss in most countries and the Committee has agreed that the proposed framework should recognise this by assigning a 50 per cent. weight to loans to owner occupiers for residential house purchase, secured against a mortgage on the property. Other collateral will not be regarded as justifying the reduction of the weightings that would otherwise apply.⁸

40. As regards loans or other exposures guaranteed by third parties, the Committee proposes that loans guaranteed by the domestic central government, domestic public-sector agencies, or domestic (but not foreign) banks should attract the weight allocated to a direct claim on the guarantor (e.g. 20 per cent. in the case of banks). In the case of loans

⁸ One member country takes the view that other forms of physical collateral, notably land and commercial mortgages, should also justify diminished risk weightings and that the valuation for collateral purposes should be strictly defined to ensure a precise margin of surplus value over the loan.

covered by partial guarantees, only that part of the loan which is covered by the guarantee would attract the reduced weight. The contingent liability assumed by banks in respect of guarantees would attract a credit conversion factor of 100 per cent. (see sub-section (v) below).

(v) Off-balance-sheet engagements

41. The Committee believes that it is of great importance that all off-balance-sheet activity should be caught within the capital adequacy framework. At the same time, it is recognised that there is only limited experience in assessing the risks in some of the activities; also that for some countries, a complex analytical approach and detailed and frequent reporting systems cannot easily be justified when the amounts of such business, particularly in the newer, more innovative instruments, are only small. The approach recommended, which is on the same lines as that described in the Committee's report on the supervisory treatment of off-balance-sheet exposures issued to banks in March 1986, is comprehensive in that all categories of off-balance-sheet engagements, including recent innovations, will be converted to credit risk equivalents by multiplying the nominal principal amounts by a credit conversion factor, the resulting amounts then being weighted according to the nature of the counterparty. The different instruments and techniques are divided into five broad categories (within which member countries will have some limited discretion to allocate particular instruments according to their individual characteristics in national markets):

- (a) those which substitute for loans (e.g. general guarantees of indebtedness, bank acceptance guarantees and standby letters of credit serving as financial guarantees for loans and securities) - these will carry a 100 per cent. credit risk conversion factor;
- (b) certain transaction related contingencies (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions) - a 50 per cent. credit risk conversion factor;
- (c) short-term, self-liquidating trade-related contingent liabilities arising from the movement of goods (e.g. documentary credits

collateralised by the underlying shipments) - a 20 per cent. credit risk conversion factor;

(d) Commitments with an original maturity exceeding one year (the longer maturity serving broadly as a proxy for higher risk facilities) and all NIFs and RUFs - a 50 per cent. credit risk conversion factor. Shorter-term commitments or commitments which can be cancelled at any time, it is agreed, generally carry only low risk and a nil weight for these is considered to be justified on de minimis grounds;

(e) interest and exchange rate related items (e.g. swaps, options, futures) - the credit risk equivalent amount for these contracts will be calculated in one of two ways (see below and Annex 3).

42. Special treatment is needed for the items in (e) above because banks are not exposed to credit risk for the full face value of their contracts, but only to the cost of replacing the cash flow if a counterparty defaults. Most members of the Committee accept that the correct method of assessing the credit risk on these items is to calculate the current replacement cost by marking to market and to add a factor to represent potential exposure during the remaining life of the contract. Some member countries, however, are concerned about the complexity of this method in a system which only makes broad distinctions between relative risks on balance-sheet items, particularly for banks where these off-balance-sheet items currently constitute only a very small part of the total risks. They would prefer to apply an alternative approach consisting of conversion factors based on the nominal principal sum underlying each contract according to its type and maturity. The Committee has concluded that, for the time being, members should be allowed to choose either of the two methods. The details of the two alternative methods are set out in Annex 3 and comments are invited, particularly on the second method involving the application of conversion factors to the nominal principal.

III. A TARGET STANDARD RATIO

43. The majority of member countries of the Committee consider it very desirable to announce at the outset, as a basis for consultations with banks, an indicative numerical standard which supervisors believe at the

present time is a level which their international banks generally should be encouraged to achieve at the end of a transitional period. They believe that not to announce such a figure at the start of consultations would leave banks with incomplete information and guidance for testing and assessing the impact of the application of the system of measurement. Two member countries, however, while supporting the intention to achieve convergence towards higher standards of capital adequacy, take the view that it is not appropriate to announce a figure in advance of detailed consultation on the framework and would prefer to promulgate a minimum standard only after application of the framework had been thoroughly tested and comments received. Those countries, therefore, prefer to go into consultations with their banks without being bound to any indicative figure at this stage. These and other matters concerning the precise application of the framework in national systems will be raised in parallel consultation documents to be issued by the authorities at national level.

44. In arriving at an appropriate international standard, there is a choice between, on the one hand, a low figure which banks in all countries may be expected to be able to observe immediately; and, on the other hand, a higher figure to be achieved over time that is consistent with the objective of strengthening the capital ratios of international banks and which may serve as a reasonable minimum target level for international banks generally to sustain. The Committee believes that the latter approach is to be preferred. The Committee as a whole has not endorsed any precise indicative figure at this stage but the present view of those ten countries wishing to promulgate a figure now as a basis for consultation is that the target standard ratio of capital to weighted risk assets should be 8 per cent. (of which the core capital element should be at least 4 per cent.). This is expressed as a common minimum standard which international banks in member countries would be expected to observe by the end of 1992, thus allowing a transitional period of five years for any necessary adjustment by banks who need time to build up to those levels.

IV. TRANSITIONAL AND IMPLEMENTING ARRANGEMENTS

(i) Transition

45. Certain transitional arrangements have been agreed upon to ensure that there are sustained efforts during the transitional period to build up individual banks' ratios towards the ultimate target standard; and to facilitate smooth adjustment and phasing in of the new arrangements within a wide variety of existing supervisory systems.

46. The transitional period will be five years, beginning at end-1987 and ending at end-1992, by which date it is proposed the standard should be met in full by all banks undertaking significant cross-border business (see paragraph 50. below). In addition, there will be an interim standard to be met by the end of 1990 (see paragraph 49. below).

47. Initially, from end-1987, no formal standard or minimum level will be set. It is the general view of the Committee, however, that every encouragement should be given to those banks whose capital levels are at the low end of the range to build up their capital as quickly as possible and the Committee would expect no erosion of existing capital standards in individual member countries' banks. Thus, during the transitional period, all banks which need to improve capital levels up to the interim and final standards should not diminish even temporarily the capital levels prevailing as at end-1987 (subject to the fluctuations which can occur around the time new capital is raised). A level of 5 per cent. attained by application of the proposed framework and transitional arrangements is considered by some countries to be a reasonable yardstick for the lower capitalised banks to seek to attain in the short term. Individual member countries will, of course, be free to set, and announce, at the outset of the transitional period the level from which they would expect all their banks to move towards the interim and final target standard. In order to assess and compare progress during the initial three-year period of adjustment in a manner which takes account both of existing supervisory systems and the new arrangements, the Committee and individual supervisory authorities will initially apply the basis of measurement set out in paragraph 48. below.

48. In measuring the capital position of banks at the start of the three-year period, a proportion of the core capital may be made up of

supplementary elements up to a maximum of 25 per cent. of core capital elements, reducing to 10 per cent. by end-1990. In addition, throughout the transition period up to end-1992, subject to more restrictive policies which individual authorities may wish to apply, term subordinated debt may be included without limit as a constituent of supplementary elements and the deduction from tier 1 capital elements in respect of goodwill may be waived.

49. At end-1990 there will be an interim minimum standard of 7.25 per cent.⁹ of which at least half should be core capital. However, between end-1990 and end-1992 up to 10 per cent. of the required core elements may be made up of supplementary elements. This means, in round figures, a minimum core capital element of 3.6 per cent., of which tier 1 elements should total at least 3.25 per cent., is to be achieved by the end of 1990. In addition, from end-1990, general loan loss reserves or general provisions which include amounts reflecting lower valuations of assets or latent but unidentified losses present in the balance sheet will be limited to 1.5 percentage points, or exceptionally up to 2.0¹⁰ percentage points, of risk assets within supplementary elements.

50. At end-1992 the transitional period ends. The minimum standard will then be 8 per cent.,⁹ of which core capital (tier 1, equity and reserves) will be at least 4 per cent., supplementary elements no more than core capital and term subordinated debt within supplementary elements no more than 50 per cent. of tier 1. In addition, general loan loss reserves or general provisions (having the characteristics described in paragraph 49) will be limited at end-1992 to 1.25 percentage points, or exceptionally and temporarily up to 2.0¹⁰ percentage points, within supplementary elements.

9 The position of two member countries is reserved on the appropriateness of this figure (see also paragraphs 43 and 44).

10 These limits 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).

For ease of reference, the arrangements described in paragraphs 45 to 50 are summarised in a table at Annex 4.

(ii) Implementation

51. As is customary when national proposals are made in member countries to modify supervisory requirements, a process of consultation with commercial banks and other interested parties in respect of this international accord is proposed. This consultative process will be handled at national level in the first instance and the Committee will co-ordinate the comments and responses made to its members individually. It is proposed that six months should be the maximum period envisaged for consultation (i.e. to end-June 1988). Parallel explanatory papers are being prepared for issue by individual national authorities to deal with particular local aspects of the way it is proposed the framework should be applied.

52. Each country will decide the way in which the supervisory authorities will introduce and apply these recommendations in the light of their different legal structures and existing supervisory arrangements. In some countries, changes in the capital régime may be introduced, after consultation, relatively speedily without the need for legislation. Other countries may employ more lengthy procedures, and in some cases these may require legislation. In due course the member states of the European Community will also need to ensure that their own domestic regulations are compatible with the Community's own legislative proposals in this field. None of these factors needs result in any inconsistency in the timing of implementation among member countries. For example, some countries may apply the framework in this report, formally or informally, in parallel with their existing system, certainly during the initial period of transition. In this way banks can be assisted to start the necessary process of adjustment in good time before substantive changes in national systems are formally introduced.

December 1987