

Convergence of capital adequacy in the UK and US

Notice issued by the Bank's Banking Supervision Division 8 January 1987

1 Following discussions in Washington and London during the last three months, the Bank of England and the US Federal Banking Regulatory Authorities have reached agreement on proposals for a common measure of capital adequacy. This initiative is in response to growing demands from banks with international activities that there should be convergence in national supervisory systems, particularly in the area of capital adequacy.

2 With the rapid growth of international banking, the case for convergent capital adequacy requirements on both prudential and competitive grounds has strengthened substantially in recent years. The case is further strengthened by the development of new financial instruments which have been introduced and are traded in the principal financial centres. As a first step in convergence the UK and US banking supervisory authorities are proposing a common system of measurement and a common minimum primary capital requirement. It is hoped that the approach adopted by these two countries will provide a basis which other countries, notably Japan and the other countries represented in the G10, can follow.

3 The attached paper, which is being released today in the UK and the US, sets out the proposed common system. It is a risk-related approach similar in many respects to that currently in use in the UK and that proposed in papers published by the US regulatory authorities in January 1986. It also draws on work which has taken place over the last two years within the Committee on Banking Regulations and Supervisory Practices (the Cooke Committee) in Basle.

4 The system measures credit risk by means of a hierarchy of risk weights classified, broadly, accordingly to the nature of the obligor. It is designed to measure the capital requirements for all off-balance-sheet as well as on-balance-sheet transactions, including the full range of innovative financial instruments developed in recent years. The approach is, nevertheless, simple in its construction, with the objective of being relatively easy to understand and capable of being applied without undue risk of confusion.

5 It is acknowledged, however, that it is not comprehensive as a system of measuring risks in banking transactions. In particular, the risk weighting attaching to holdings of domestic national government securities,

where the credit risks are considered to be nil, is intended as a proxy for investment or position risk. The same approach has been used in the treatment of holdings of other securities. It is recognised that it is a crude measure and is included in this form for the present while further work on the risks in holdings of securities is pursued. This work, which will involve discussions with, inter alia, the Securities and Investments Board and the relevant US supervisory authorities, will be carried forward urgently.

The primary capital ratio

6 Using the approach set out in the attached paper, the Bank of England and the US banking regulatory authorities will calculate a ratio of primary capital to total weighted risk assets for each institution authorised and supervised by them. In the UK, discount houses and money funds will continue to be subject to separate supervisory regimes, given their specialised functions.

7 A common ratio of primary capital to total weighted risk assets will be set and published as a minimum requirement which will apply to all banks in both countries. In addition, it is the intention of the supervisory authorities in both countries to set a minimum primary capital ratio for each individual institution to reflect its relative strengths and weaknesses. This latter ratio, which is likely to be significantly higher than the published minimum for the great majority of banks, may be adjusted from time to time in the light of the continuing supervisory process, and will remain confidential.

8 The Bank of England will continue to calculate and set, for each bank, a ratio of total capital to weighted risk assets, including off-balance-sheet items. The US authorities will maintain a ratio of primary capital to total assets and a ratio of total capital to total assets. The old and new capital adequacy requirements will be applied in tandem for a period in both countries.

The risk asset weighting structure

9 The Bank has calculated a risk asset ratio for a number of years. The methodology is as set out in *Measurement of Capital 1980*. In the light of the agreement with the US supervisory authorities a number of changes will be made.

10 There will be five risk weight categories: 0%, 10%, 25%, 50% and 100%, depending upon the nature of the

obligor. The weights of 150% and 200% attaching at present to unquoted investments, connected lending and property will cease to apply; these claims will be allocated according to the relevant category of obligor, usually 100%. There will be two classes of exception to the obligor-determined categorisation of assets: claims on banks and on domestic national governments will vary with the maturity of the claim, and some account will be taken of security (collateral) in the form of cash or domestic government securities.

11 There will be no distinctions in the risk weightings to reflect differences in country risk. This will be done qualitatively in setting individual bank primary and total ratios.

Off-balance-sheet transactions

12 The proposals will incorporate all off-balance-sheet business which bears a credit risk of any significant size. The supervisory authorities consider this to be a significant step forward in the measurement of capital adequacy for banks. The volume of such transactions has grown rapidly in recent years and it is important that they be captured and measured. There are particular technical problems in fitting them into a system of capital adequacy, given the variety and complexity of instruments. The approach proposed is to fit them into the risk asset system set out in the attached paper.

13 The weight to be applied to each class of transaction will be that borne by the equivalent on-balance-sheet exposure to the same category of obligor, taking account of maturity and collateral where this is relevant. To this end, each class of off-balance-sheet business will be converted into a 'demand credit equivalent' by applying a conversion factor.

14 For example, credit substitutes will be weighted for their full principle amount. This treatment will apply to guarantees and acceptances. Some obligations described

as commitments will also be treated in this way if in reality they amount to credit substitutes.

15 Some contingents—notably commercial letters of credit, and performance bonds—in practice involve less credit exposure and will be converted to a deemed credit equivalent using a 50% conversion factor.

16 Undrawn commitments will have conversion factors which vary with the original maturity of the facility. The supervisory authorities believe that the longer-term obligations, like Revolving Underwriting Facilities, involve a particularly significant credit risk. Therefore, facilities with an original maturity of over 5 years will have a conversion factor of 50%; facilities of an original maturity of between 1 and 5 years will be converted at 25%; and those formally reviewable annually, including overdrafts, will have a conversion factor of 10%.

17 The treatment of interest rate and foreign exchange rate transactions remains to be finally determined, but the approach of calculating a 'deemed credit equivalent' will also apply. Work is well advanced and a paper setting out the means of deriving the 'deemed credit equivalent' will be published in the near future.

Large exposures

18 The Bank will continue to use the total capital base as presently defined for the purposes of defining and calculating large exposures.

Period of consultation

19 The Bank and the US supervisory authorities invite comments from banks and other interested parties on the proposals. Comments, which will be considered jointly by the UK and US authorities, should be submitted to the Bank by 16 April 1987. The Bank and the US supervisory authorities intend to introduce the new system as soon as possible after the period of consultation.