Off balance sheet risks
Note issuance facilities/revolving underwriting facilities

Notice to recognised banks and licensed deposit-takers issued by the Bank's Banking Supervision Division on 3 April 1985.

1 Pressures on banks' capital adequacy ratios in recent years have contributed to a significant growth in off balance sheet instruments not all of which are currently captured in the prudential measurement of capital and liquidity. This has led not only to a growth in such new instruments but also to banks taking on such obligations on terms which, in the Bank's view, do not properly reflect the risks involved. The Bank, therefore, wishes to set in train a review, in consultation with banks and other institutions, of the range of off balance sheet risks to which they may be exposed in order to assess those risks more accurately. This review will include the treatment of more traditional and well-established contingent liabilities as well as instruments which have been developed more recently.

2 An area of particular concern arises from the obligations assumed by institutions which act as underwriters of note issuance facilities[1] or revolving underwriting facilities. The Bank considers that these obligations represent a long-term credit risk for an underwriting bank,[2] as the bank can be called upon to honour its undertaking to lend at any time during the life of the facility, including circumstances in which the financial position of the borrower has deteriorated and when it might otherwise prefer not to lend. This obligation is different from normal underwriting engagements where, unless the issue has been wrongly priced and is left with the bank, a bank's obligation to the borrower terminates when the issue has been completed.

3 Although many facilities now include a condition involving any material adverse change in the financial position of the borrower, the Bank considers that an underwriting bank could find itself under strong pressure to provide funds, particularly where there is a long-term relationship between the borrower and the bank.

4 The Bank therefore considers that a bank's underwriting obligations under a note issuance facility should be included in the measurement and assessment of its capital adequacy. The Bank will henceforth, as a provisional measure, treat all such obligations as contingent liabilities for capital adequacy purposes and will include them at a weight of 0.5 in the calculation of the risk asset ratio, whether or not the facility has been drawn down by the borrower. Where an institution holds paper issued under a note issuance facility of which it is an underwriter, its holding of the paper will be weighted as a balance sheet item, and the amount of its underwriting obligations reduced accordingly.

5 From discussions which the Bank has had with individual institutions, it is clear that many institutions already include underwriting obligations under note issuance facilities within their existing credit limits for individual borrowers. The Bank believes that this is a prudent practice and that it should be adopted by all banks underwriting these facilities. It is important that an underwriting institution makes a full credit assessment of a borrower under a note issuance facility in the same way as it would if it were making an advance, and that it keeps its exposure under continuous review during the life of the facility.

6 An underwriting institution should also ensure that in managing its liquidity it takes account of the possibility that it may be requested to take up at short notice any unsold notes issued by the borrower.

7 Although the Bank does not apply capital adequacy requirements to UK branches of overseas banks, the Bank nevertheless wishes to monitor branches' activities as underwriters of note issuance facilities and to include these obligations in measuring an institution's large exposures to individual customers. Branches of overseas banks should therefore report their underwriting obligations under these facilities to the Bank. Treatment of these obligations of overseas branches for capital adequacy purposes is of course a matter for the authorities in the home countries of these banks. The issues raised in this note have been discussed by the Bank with the authorities in the major industrialised countries who are also considering their own arrangements in respect of this business.

8 A statistical notice to all reporting institutions is being issued at the same time as this notice. In future an institution's underwriting obligations under a note issuance facility should be reported separately, as a

(1) For the purpose of this notice, these facilities are defined as arrangements which enable a borrower to raise funds through the issue of short-term paper, where the availability of funds is in effect guaranteed by a bank or a group of banks underwriting the issue of paper by the borrower. These include facilities arranged for both bank and non-bank borrowers, where the paper is issued in the form of certificates of deposit or promissory notes. They may also include multi-component facilities under which the underwriting institutions may make available alternative funds if the borrower chooses not to make an issue of the notes.

(2) For the purpose of this notice, the term 'bank' includes recognised banks and licensed deposit-taking institutions.

contingent liability, under item 13.7 on the form Q7 or under item 7.6 on the form B7, as appropriate. These obligations should also be included, where appropriate, under item 20 on the form Q7, or under items 11 and 12 on the form B7.

9 The increasing scale of many banks' obligations under note issuance facilities has prompted the Bank to bring them within the measurement of the risk asset ratio at an early stage. The Bank recognises that some of these facilities may be arranged for a bank borrower. In such cases there will initially be an inconsistency between the weight (0.5) given to all obligations under these facilities and the weight given to market lending to monetary sector institutions (0.2). This matter will, *inter alia,* be taken up in the broader review of off balance sheet exposure referred to in paragraph 1.

10 Meanwhile the Bank is willing to discuss the impact of the introduction of this policy with any institution the calculation of whose capital adequacy will be materially affected.