FEDERAL RESERVE BANK
OF DALLAS

DALLAS, TEXAS
75265-5906

July 20, 1999

Notice 99-58

TO: The Chief Executive Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

**Assessing Capital Adequacy in
Relation to Risk**

DETAILS

The Board of Governors of the Federal Reserve System has issued a supervisory letter that emphasizes the growing need for large and complex banking organizations to maintain strong internal processes. Supervisory letters are the primary means by which the Federal Reserve communicates key policy directives to its examiners, supervisory staff, and the banking industry. The long-term goal of this supervisory letter is to

- encourage broader adoption of sound practices in internal analysis of capital adequacy,
- promote further innovation and enhancements by the industry in this area, and
- integrate better internal analysis into the supervisory process.

ATTACHMENTS

Copies of the Board's press release and supervisory letter are attached.

MORE INFORMATION

For more information, please contact Dorsey Davis of the Banking Supervision Department at (214) 922-6051. For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254.

Federal Reserve Release

Press Release

Release Date: *July 1, 1999*

For immediate release

The Federal Reserve today issued a supervisory letter which emphasizes the growing need for large and complex banking organizations to maintain strong internal processes to assure that their capital is fully sufficient to support the underlying risks they face as well as to meet minimum regulatory standards.

Capital adequacy is a critical element of a bank's safety and soundness. With the growing scope and complexity of business activities and ongoing financial innovation, simple ratios - including risk-based capital ratios - and traditional rules of thumb no longer suffice in assessing the overall capital adequacy of many banking organizations.

The supervisory letter directs examiners to evaluate internal capital management processes to judge whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the institution's capital needs. To support that evaluation, this letter describes the fundamental elements of a sound and comprehensive internal capital adequacy analysis and the key areas of risk it should encompass.

This letter grows in part from a recent supervisory review of internal capital management processes at several large complex banking organizations. This review suggests that these processes could be significantly improved, in particular to become better integrated with internal risk measurement and analysis. In providing guidance to examiners and supervisors, this supervisory letter is also intended to encourage such banking organizations to strengthen their risk measurement capabilities as well as to integrate these capabilities more fully in evaluating their own capital adequacy.

The practices described in this letter extend in some cases beyond those currently followed by most large banking organizations. Examiners should generally expect these institutions to make steady and meaningful progress towards implementation of a comprehensive internal process for assessing capital adequacy in relation to risk, rather than immediate and full implementation. However, examiners should expect those banking organizations actively involved in complex securitizations or other similar transfers of risk to have in place or immediately implement a comprehensive internal capital analysis that fully reflects all risks.

Supervisory letters are the primary means by which the Federal Reserve communicates key policy directives to its examiners, supervisory staff, and the banking industry. The long-term goal of this supervisory letter is to encourage broader adoption of sound practices in internal analysis of capital adequacy, to promote further innovation and enhancements by the industry in this area, and to integrate better such internal analysis into the supervisory process.

The supervisory letter is attached.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 99-18 (SUP)
July 1, 1999

TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE
SUPERVISORY AND EXAMINATION STAFF AT EACH
FEDERAL RESERVE BANK AND CERTAIN DOMESTIC
ORGANIZATIONS SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: **Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles**

Overview

Over the past several years, supervisors have placed increasing emphasis on banking organizations' internal processes for assessing risks and for ensuring that capital, liquidity, and other financial resources are adequate in relation to the organizations' overall risk profiles. This emphasis has been motivated in part by the greater scope and complexity of business activities at many banking organizations, and in particular those activities related to ongoing financial innovation. In this setting, one of the most challenging issues faced by bankers and supervisors is how to integrate the assessment of an institution's capital adequacy with a comprehensive view of the risks it faces. Simple ratios - including risk-based capital ratios - and traditional rules of thumb no longer suffice in assessing the overall capital adequacy of many banking organizations, especially large institutions and others with complex risk profiles such as those significantly engaged in securitizations or other complex transfers of risk.

This SR letter emphasizes the growing need for banking organizations to take greater efforts to assure that their capital is not only adequate to meet formal regulatory standards, but also is fully sufficient to support their underlying risk positions. A recent supervisory review of internal capital management processes at several large complex banking organisations suggests that these processes could be significantly improved, in particular to become better integrated with internal risk measurement and analysis.

Consequently, this letter directs supervisors and examiners to evaluate internal capital management processes to judge whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the institution's capital needs. To support that evaluation, this letter describes the fundamental elements of a sound internal capital adequacy analysis - identifying and measuring all material risks, relating capital to the level of risk, stating explicit capital adequacy goals with respect to risk, and assessing conformity to the institution's stated objectives - as well as the key areas of risk to be encompassed by such analysis.

It is particularly important that large institutions and others with complex risk profiles be able to assess their current capital adequacy and future capital needs in a systematic and comprehensive manner in light of their risk profiles and business plans. In providing guidance to examiners and supervisors, this letter is also intended to encourage such banking organizations to strengthen their risk measurement capabilities as well as to integrate these capabilities more fully into evaluations of their own capital adequacy.

The practices described in this letter extend in a number of respects beyond those currently followed by most large banking organisations to evaluate their capital adequacy. In general, therefore, examiners should not expect these institutions to have in place immediately a comprehensive internal process for assessing capital adequacy, but rather to initiate efforts to do so promptly and thereafter to make steady and meaningful progress toward that end. Examiners should evaluate an institution's progress at each examination or inspection, considering progress both relative to the institution's former practice and relative to its peers, and record the results of this evaluation in the examination or inspection report.

For those banking organizations actively involved in *complex* securitizations, other secondary market credit activities, or other complex transfers of risk, however, examiners should expect a sound internal capital adequacy analysis process as described in this letter to be in place immediately as a matter of safe and sound banking.[1]

Using as a guide the elements of sound practice described in this SR letter, examiners should evaluate whether the organisation is making adequate progress in assessing its capital needs on the basis of the risks arising from its business activities, rather than focusing its internal processes primarily on compliance with regulatory standards or comparisons with the capital ratios of peer institutions. Examiners should discuss the issues raised by this SR letter with bank management and directors in this context.

In addition to evaluating the organisation's current practices, examiners should take account of plans and schedules to enhance existing capital assessment processes and related risk measurement systems, with appropriate sensitivity to transition timetables and implementation costs. Evaluation of adherence to schedules should be part of the examination process. But, regardless of planned enhancements, supervisors should expect *current* internal capital adequacy assessment processes to be appropriate to the nature, size and complexity of the organisation's activities, and to its process for determining the allowance for credit losses.

The results of this evaluation of internal processes for assessing capital adequacy should for the present time be reflected in the institution's ratings for *management* . Examination and inspection reports should contain a brief description of the internal processes involved in internal analysis of the adequacy of capital in relation to risk, an assessment of whether these processes are adequate for the complexity of the institution and its risk profile, and an evaluation of the institution's efforts to develop and enhance these processes. Significant deficiencies and inadequate progress in developing and maintaining capital assessment procedures should be noted in examination and inspection reports. As noted above, examiners should expect those institutions already engaged in complex activities involving the transfer of risk, such as securitization and related activities, to have sound internal capital adequacy analysis processes in place immediately as a fundamental component of safe and sound operation.

As these processes develop and become fully implemented, supervisors and examiners should also place increasing reliance on internal assessments of capital adequacy as an integral part of an institution's *capital adequacy* rating. If these internal assessments suggest that capital levels appear to be insufficient to support the risks taken by the institution, examiners should note this finding in examination and inspection reports, discuss plans for correcting this insufficiency with the institution's directors and management and, as appropriate, initiate supervisory actions.

The guidance set forth in this SR letter does not constitute a regulation, nor does it seek to establish new regulatory requirements. Rather, it is intended to assist examiners in assessing capital adequacy and associated internal processes at banking organisations, and to inform the banking industry of some of the factors examiners will consider during on-site examinations.

Background

Over the past several years, the federal banking agencies have sought to refine and strengthen their examination and supervisory programs to adapt to significant changes taking place in the U.S. banking and financial system. A central goal of this effort has been to focus supervisory resources on areas of greatest risk. Examiners are also directing greater attention to the risk management and internal control systems of banking organizations to ensure that they effectively identify, measure, monitor and control major risks. An area of increasing interest to supervisors now is the way that directors and senior management of banking organizations integrate the assessment of major risks with the processes they use to determine the appropriate capital levels for their organizations.

Evolution of supervisory approach to capital: A critical component of the examination and supervisory process is the assessment of a banking organization's capital adequacy. Historically, examiners evaluated capital adequacy primarily by first assessing the soundness of an organization's investments, loan portfolio and asset valuation process, and then determining how its capital position compared with regulatory capital minimums and those of its peer group. Risks to solvency arising from other sources were incorporated into this evaluation only in exceptional cases.

Today, however, financial institutions and supervisors must consider a much broader range of exposures, and must deal with an increasingly complex array of financial instruments and activities that reflect important, but often subtle, differences in levels of risk. Simple ratios and traditional rules of thumb no longer suffice in assessing the overall capital adequacy of many banking organisations, especially large institutions and others with complex risk profiles or engaged in complex transfers of risk.[2] As a result, such organisations require formal, analytical processes to identify and measure their risks and to maintain an adequate overall level of capital that is appropriate to that risk. A recent review of such processes at several large institutions suggests that current industry practices appear only partially to meet these objectives.

Current industry practice: Most institutions consider several factors in evaluating their overall capital adequacy: a comparison of their own capital ratios with regulatory standards and with those of industry peers; consideration of identified risk concentrations in credit and other activities; their current and desired credit agency ratings, if applicable; and their own historical experiences including severe adverse events in the institution's past. Some more sophisticated banks also use risk modeling techniques and scenario analyses to evaluate risk, but generally have not yet incorporated such analyses formally into their overall assessment of capital adequacy. Their evaluation of the adequacy of capital relative to risk - as well as their decisions on the appropriate level and structure of capital - continue to rely heavily on subjective considerations, including implicit or explicit regulatory and market expectations, peer group analysis, and other qualitative factors.

Some institutions are using risk modeling and scenario analysis as tools to illuminate potential economic losses arising from certain types of risk, and are working to integrate such tools as they apply to different risk types. The approaches and methods used vary by institution, as do the current degree of precision and integration. Such tools nonetheless provide valuable reference points in overall risk measurement and, when more fully developed, may provide useful comparisons for analysis of overall capital adequacy.

While the industry may not have reached consensus on the best techniques to use for assessing capital adequacy internally, sound practices are clearly moving toward a more quantitative, systematic, and comprehensive process. Sophisticated institutions are making greater use of analytical techniques developed either for pricing and performance measurement across business and product lines or for making portfolio risk management decisions. These techniques incorporate one or more volatility-based measures that allow for analysis of unexpected losses as well as more subjective considerations.

Regardless of the techniques used, nearly all U.S. banking organizations have found it advantageous to operate with capital levels above regulatory minimums, and indeed above levels defined as "well-capitalized" by regulation. Such decisions recognize supervisory expectations for strong capital positions, the cyclical nature of credit risks, the uncertainties and errors associated with measuring risk, pressures from significant business counterparties and other market participants, geographic or industry concentrations, business uncertainties associated with specific banking activities, and other factors not considered in the current risk-based capital measurement framework. Nonetheless, even high capital ratios are often not indicative of overall capital adequacy, especially for institutions engaging in securitization of high quality assets and other capital arbitrage techniques. Supervisors thus often cannot rely on risk-based capital ratios as indicators of capital strength at institutions engaging in such activities.

<u>Fundamental Elements of a Sound Internal Capital Adequacy Analysis</u>

Because risk measurement and management issues are evolving rapidly, at this stage it is neither possible nor desirable for supervisors to prescribe in detail the precise contents and structure of a sound and effective internal capital assessment process for large and complex institutions. Indeed, the attributes of sound practice will evolve over time as methodologies and capabilities change, and will depend importantly on the individual circumstances of each institution.

Nonetheless, it is clear that such a process should include four fundamental elements:

1. *Identifying and measuring all material risks:* A disciplined risk measurement program promotes consistency and thoroughness in assessing current and prospective risk profiles, recognizing that risks often cannot be measured with precision. The detail and sophistication of risk measurement should be appropriate to the characteristics of the institution's activities and to the size and nature of the risks that each activity presents. At a minimum, risk measurement systems should be sufficiently comprehensive and rigorous to capture the nature and magnitude of risks faced by the institution, while differentiating risk exposures consistently among risk categories and levels of riskiness. Controls should be in place to ensure objectivity and consistency and that all material risks - both on- and off-balance-sheet - are adequately addressed.

    Banks should conduct detailed analyses to support the accuracy or appropriateness of the risk measurement techniques used. Similarly, inputs used in risk measurement should be of good quality. Those risks not easily quantified should be evaluated through more subjective, qualitative techniques or through stress testing. Changes in an institution's risk profile should be incorporated into risk measures on a timely basis, whether due to new products, increased volumes or changes in concentrations, the quality of the bank's portfolio, or the overall economic environment. Measurement thus should not be oriented to the current treatment of these transactions under risk-based capital regulations.

    In general, in measuring these risks, institutions should perform comprehensive and rigorous stress tests to identify possible events or changes in markets that could have serious adverse effects in the future. Institutions should also give adequate consideration to contingent exposures arising from loan commitments, securitization programs, and other transactions or activities that may create such exposures for the bank.

2. *Relating capital to the level of risk* : The amount of capital held should reflect not only the measured amount of risk, but also an adequate "cushion" above that amount to take account of potential

uncertainties in risk measurement. A banking organization's capital should reflect the perceived level of precision in the risk measures used, the potential volatility of exposures, and the relative importance to the institution of the activities producing the risk. Capital levels should also reflect that historical correlations among exposures can rapidly change.

> Institutions should be able to demonstrate that their approach to relating capital to risk is conceptually sound and that outputs and results are reasonable.[3] Sensitivity analysis of key inputs and peer analysis could be used by an institution in assessing its approach.

3. *Stating explicit capital adequacy goals with respect to risk* : Institutions need to establish explicit goals for capitalization as a standard for evaluating their capital adequacy with respect to risk. Such target capital levels might reflect the desired level of risk coverage, or alternatively, a desired credit rating for the institution that reflects a desired degree of creditworthiness and thus access to funding sources. These goals should be reviewed and approved by the board of directors. Because risk profiles and goals may differ across institutions, the chosen target levels of capital may differ significantly as well. Moreover, institutions should evaluate whether their long-run capital targets might differ from short-run goals, based on current and planned changes in risk profiles and the recognition that accommodating new capital needs can require significant lead time.

> In addition, capital goals and the monitoring of performance against those goals should be integrated with the methodology used to identify the adequacy of the allowance for credit losses (allowance). Although both the allowance and capital represent the ability to absorb losses, insufficiently clear distinction of their respective roles in absorbing losses can distort analysis of their adequacy. For example, an institution's internal standard of *capital* adequacy for credit risk could reflect the desire that capital absorb "unexpected losses" - that is, some level of potential losses in excess of that level already estimated as being inherent in the current portfolio and reflected in the allowance.[4] In this setting, an institution that does not maintain its allowance at the high end of the range of estimated credit losses would require more capital than would otherwise be necessary to maintain its overall desired capacity to absorb potential losses. Failure to recognize this relationship could lead an institution to overestimate the strength of its capital position.

4. *Assessing conformity to the institution's stated objectives:* Both the target level and composition of capital, along with the process for setting and monitoring such targets, should be reviewed and approved periodically by the institution's board of directors.

Risks Addressed in a Sound Internal Capital Adequacy Analysis

Sound internal risk measurement and capital assessment processes should address the full range of risks faced by the institution. This section describes four such areas, referring as appropriate to previous examination guidance specifically related to capital adequacy. This does not represent an exhaustive list of potential issues. The capital regulations of the Federal Reserve (and the other U.S. banking agencies) make reference to many specific factors and other risks that institutions should consider in assessing capital adequacy.[5]

Credit risk: Internal credit risk rating systems are vital to measuring and managing credit risk at large banking organizations. Accordingly, a large institution's internal ratings system should be adequate to support the identification and measurement of risk for its lending activities and be adequately integrated into the institution's overall analysis of capital adequacy (SR letter 98-25). Well-structured credit risk rating systems should reflect implicit, if not explicit, judgments of loss probabilities or expected loss, and should be supported where possible by quantitative analysis. Definitions of risk ratings should be sufficiently detailed and descriptive, applied consistently, and regularly reviewed for consistency throughout the institution.[6]

Banking organizations should also take full account of credit risk arising from securitization and other secondary market credit activities, including credit derivatives (SR letter 97-21). Maintaining detailed and comprehensive credit risk measures is most necessary at institutions that conduct asset securitization programs, due to the potential of these activities to greatly change - and reduce the transparency of - the risk profile of credit portfolios.[7] Because the current capital standard treats most loans alike, banks have incentives to reduce their regulatory capital requirements by securitizing or otherwise selling lower-risk assets, while increasing the average level of remaining credit risk through devices like first-loss positions and contingent exposure. It is important, therefore, that these institutions have the ability to assess their remaining risks and hold appropriate levels of capital and allowances for credit losses. Such institutions, which are at the frontier of financial innovation, should also be at the frontier of risk measurement and internal capital allocation.

Market risk: The current regulatory capital standard for market risk is based largely on a bank's own measure of value-at-risk (VaR). This approach was intended to produce a more accurate measure of risk and one that is also compatible with the management practices of banks. The market risk standard also emphasizes the importance of stress testing as a critical complement to a mechanical VaR-based calculation in evaluating the adequacy of capital to support the trading function.

Interest rate risk: Interest rate risk within the banking book (i.e., in nontrading activities) should also be closely monitored. The banking agencies have emphasized that banks should carefully assess the risk to the economic value of their capital from adverse changes in interest rates. The Joint Policy Statement on Interest Rate Risk (SR 96-13) provides guidance in this matter that includes the importance of assessing interest rate risk to the economic value of a banking organization's capital and, in particular, sound practice in selecting appropriate interest rate scenarios to be applied for capital adequacy purposes.

Operational and other risks: Many banking organizations view operational risk - often viewed as comprising any risk not categorized as credit or market risk - as being second in significance only to credit risk. This view has become more widely held in the wake of recent, highly visible breakdowns in internal controls and corporate governance by internationally active institutions. Although operational risk does not easily lend itself to quantitative measurement, it can have substantial costs to banking organizations through error, fraud, or other performance problems. The great dependence of banking organizations on information technology systems, including Year 2000 preparedness issues, highlights only one aspect of the growing need to identify and control this risk.

Composition of Capital

Analysis of capital adequacy should couple a rigorous assessment of the particular measured and unmeasured risks faced by the institution with consideration of the capacity of the institution's paid-in equity and other capital instruments to absorb economic losses. In this regard, it has been the Board's long-standing view that common equity (that is, common stock and surplus and retained earnings) should be the dominant component of a banking organization's capital structure and that organizations should avoid undue reliance on noncommon equity capital elements.[8] Common equity allows an organization to absorb losses on an ongoing basis and is permanently available for this purpose. Further, this element of capital best allows organizations to conserve resources when they are under stress because it provides full discretion as to the amount and timing of dividends and other distributions. Consequently, common equity is the basis on which most market judgements of capital adequacy are made.

Consideration of the capacity of an institution's capital structure to absorb losses should also take into account how that structure could be affected by changes in the institution's performance. For example, an institution experiencing a net operating loss - perhaps due to realization of unexpected losses - not only will face a reduction in its retained earnings, but also possible constraints on its access to capital markets. These constraints could be exacerbated should conversion options be exercised to the detriment of the institution. A decrease in common equity, the key element of Tier 1 capital, may have further unfavorable implications for an organization's regulatory capital position. The eligible amounts of most types of Tier 1 preferred stock and Tier 2 or Tier 3 capital elements may be reduced, because current capital regulations limit the amount of these elements that can be included in regulatory capital to a maximum percentage of Tier 1 capital. Such adverse magnification effects could be further accentuated should adverse events take place at critical junctures for raising or maintaining capital, for example, as limited-life capital instruments are approaching maturity or as new capital instruments are being issued.

Examiner Review of Internal Capital Adequacy Analysis

As part of the regular supervisory and examination process, examiners should review internal capital assessment processes at large and complex banking organizations as well as the adequacy of their capital and their compliance with regulatory standards. In general, this review should assess the degree to which an institution has in place, or is making progress toward implementing, a sound internal process to assess capital adequacy as described above. Examiners should briefly describe in the examination or inspection report the approach and internal processes used by the institution to assess its capital adequacy with respect to the risks it takes. Examiners should then document their evaluation of the adequacy and appropriateness of these processes for the size and complexity of the institution, along with their assessment of the quality and timing of the institution's plans to develop and enhance its processes for evaluating capital adequacy with respect to risk.

In all cases, the findings of this review should be considered in determining the institution's supervisory rating for management. Examiners should expect those institutions already active in complex activities involving the transfer of risk, such as securitization and related activities, to have sound internal processes for assessing capital adequacy as described in this SR letter immediately as a fundamental element of safe and sound operation.

Beyond its consideration in evaluating management, over time this review should also become an integral element of assessing, and assigning a supervisory rating for, capital adequacy as the institution develops appropriate processes for establishing capital targets and analysing its capital adequacy as described above. If these internal assessments suggest that capital levels appear to be insufficient to support the risks taken by the institution, examiners should note this finding in examination and inspection reports, discuss plans for correcting this insufficiency with the institution's directors and management and, as appropriate, initiate follow-up supervisory actions.

Measurement and risk coverage : Examiners should assess the degree to which internal targets and processes incorporate the full range of material risks faced by the banking organisation. Examiners should also assess the adequacy of risk measures used in assessing internal capital adequacy for this purpose, and the extent to which these risk measures are also used operationally in setting limits, evaluating business line performance, and evaluating and controlling risk more generally. Measurement systems that are in place but are not integral to the institution's risk management should be viewed with some skepticism. Examiners should review whether an institution's approach treats similar risks across products and/or business lines consistently, and whether changes in the institution's risk profile are fully reflected in a timely manner. Finally, examiners should consider the results of sensitivity analyses and stress tests conducted by the institution and how these results relate to capital plans.

Relating capital to the level of risk : In addition to being in compliance with regulatory capital ratios, banking organizations should be able to demonstrate through internal analysis that their capital levels and composition are adequate to support the risks they face, and that these levels are properly monitored and reviewed by directors. Examiners should review this analysis, including the target levels of capital chosen, to determine whether it is sufficiently comprehensive and relevant to the current operating environment. Examiners should also consider the extent to which the institution has provided for unexpected events in setting its capital levels. In this connection, the analysis should cover a sufficiently wide range of external conditions and scenarios, and the sophistication of techniques and stress tests used should be commensurate with the institution's activities. Consideration of such conditions and scenarios should take appropriate account of the possibility that adverse events may have disproportionate effects on overall capital levels, such as the effect of Tier 1 limitations, adverse capital market responses, and other such magnification effects. Finally, supervisors should consider the quality of the institution's management information reporting and systems, the manner in which business risks and activities are aggregated, and management's record in responding to emerging or changing risks.

As a final matter, in performing this review supervisors and examiners should be careful to distinguish between a comprehensive process that seeks to identify an institution's capital requirements on the basis of measured economic risk, and one that focuses only narrowly on the calculation and use of allocated capital or "economic value added" (EVA) for individual products or business lines for internal profitability analysis. This latter approach, which measures the amount by which operations or projects return more or less than their cost of capital, can be important to an organization in targeting activities for future growth or cutbacks. It requires, however, that the organization first determine - by some method - the amount of capital necessary for each activity or business line. It is that process for determining the necessary capital that is the topic of this SR letter and should not be confused with related efforts of management to measure relative returns of the firm or of individual business lines, given an amount of capital already invested or allocated. Moreover, such EVA approaches often are unable to meaningfully aggregate the allocated capital across business lines and risk types as a tool for evaluating the institution's overall capital adequacy.

This SR letter should be disseminated to all domestic large complex banking organizations, large institutions actively engaged in securitization or similar risk-transfer activities, and other institutions supervised by the Federal Reserve as Reserve Bank staff believes appropriate. Questions may be directed to Roger Cole, Associate Director, at 202-452-2618 or William Treacy, Senior Supervisory Financial Analyst, at 202-452-3859.

Richard Spillenkothen
Director

Cross-References: SR letters 93-70, 96-13, 96-17, 97-21, 98-25, and 99-13

Notes:

1 Secondary market credit activities generally include loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to such transactions. Such activities are described further in SR letter 97-21, “Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities”.

2 Such complex transfers of risk would include collateralized loan obligations (CLOs), credit derivatives, and credit-linked notes. For further information on CLOs, see the section entitled “Collateralized Loan Obligations” in the Trading Activities Manual. For further information on credit derivatives and other secondary market credit activities, see SR letter 96-17, “Supervisory Guidance for Credit Derivatives”, and SR letter 97-21, “Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities”.

3 One credible method for assessing capital adequacy would be for an institution to consider itself to be adequately capitalized if it meets a reasonable and objectively determined standard of financial health, tempered by sound judgement, such as a target public agency debt rating or even a statistically measured maximum probability of becoming insolvent over a given time horizon. In effect, this latter method is the foundation of the Basle Accord’s treatment of capital requirements for market and foreign exchange risk.

4 In March 1999 the banking agencies and the Securities and Exchange Commission issued a Joint Interagency Letter to Financial Institutions stressing that depository institutions should have prudent and conservative allowances that fall within an acceptable range of estimated losses. The Federal Reserve has issued additional guidance on credit loss allowances to supervisors and bankers in SR letter 99-13, “Recent Developments Regarding Loan Loss Allowances”.

5 See 12 CFR 208 appendix A (Overview) for state member institutions and 12 CFR 225 Appendix A (Overview) for bank holding companies.

6 SR letter 98-25, “Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations”, discusses the need for banks to have sufficiently detailed, consistent, and accurate risk ratings for all loans, not only for criticized or problem credits. It describes as an emerging sound practice the incorporation of such ratings information into internal capital allocation frameworks, recognizing that riskier assets require higher capital levels.

7 SR letter 97-21, “Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities”, states that such changes have the effect of distorting portfolios that were previously “balanced” in terms of credit risk. As used here, the term “balanced” refers to the overall weighted mix of risks assumed in a loan portfolio by the current regulatory risk-based capital standard. This standard, for example, effectively treats the commercial loan portfolios of all banks as having “typical” levels of risk.

8 The Basle Committee on Banking Supervision affirmed this view in a release issued in October 1998, which stated that common shareholders’ funds are the key element of capital. This release also suggested that, to protect the integrity of an organization’s Tier 1 capital and its common equity base, innovative instruments included in Tier 1 capital generally should be limited to 15 percent of total Tier 1.

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