

**Committee on Banking Regulations
and
Supervisory Practices**

Note for editors

**Outcome of the consultative process on proposals for
international convergence of capital measurement
and capital standards**

Introduction

1. In December 1987 the Basle Committee on Banking Regulations and Supervisory Practices issued a consultative paper containing proposals for international convergence of supervisory regulations governing the capital adequacy of international banks. Comments on the proposals were invited from national banking associations, supervisory authorities in non-G-10 countries and other interested parties. The Committee gratefully acknowledges the many positive and constructive comments that have been submitted and has given careful and thorough consideration to all the points raised.

2. In the light of these comments, the Committee has reviewed its proposals and has drawn up a new document¹ in the form of an agreed framework for measuring capital adequacy which sets a minimum capital standard which international banks will be expected to achieve by end-1992. The framework will therefore be applied by the banking supervisory authorities in the countries of the Group of Ten.

3. The Committee notes that the response of banks generally has been to welcome the purpose and the general form of the convergence proposals and to encourage their application at the national level in a common form to the maximum degree possible. Against this background of broad support, the Committee has had to weigh two overriding considerations when assessing comments from individual banks and banking associations suggesting possible modifications to the framework. These two fundamental considerations, which lie at the heart of the Committee's work on regulatory convergence, are, 'firstly, that the framework should serve to strengthen the soundness and stability of the international banking system; and, secondly, that the framework should be fair and consistent in its application to international banks in different countries so as to diminish one important source of competitive inequality.

4. With these considerations in mind, the Committee has been able to incorporate a number of amendments in the final report which carry general support among supervisors and banks in G-10 countries. On the other hand, the Committee has not found it possible to accommodate a range of comments, particularly relating to the definition of capital, the effect of which would have been to weaken the emphasis on high-quality capital or to alter the competitive neutrality presently embodied in the framework and thereby to undermine its general acceptability to supervisors and banks in all countries.

¹ *International convergence of capital measurement and capital standards*, due to be released on Friday 15 July at 13.00 Central European Time.

The outcome of the review

(a) *Capital definition*

5. The Committee concluded that it was not desirable to alter the basic definition of capital.² It is therefore confirmed that at least half of a bank's capital base for the purpose of meeting the standard must consist of a core element comprised of equity capital and published reserves from post-tax retained earnings. The target standard ratio to be achieved by end-1992 is confirmed at the level of 8 per cent. The transitional arrangements set out in the December 1987 paper also remain unchanged. One member country, however, maintains the view that an international definition of capital should be confined to core capital elements and indicated that it would continue to press for the definition to be reconsidered by the Committee in the years ahead.

(b) *Risk weightings*

6. The following are the main modifications which have been agreed to the framework published in December 1987 in respect of the risk weights applied to different categories of asset or contingent liability:

- (i) Reduced risk weights have been applied in respect of claims on certain categories of obligor - central governments (and central banks), public-sector entities and longer-term claims on banks - in a defined group of countries. The group will comprise full members of the OECD and any countries which have concluded special lending arrangements with the IMP associated with the Fund's General Arrangements to Borrow. The need for some clearly defined, albeit arbitrary, distinction between countries where different degrees of transfer risk are perceived was universally requested by all G-10 countries' banking associations.
- (ii) Claims on all other central governments (and central banks) denominated in the currency of the borrower will bear a 0 per cent. weight (or a low weight where the parent supervisory authority elects to include a proxy for investment risk into the framework) provided that these claims are backed by funding in the currency of the borrower. The consultative paper had earlier proposed a 20 per cent. weight for local currency claims on foreign central governments booked in banks' foreign offices and funded by local currency liabilities.
- (iii) Claims on the five main multilateral development banks (IBRD, IADB, AsDB, AfDB, EIB) have been standardised at a weight of 20 per cent. (previously a matter for national discretion). Countries have an option to apply a 20 per cent. weight to similar multilateral development banks of which G-10 countries are shareholding members.
- (iv) The concessionary weight of 50% for residential house mortgages has been extended from loans to owner-occupiers to cover also loans to other parties fully secured by mortgage on residential property, thus including housing available for rent as well as owner occupation. The main justification for this change is that in a number of member countries the owner occupied sector of the housing market is relatively small (so that for them the original concession had only limited application) and the rented sector also carries very low loss experience. To avoid abuse,

² Except that non-cumulative perpetual preference shares are now explicitly included in core capital. This was previously implicit.

however, the wording of this section of the main document will make it clear that the lower weight will not apply to lending for speculative property development and building. One member country feels strongly that the lower weight should also apply to other loans secured by mortgages on domestic property, provided that the amount of the loan does not exceed 60 per cent. of the value of the property as calculated according to strict legal valuation criteria.

- (v) The credit conversion factors for most off-balance-sheet instruments remain the same as in the consultative paper. The only changes relate to foreign exchange and interest rate related contingencies, where the proposals in the consultative paper had in some respects been tentative and where comments from practitioners had been invited. The main differences from the proposals in the consultative paper are:
- netting of contracts by novation is now accepted, and further work will continue on the acceptability of other forms of netting ;
 - the conversion factors for the original exposure method have been reduced to bring them closer into line with those for the current exposure method.

Certain other technical modifications are being incorporated into the text of the final report which will be released on Friday, 15th July.

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