Development Of Capital Adequacy Guide-lines And Its Impact On Banking Operations

Commercial banks must have sufficient capital to provide a cushion for absorbing possible loan losses and other problems, funds for their internal needs and for growth and expansion, security for depositors and the deposit insurance system, and security for stockholders in the sound operation of a bank. Consequently, bank regulators view adequate capital as critical to the well being of banks in managing the risks of their business.

The main factors considered by bank regulators in determining capital adequacy are:

- the amount of risk assets;
- the amount of marginal and low quality assets;
- the bank's growth experience, plans and prospects; and
- the strength of management.

Other considerations include peer group comparisons, earnings retention, and access to capital markets or other capital sources. Thus, the adequacy of a bank's capital is rated according to its ability to withstand the risks the bank has assumed, as well as any possible risks that might occur in the future.

In December 1981, the Comptroller of the Currency and the Federal Reserve Board issued some general guide-lines on minimum capital ratios. These guide-lines divided banks and bank holding companies into three categories: multi-national organisations, regional organisations (all other institutions with assets in excess of $1 billion), and community organisations (less than $1 billion).

No specific capital guide-lines were set for multi-national organisations and bank supervisors reviewed their capital holdings on an individual basis. For regional organisations, the ratio of primary capital to total assets had to be at least 5 percent, and for community organisations, the minimum ratio was 6 percent.

As a result of various financial crisis in the early 1980s, the 17 multi-national banks were also brought under the capital guide-lines in June 1983. With strains in the US financial sector increasing, the primary capital ratios of banks were further increased from 5 to 5½ percent in April 1985.

The imposition of capital guide-lines on banks and the greater awareness of cross-border sovereign risks as a result of the LDC debt problems caused a dramatic shift in traditional offshore loans business to fee-based activities.

The major changes seen are:

- International loan syndication business dropped off dramatically. This was also seen to some extent in Singapore.

- The decline in loan syndications was, however, substantially replaced by an increase in "securitisation" business. Investment banks raised funds for the major borrowers by bringing them directly to the investors through Note Issuance Facilities (NIF), Revolving Underwriting Facilities (RUF) and Floating Rate Notes (FRN). On the domestic corporate front in Singapore, fixed rate corporate bonds, and equity-linked bonds were also introduced into the market.

- The asset sales and loan participations seen internationally, hardly affected the Singapore market.

- Significant developments were also seen in the Treasury business where interest rate gapping became a significant revenue earner. With a reduction in loans and bank placement activities as a result of the capital guide-lines, gapping and trading money market activities were substantially extended into Forward Rate Agreements (FRA), Eurodollar and US Treasury bond futures activities. FRA volumes increased in Singapore, Eurodollar futures activities have seen very substantial growth in SIMEX, and US Treasury bond futures activities have gradually increased.

- Treasury gapping and trading of interest rate movements were also expanded into shorter-term (generally less than one year) interbank interest rate swaps. While longer-term interest rate swaps were generally tied in with securities activities, the shorter-term interest rate swap activities were very actively undertaken by the money market desks of the commercial banks.

The explosive growth in the off-balance sheet activities of financial institutions worldwide, especially in interest rate swaps and forward foreign exchange contracts, has led US regulators, jointly with the Bank of England, to propose new capital guide-lines that incorporate off-balance sheet credit exposures. The risk-based capital guide-lines propose that:

- activities that are traditionally off-balance sheet, such as loan commitments, stand-by letters of credit, and foreign exchange and interest rate contracts, be included in risk assets when determining capital to asset ratios; and

- assets be weighted differently depending on risk characteristics.

This joint US-UK proposal, when implemented after consultation with the private sector, is expected to be considered by the major European countries as well. The immediate impact will be to put some restraint on the growth of interest rate swaps and FRAs, as the pricing and trading of these deals will have to take into consideration the capital required to back the activities.

The proposal will also encourage automated netting arrangements of foreign exchange and interest rate contracts between counterparties. Automated foreign exchange netting arrangements have just been implemented in London and are scheduled in New York later in the year.

By the New Products & International Development Sub-Committee