Foreign Bank Capital and the United States Federal Reserve Board

In several recent decisions involving foreign banking organizations, the Board of Governors of the U.S. Federal Reserve System (the "Board" or "Federal Reserve Board") has expressed concern about capital levels. More specifically, the Board has worried that some foreign banking organizations possess lower capital-to-assets ratios than do their U.S. counterparts. A typical Board statement has been as follows: "In evaluating this application, the Board noted that the primary capital ratio of Applicant, as publicly reported, is well below the capital guidelines for U.S. multinational bank holding companies."¹

This article examines the foreign bank capital problem perceived by the Board. In Part I, the pertinent Board pronouncements and decisions on foreign banking organizations are reviewed. The concerns of the Board, and of the other U.S. banking regulators, about capital levels in general are covered in Part II. In Part III, the international environment is briefly discussed. Finally, in Part IV, some general thoughts on the role of capital in bank supervision and regulation are presented. The article concludes with a recommendation that the Board continue its case-by-case handling of the issue of the capital levels of foreign banking organizations.²

² A certain hubris, or at least a particular viewpoint, is involved in referring to non-U.S. banking organizations as "foreign banking organizations." Nevertheless, several factors support the use of the term. One is that from the standpoint of the major protagonist of this work, the Board of Governors of the U.S. Federal Reserve System, non-U.S. banking organizations are "foreign." Another is that the author of the paper is a U.S. citizen and consequently also views non-U.S. banking organizations as "foreign." But perhaps most important, "foreign" is a much less stilted term than is "non-U.S.," and given the number of times either one or the other term would have to appear in any discussion of the capital of banking organizations that are not predominantly located in the United States, stiltedness becomes a consideration.
I. The Federal Reserve Board's Pronouncements

A. BACKGROUND

The Federal Reserve Board is one of three federal banking regulators in the United States. The other two are the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). The Federal Reserve Board is the primary regulator of bank holding companies, which are organizations that own or control banks, and of state-chartered banks that are members of the Federal Reserve System. The OCC is the primary regulator of national banks, and the FDIC is the primary regulator of federally insured state-chartered banks that are not members of the Federal Reserve System.

Foreign banking organizations with, or contemplating, operations in the United States come into contact with the Federal Reserve Board under several statutory provisions. Such an organization seeking to acquire a U.S. bank or bank holding company must apply to the Board under section 3(a)(1) of the Bank Holding Company Act in order to become a bank holding company as defined in that act. A foreign banking organization that is already a U.S. bank holding company by virtue of its ownership or control of a U.S. bank or bank holding company must apply to the Board under sections 3(a)(3) or (5) of the act if it wishes to acquire another U.S. bank or bank holding company, and such a foreign banking organization must apply to the Board under section 4(c)(8) of the act if it wishes to engage in a section 4(c)(8) activity in the United States. Such activities are nonbanking activities that the Board has determined to be closely related to banking. Closely related activities are permissible for

3. 12 U.S.C. § 1841(a) (1982). As of December 31, 1984, there were 5,522 bank holding companies in the United States, with a total of 8,657 bank subsidiaries.

4. As of December 31, 1984, there were: 4,904 national banks, with total assets of $1.498 billion; 1,056 state-chartered member banks, with total assets of $460 billion; and 8,534 state-chartered federally insured nonmember banks, with total assets of $555 billion. The number of U.S. banks not subject to a federal regulator totalled only ten, according to one estimate by the FDIC.


6. 12 U.S.C. § 1842(a)(3) and (5) (1982). Section 3(a)(3) concerns the acquisition of a bank by a bank holding company. Section 3(a)(5) concerns the acquisition of a bank holding company by another bank holding company, or a merger between bank holding companies.


8. Section 4(c)(8) is the principal, but by no means the only, statutory provision under which bank holding companies, whether U.S. or foreign-based, can conduct so-called nonbanking activities. Section 4 of the Bank Holding Company Act contains a number of other nonbanking provisions. See 12 U.S.C. § 4 (1982). In addition, there are two statutory provisions that permit foreign banking organizations falling under the jurisdiction of the Bank
U.S. bank holding companies to engage in, provided a particular holding company's conduct of a particular activity will result in net benefits to the public.\textsuperscript{9}

A foreign bank that is not a U.S. bank holding company but that maintains a branch or agency in the United States must also seek the Board's approval under section 4(c)(8) of the Bank Holding Company Act to engage in section 4(c)(8) activities in the United States. The reason is that section 8 of the International Banking Act of 1978 imposes the nonbanking restrictions of the Bank Holding Company Act on foreign banks with branches or agencies in the United States.\textsuperscript{10}

Finally, foreign banking organizations, either with or without U.S. banking operations, that wish to establish Edge Act corporations must seek Federal Reserve Board approval.\textsuperscript{11} Edge Act corporations are entities established under the act by that name to engage in international banking and related activities.\textsuperscript{12} Foreign banking organizations with, or contemplating, establishing or acquiring Edge Act corporations will usually also be subject to the Bank Holding Company Act by virtue of their ownership or control of U.S. banks or bank holding companies.

For applications under sections 3(a)(1), (3), or (5) of the Bank Holding Company Act, the Board must, among other factors, consider "the financial and managerial resources and future prospects of the company or companies and the banks concerned."\textsuperscript{13} To engage in a permissible closely related nonbanking activity under section 4(c)(8) of the Bank Holding Company Act, a banking organization must pass a net public benefits test. This test is stated in the following manner: \textsuperscript{14}

In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or...
gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

Financial factors would appear to be subsumed within the unsound banking practices category.

The Edge Act is much less specific than are the preceding statutory provisions on the matter of standards for approval of applications. The purposes of the act are to provide for federally-chartered and supervised entities engaging in international banking and financial activities. The Board is required to issue rules and regulations in furtherance of the statute’s purposes and to review and revise such regulations at least once every five years “in order to ensure that such purposes are being served in light of prevailing economic conditions and banking practices.”

B. 1979 Statement

In early 1979, the Federal Reserve Board issued a policy statement entitled, “Statement of Policy on Supervision and Regulation of Foreign Bank Holding Companies.” The statement, issued on February 23, 1979, is still outstanding. It was the result of a review of the Board’s supervisory and regulatory policies concerning foreign bank holding companies. The Board cited as major elements underlying the review (1) the growth in the number and total assets of U.S. banks owned by foreign organizations and (2) the experience the Board had gained in regulating foreign bank holding companies since the 1970 amendments to the Bank Holding Company Act.

The Board also noted that as the review was being conducted, Congress passed the International Banking Act of 1978. This act expanded the Board’s responsibilities concerning the operations of foreign banks in the United States. The act also established certain legislative policies—the primary one being the policy of national treatment—concerning the U.S. operations of foreign banking organizations. Under the national treatment policy, the United States committed to treat foreign banking organizations with or desiring operations in the United States in the same manner as it treats U.S. banking organizations. An antithesis of national treatment is reciprocity. Under a reciprocity policy toward foreign banking organizations, a country would treat the banking organizations from a particular nation in the same manner as that nation treats the first country’s own banking organizations.

Capital levels or ratios were not a particular focus of the 1979 statement. The Board's concerns were broad and not expressed quantitatively: "the Board believes that in general foreign banks seeking to establish banks or other banking operations in the United States should meet the same general standards of strength, experience and reputation as required for domestic organizers of banks and bank holding companies."  

On the other hand, the Board noted the different banking practices and traditions in other countries and the different legal and social environments in which foreign banking organizations operate. The Board also noted the limits of its concerns. Its supervisory responsibilities were for the safety and soundness of U.S. banking operations. Interest in the operations and activities of foreign banking organizations outside the United States were "limited to their possible effects on the ability of those banks to support their operations inside the United States." Whenever a foreign banking organization sought to acquire a U.S. banking organization, the Board stated that it would "seek to assure itself of the foreign bank's ability to be a source of financial and managerial strength and support to the U.S. subsidiary bank." In making this determination, the Board would "analyze the financial condition of the foreign organization, evaluate the record and integrity of management, assess the role and standing of the bank in its home country, and request the views of the bank regulatory authorities in the home country."  

Capital was mentioned, but not in isolation and only in the context of information that would be required of the foreign applicant. The Board stated that reports would be required to provide sufficient information to permit an assessment of the foreign organization's financial strength and operating performance. The reports would be "prepared in accordance with local practices together with an explanation and reconciliation of major differences between local accounting standards and U.S. generally accepted accounting procedures including full information on earnings, capital, charge-offs, and reserves."  

C. Board Decisions in 1983

The Board has issued a number of decisions involving foreign banking organizations in the years since the promulgation of the 1979 policy statement. It was not until 1983, however, that capital began to surface in the decisions as a major preoccupation.
1. The Long-Term Credit Bank of Japan, 1983

An indication of growing interest in capital on the part of the Board was provided by an August 23, 1983, decision. The applicant was The Long-Term Credit Bank of Japan, Limited, Tokyo, Japan. It applied under section 4(c)(8) of the Bank Holding Company Act to acquire a de novo limited-purpose trust company, LTCB Trust Company, New York, New York. The Long-Term Credit Bank had assets of approximately $50.7 billion, making it the seventh largest private bank in Japan and the thirty-fifth largest bank in the world. Its principal business was the extension of long-term credit in the form of secured loans, discounts, and guarantees. Under a 1982 revision in the Japanese Banking Law, it could also underwrite and sell central and local government bonds and government-guaranteed bonds.

Because it had a branch in New York and an agency in Los Angeles, The Long-Term Credit Bank was subject in the United States to the nonbanking restrictions of section 4 of the Bank Holding Company Act. Consequently, it had to apply to the Board to engage in the trust and fiduciary business, a business the Board has found permissible for bank holding companies under section 4(c)(8) of that act.

In its decision, the Board noted that The Long-Term Credit Bank’s capitalization was below that of comparable U.S. banking organizations. There were mitigating circumstances, however:

Although Applicant’s capitalization is below the standards for comparably sized banking organizations in the United States, there appear to be substantial differences between Applicant’s business and that conducted by large U.S. banks, particularly with respect to its asset and liability status, that mitigate the Board’s concerns in this regard.

In particular, the Board noted that the Japanese organization’s investment in the New York trust company represented only 0.27 percent of the former’s equity capital and reserves and less than 0.01 percent of its total assets. In addition, the trust company would be providing fiduciary rather than banking services. The Board apparently viewed fiduciary activities as being less risky than banking activities.

2. Fuji Bank, 1983

The Board’s concern about the capital adequacy of foreign banking organizations came to the fore in late 1983. In December of that year, the
Board issued three decisions involving foreign banking organizations in which it gave prominent play to capital matters.

The first decision, issued on December 20, 1983, involved an application by Fuji Bank, Limited, Tokyo, Japan, to acquire most of the nonbanking operations of Walter E. Heller International Corporation.28 Fuji’s application was under section 4(c)(8) of the Bank Holding Company Act. Fuji was a U.S. bank holding company by virtue of its ownership of the Fuji Bank and Trust Company, New York. It also had a branch in Chicago, agencies in New York and Los Angeles, representative offices in Atlanta, Houston, Seattle, and San Francisco, and an Edge Act corporation in San Francisco. Fuji had assets of $99.8 billion and was ranked as the thirteenth largest commercial banking organization in the world. It was the second largest commercial banking organization in Japan.

Walter E. Heller International Corporation was a U.S. bank holding company by virtue of its ownership of American National Bank, Chicago. Fuji desired to acquire a subsidiary of Walter E. Heller International Corporation, Walter E. Heller and Company. As a result of the transaction, Fuji would engage in the following nonbank activities: commercial financing and servicing; real estate financing and servicing; leasing; real estate appraisal and investment advisory services; the provision of credit-related insurance; and arranging equity financing for certain types of income-producing properties.

In its decision, the Board noted that Fuji’s primary capital ratio as publicly reported was "well below the Board’s capital guidelines for U.S. multinational bank holding companies."29 At that time, the guideline for the ratio of primary capital to assets for U.S. multinational bank holding companies was five percent.30 Nevertheless, the Board stated that after reviewing all the facts of record it had determined that the financial factors relating to the application were consistent with approval. The following caveat was given, however:31

In making this determination, the Board notes that the application raises the general question of whether the capital standards applicable to domestic bank holding companies should also be applied to foreign banking organizations making acquisitions in the United States, including the acquisition of nonbanking companies. This question presents a number of complex issues which the Board believes require careful consideration and which the Board has under review.

Concerning the determination that the financial factors relating to the application were consistent with approval, the Board stated that it took into account the nonbanking nature of Fuji’s acquisition.


On December 21, 1983, the Board approved two applications by Korean banking organizations to establish de novo banks in the United States. The applicant in one of the decisions was Korea First Bank, of Seoul.32 Korea First was the fourth largest commercial banking institution in Korea. It had a branch in Chicago and agencies in New York and Los Angeles. The new institution that Korea First Bank wished to establish would be located in New York City and would provide a full range of commercial banking services. Korea First's application was under section 3(a)(1) of the Bank Holding Company Act, the section requiring an application by an organization seeking to become a bank holding company.

In its decision, the Board described Korea First Bank's primary capital ratio as being below the minimum capital guidelines for U.S. multinational bank holding companies. The Board found offsetting considerations, however. The new bank would be small in relation to the parent organization and would be strongly capitalized. Moreover, the Board stated that it expected the new bank to be maintained "among the more strongly capitalized banking organizations of comparable size in the United States."33 The Board noted that it was studying the general question of whether foreign banking organizations with U.S. banking operations should be subject to the capital standards applicable to domestic bank holding companies.

The other Korean institution concerning which the Board issued a decision on December 21, 1983, was The Commercial Bank of Korea, Ltd., also of Seoul.34 The application was under section 3(a)(1) of the Bank Holding Company Act. The Commercial Bank desired to become a bank holding company by acquiring a de novo bank, Korea Commercial Bank of New York. The Commercial Bank was the second largest bank engaged in the general banking business in Korea. In the United States, it had agencies in New York and Los Angeles and a limited purpose non-insured branch office in Chicago. The new institution would offer a full range of commercial banking services in the New York banking market.

The Board's decision was very similar to its decision on Korea First Bank. The Board noted that the primary capital ratio of The Commercial Bank of Korea was below the minimum capital guidelines for U.S. multinational bank holding companies. But the regulator found offsetting considerations. The new bank would be small in relation to the parent organization. It would be strongly capitalized initially. And it would be

maintained in a comparatively strong capitalized position after it began operations.

As in the *Korea First Bank* decision, the Board noted that it was considering the general question of whether the capital standards applicable to domestic bank holding companies should be applied to foreign banking organizations with U.S. banking operations.

D. THE 1984 MEMORANDUM

The next Board document on the capital adequacy of foreign banking organizations with U.S. banking operations was a memorandum by the Board’s staff dated February 1, 1984 (the 1984 Memorandum). The memorandum, entitled “Relevance of domestic capital adequacy considerations to foreign banks seeking to make acquisitions in the United States,” was the subject of a rather inconclusive discussion at a February 2, 1984, meeting of the Board of Governors.

According to the 1984 Memorandum, the question of the capital adequacy of foreign banking organizations was being raised in two contexts. First, in section 908(b) of the recently passed International Lending Supervision Act of 1983, the Chairman of the Federal Reserve Board and the Secretary of the Treasury were directed to work with other countries to strengthen the capital bases of international banks. The precise language was as follows:

The Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury shall encourage governments, central banks, and regulatory authorities of other major banking countries to work toward maintaining and, where appropriate, strengthening the capital bases of banking institutions involved in international lending.

The International Lending Supervision Act was in large measure a response to the international debt crisis that surfaced in August of 1982 when Mexico made known its debt servicing problems. Parenthetically, and as will be noted in Section II of this paper, the International Lending Supervision Act has provided a major impetus for the recent interest of the three federal banking agencies in capital. Section 908(a) of the act directs the federal banking agencies to “cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of

35. Memorandum, Relevance of domestic capital adequacy considerations to foreign banks seeking to make acquisitions in the United States, From the Division of Banking Supervision and Regulation To the Board of Governors, Feb. 1, 1984 [hereinafter cited as 1984 Memorandum].


capital for such banking institutions and by using such other methods as the appropriate Federal banking agency deems appropriate."

The second context, according to the 1984 Memorandum, within which the question of the capital adequacy of foreign banking organizations was arising concerned acquisitions in the United States by such institutions. In particular, questions were developing about the extent to which U.S. numerical capital standards should be applied to foreign institutions making U.S. acquisitions.

These questions in turn arose because in mid-1983 the Board and the OCC issued guidelines concerning the minimum capital standards for the largest U.S. banking organizations, termed multinational banking organizations. These guidelines called for, among other things, the maintenance of a minimum primary capital to assets ratio of 5 percent for U.S. multinational banking organizations. Safety and soundness reasons, and competitive equity reasons, caused the Board to ponder about applying similar standards to foreign banking organizations seeking to make U.S. acquisitions.

The Board’s staff mentioned the conflicting considerations. The guidelines of the Board and the OCC were adopted in the context of the particular U.S. environment. Elements of this environment include U.S. accounting principles and the risk factors, banking laws, and banking regulations peculiar to the United States. These environmental factors might not be similar in other countries. In addition, foreign banking organizations and foreign governments might view the application of U.S. domestic capital adequacy guidelines to foreign banks as "an inappropriate application of U.S. bank supervisory standards.""}

A major consideration on the other side was the U.S. supervisory interest in the condition of a foreign owner of a U.S. banking organization. "The foreign bank parent would be looked to as the ultimate source of strength in the event that its U.S. banking operations required support." It should be noted that this attitude could be considered somewhat of an alteration from the Board's 1979 policy statement. There, the Board stated that its supervisory concerns about the operations and activities of foreign banks outside the United States were "limited to their possible effects on the ability of those banks to support their operations inside the United States." In the 1984 Memorandum, the Board’s staff might have been implying that it is difficult, if not impossible, to make supervisory concerns following national boundaries. That is, implementing a U.S. supervisory

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39. 1984 Memorandum, supra note 35.
40. Id.
41. 1 FED. RES. REG. SER. ¶ 4-835 (1979).
interest in the operations and activities of foreign banking organizations, while trying to limit the implementation to only those operations and activities affecting the ability of such organizations to support their U.S. banking operations, might be too much of a task.

Supporting the argument that there might be a difference in attitude between the 1979 policy statement and the 1984 Memorandum is the following language from the latter document: "the problems suffered by the parent could well have an effect on the safety and soundness of the U.S. operations." The term "problems" would seem to encompass any problems, whether U.S. related or non-U.S. related, affecting the ability of a foreign banking organization to support its U.S. operations.

The 1984 Memorandum presented the Board with three possible approaches: (1) the Board could continue to analyze potential foreign bank acquirers or establishers of U.S. operations on a case-by-case basis, using the 1979 policy statement; (2) the Board could request comment on the extent to which domestic minimum quantitative capital standards should be applied to foreign banking organizations seeking to make acquisitions in the United States; or (3) the Board could institute consultations with foreign bank supervisors on capital standards for international banking organizations. The discussion at the meeting at which the Board considered the memorandum was inconclusive. In effect, however, the Board seems to have opted for all three alternatives. It has continued to judge applications by foreign banking organizations on a case-by-case basis. It sought, in conjunction with an application by The Mitsubishi Bank to acquire BanCal Tri-State Corporation, comments on the general issue of the capital adequacy of foreign banking organizations with U.S. banking operations. And it has indicated that it is pursuing the issue of capital adequacy with bank supervisory authorities in other countries. The request for comments in conjunction with the Mitsubishi application was actually issued prior to the submission of the 1984 Memorandum to the Board.

E. Board Decisions in 1984

1. The Mitsubishi Bank, 1984

On May 14, 1984, the Board approved, in a four to two decision, the acquisition of BanCal Tri-State Corporation, San Francisco, by The Mitsubishi Bank, Limited, Tokyo, Japan. BanCal was the parent holding company of The Bank of California, National Association. The Mitsubishi

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42. 1984 Memorandum, supra note 35.
43. The Mitsubishi Bank, Limited, 70 FED. RES. BULL. 518 (June 1984).
Bank had total assets of $97.1 billion and was the third largest commercial banking organization in Japan. Worldwide, it ranked number twelve. In the United States, it operated branches in New York and Chicago, and an agency in Los Angeles. It also owned the twenty-first largest commercial banking organization in California, The Mitsubishi Bank of California.

BanCal Tri-State, with total assets of $3.8 billion, was the eighth largest banking organization in California. It was one of only two national banks with branches in more than one state. In addition to sixteen branches in California, it had three branches in Washington and one in Oregon. These branches were established prior to February 25, 1927, and were thus grandfathered under the McFadden Act.44

The application was considered by the Board primarily under section 3(a)(3) of the Bank Holding Company Act. Since The Mitsubishi Bank already had a U.S. bank subsidiary, it was a U.S. bank holding company. Its application was to acquire an additional U.S. banking organization. The Edge Act also played a part in the Board's review because the BanCal organization included an Edge Act corporation.

The transaction raised several issues, but the predominant one in the Board's view, and the one that gave rise to the two dissenting votes, concerned capital. The majority's decision began the consideration of the capital issue in a general manner. The principles of national treatment and competitive equity were cited as requiring that foreign banks seeking to establish or acquire U.S. banking operations meet the same general standards expected of U.S. banking organizations. Offsetting considerations mentioned by the majority were different regulatory and supervisory requirements, accounting principles, asset quality standards, and banking practices and traditions. All of these elements produce a different environment for foreign banking organizations and make comparisons "of the capital positions of foreign and domestic banks" difficult.45 The Board then stated:46

The appropriate balancing of these concerns raises a number of complex issues that the Board believes require careful consideration and that the Board has currently under review. In this regard, the Board has initiated consultations with appropriate foreign bank supervisors and notes that work is currently in progress among foreign and domestic bank supervisory officials to develop more fully the concept of functional equivalency of capital ratios for banks of different countries. Pending the outcome of these consultations and deliberations, the Board has determined to consider the issues raised by applications by foreign banks to acquire domestic banks on a case-by-case basis.

46. Id.
After going through these preliminaries, the Board was ready for the specifics of the Mitsubishi situation. The publicly reported primary capital ratio of The Mitsubishi Bank was characterized as "well below the Board's capital guidelines for U.S. multinational bank holding companies." This was a negative factor, but the Board found several mitigating factors. One set of these factors was the satisfaction with The Mitsubishi Bank indicated by Japanese supervisory authorities. The Board stated that the bank was in compliance with the capital and other financial requirements of those authorities. In addition, those authorities viewed the bank's resources and prospects as satisfactory. Other factors listed by the Board were: a satisfactory record of operation by The Mitsubishi Bank in its local markets; a history of relatively low loan losses; a comparatively stable and substantial deposit base; a strong liquidity position; and a substantial portfolio of securities of publicly held Japanese companies. Regarding the latter factor, the Board stated that the securities were carried on The Mitsubishi Bank's books at cost, which was substantially below their market value.

A final set of factors cited by the Board consisted of commitments made by The Mitsubishi Bank. In general, The Mitsubishi Bank committed to maintain The Bank of California as a "strong and particularly well capitalized banking organization." This general commitment encompassed another commitment by The Mitsubishi Bank to increase the capital ratio of The Bank of California to such a level that the latter would be among the more strongly capitalized banks of comparable size in the country. This level was much above the Board's minimum capital standard. The Mitsubishi Bank also committed to maintain this capital level once it was reached.

The dissenting votes on the transaction were cast by Board Vice Chairman Preston Martin and Governor Emmett Rice. They said that foreign banking organizations with low capital positions "may have an unfair competitive advantage in the United States over comparably sized domestic banking organizations that are required to maintain a higher capital level." The lower capital requirements of the foreign institutions gave them a "clear advantage in many aspects of their competition with domestic banking organizations, including pricing of services and bidding for domestic bank acquisitions."

Governors Martin and Rice concluded that the principles of competitive equality and national treatment called for applying the same standards to

47. Id.
48. Id.
50. Id.
both U.S. and foreign banking organizations seeking to make acquisitions within the Board's jurisdiction. One such standard should be the Board's capital adequacy guidelines. Since a "domestic banking organization with a capital and financial position comparable to Applicant's would not be permitted to make this acquisition," Governors Martin and Rice would have denied the application.

2. Bank of Montreal, 1984

In what it termed a "difficult decision," the Board in July of 1984 approved the applications of the Bank of Montreal, Montreal, Canada, to acquire Harris Bankcorp, Inc., Chicago, Illinois. The Board's approval was announced on July 25, 1984, and a statement explaining the approval was released on July 27, 1984. The difficulty perceived by the Board concerned capital.

The Bank of Montreal had total assets of approximately $50.8 billion. It was the third largest bank in Canada and the thirty-fourth largest commercial banking organization in the world. In the United States it had bank subsidiaries in New York and California, a branch in New York, and an agency in San Francisco.

The primary statutory provision governing the transaction was either section 3(a)(3) or section 3(a)(5)—the Board did not specify which—of the Bank Holding Company Act. Since it had U.S. bank subsidiaries, Bank of Montreal was already a U.S. bank holding company. Section 4(c)(8) of the Bank Holding Company Act and the Edge Act also were involved because Harris Bankcorp had direct or indirect subsidiaries organized under these provisions.

In order to comply with the home state requirements of the International Banking Act and the Board's Regulation K, Bank of Montreal would convert its bank subsidiaries in New York and California to nondeposit trust companies. In addition, the bank's New York branch, which was not grandfathered under section 5(b) of the International Banking Act, would conform its deposit-taking operations to those permissible for corporations organized under section 25(a) of the Federal Reserve Act, section 25(a) being the Edge Act. The Board concluded that these changes would remove any impediments to the acquisition posed by section 5(a) of the International Banking Act and section 3(d) of the Bank Holding Company Act.

51. Id.
55. Section 3(d) of the Bank Holding Company Act is the Douglas Amendment, which restricts the interstate banking activities of bank holding companies (12 U.S.C. § 1842(d)).
Harris Bankcorp had assets of approximately $7.8 billion. It was the third largest commercial banking organization in Illinois. Its major subsidiary was Harris Trust and Savings Bank.

In its decision, the Board discussed the general issue of the capital adequacy of foreign banking organizations in language similar to that used in The Mitsubishi Bank decision. On the specifics of the Bank of Montreal application, the Board stated that the primary capital of the institution after consummation of the proposal would be near the minimum capital level set forth for U.S. multinational bank holding companies. In performing the calculation, the Board had made certain accounting adjustments to conform to United States banking practice. An adjustment for Bank of Montreal’s specific provision for loan losses was explicitly mentioned.

The transaction would result in Bank of Montreal’s U.S. banking operations amounting to approximately 20 percent of its consolidated worldwide assets. The Board stated:

The Board believes that when a foreign bank’s U.S. operations become so significant in relation to the totality of its activities, its capital and reserves represent an especially important measure of its ability to serve as a source of financial strength to its U.S. operations.

The Board concluded that the capital position of the Bank of Montreal was a negative factor.

Nevertheless, the Board found mitigating circumstances. As in the case of The Mitsubishi Bank and Japanese supervisory authorities, the Bank of Montreal was in compliance with the requirements of the Canadian supervisory authorities, including the capital requirements of those authorities. The Canadian authorities also viewed the bank’s resources and prospects as satisfactory.

The Board noted the Bank of Montreal’s large and relatively stable deposit base, and its satisfactory record of operations in local and international markets. The bank had initiated a capital program to raise its capital ratios, and had recently raised new capital amounting to approximately 600 million Canadian dollars.

Bank of Montreal made commitments similar to those made by The Mitsubishi Bank regarding BanCal Tri-State. The capital ratio of Harris Bankcorp would be raised to a level significantly above the Board’s minimum capital standards. The level would be such that Harris Bankcorp would be among the more strongly capitalized banks of comparable size. And Bank of Montreal committed to maintain this level of capital once it had been reached. Still, the case was a close one for the Board:

57. Id.
Even with the benefit of adjustments for differing financial and legal requirements and methodology between United States and Canadian banking organizations, this case presents a difficult decision for the Board, particularly because of the size of Harris Bankcorp and the relative prominence of Applicants' U.S. operations. On balance, however, after reviewing the record as it relates to the overall financial condition of Applicants and their U.S. banking operations, Applicants' commitments regarding the operation of Harris Bankcorp, the affirmations by Canadian supervisory authorities, as well as other facts of record, the Board believes that Applicants' financial condition is consistent with approval of this application.

Governor J. Charles Partee dissented from the decision. One of his grounds for dissent, although seemingly not the most important ground, was Bank of Montreal's capital position. Governor Partee specifically mentioned the fact that Bank of Montreal's capital level approximated only the minimum level set forth in the Board's guidelines.

3. *The Sanwa Bank, 1984*

On December 18, 1984, the Board approved the application of The Sanwa Bank Limited, Osaka, Japan, to acquire certain leasing and commercial financing subsidiaries of Continental Illinois Corporation.\(^{58}\) The Sanwa Bank had consolidated assets of approximately $106 billion. It was the fifth largest commercial banking institution in Japan, and the ninth largest in the world. The Sanwa Bank was a U.S. bank holding company as a result of its ownership of Golden State Sanwa Bank, San Francisco, California. The Sanwa Bank also had branches in New York and Chicago, an agency in San Francisco, and a representative office in Houston.

The application was under section 4(c)(8) of the Bank Holding Company Act. The leasing and commercial financing activities of the Continental Illinois Corporation subsidiaries were among those activities considered by the Board to be closely related to banking and therefore permissible for bank holding companies to engage in.

In the decision, the Board reiterated its concern with the general question of whether foreign banking organizations should be judged by the same capital standards as used to judge U.S. banking organizations. The Board also repeated its position that the issues involved were complex. And the ongoing consultations with foreign bank supervisors about the capital question were mentioned.

As for the specifics of the case, the Board stated that the publicly reported primary capital ratio of The Sanwa Bank was "well below the capital guidelines for U.S. multinational bank holding companies."\(^{59}\) As in *The Mitsubishi Bank* and *Bank of Montreal* decisions, however, the

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\(^{58}\) The Sanwa Bank Limited, 71 FED. RES. BULL. 117 (Feb. 1985).

\(^{59}\) 71 FED. RES. BULL. 118 (Jan. 1985).
Board found mitigating circumstances. The Sanwa Bank was in compliance with the capital and other financial requirements of the Japanese supervisory authorities. It had a satisfactory record of operation in its local market. It had a strong liquidity position. And it had a substantial portfolio of securities of publicly held Japanese companies. These securities were carried at book value, which was substantially below their current market value. The Board concluded that the financial factors concerning the application were consistent with approval.

Governor Emmett Rice dissented, citing his dissent in The Mitsubishi Bank decision. In his view, the principles of competitive equality and national treatment required that foreign banking organizations applying to acquire U.S. companies be judged against the same standards, including the capital adequacy guidelines, as used to judge U.S. banking organizations.

F. 1985 Capital Adequacy Guidelines

On March 1, 1985, the Board tentatively adopted revised capital adequacy guidelines. The final version of the guidelines was published in the Federal Register of April 24, 1985.60 One issue not dealt with in the guidelines is the treatment of foreign banking organizations. In supplementary material released with the guidelines, the Board noted that it was "discussing with foreign bank supervisors appropriate capital standards for banks operating internationally."61 Pending completion of those discussions, the Board stated that it would continue to review on a case-by-case basis the financial condition, including the capital adequacy, of foreign banking organizations with U.S. operations. Particular scrutiny is to be given to the capital of foreign banking organizations presenting the Board with expansion proposals.

G. Board Decisions in 1985

1. The Long-Term Credit Bank of Japan, 1985

On March 25, 1985, the Board approved an application by The Long-Term Credit Bank of Japan, Limited, Tokyo, Japan, to become a bank holding company by expanding the activities of the limited-purpose trust company for which it received approval in 1983.62 The 1983 action, discussed earlier in this section, did not make The Long-Term Credit Bank


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a U.S. bank holding company as the organization did not acquire a U.S. bank. Thus, to convert the trust company to a bank, The Long-Term Credit Bank had to make application under section 3(a)(1) of the Bank Holding Company Act.

Capital concerns were mentioned by the Board in its rather brief decision, but not in great detail. The Board noted that the primary capital ratio of The Long-Term Credit Bank was below the minimum capital guidelines established for U.S. multinational bank holding companies. The only mitigating circumstance mentioned was that the bank will initially be small in relation to The Long-Term Credit Bank, and will be strongly capitalized. The Board also noted The Long-Term Credit Bank's commitment to maintain the new bank among the more strongly capitalized banking organizations of comparable size in the United States.

2. Creditanstalt-Bankverein, 1985

The Board approved the application of Creditanstalt-Bankverein of Vienna, Austria, to acquire a U.S. investment advisory firm on November 7, 1985. The firm was McKenzie-Walker Investment Management, Inc., Larkspur, California. The application was under section 4(c)(8) of the Bank Holding Company Act. McKenzie-Walker was an investment advisor registered with the Securities and Exchange Commission. It provided portfolio investment advice to individuals, corporations, governments, and other institutions throughout the United States on both a discretionary and a non-discretionary basis. Its activities were permissible for U.S. bank holding companies.

Creditanstalt-Bankverein was the largest commercial bank in Austria, with consolidated assets equivalent to approximately $17.8 billion as of the end of 1984. It was subject to section 4(c)(8) of the Bank Holding Company Act because it had a branch in New York City.

Regarding the capital aspects of the transaction, the Board noted that the Austrian bank's primary capital ratio as publicly reported was "well below the Board's capital guidelines for U.S. multinational bank holding companies." Nevertheless, the Board found mitigating circumstances. Specifically mentioned were the overall financial condition of the Bank and its U.S. operations. Further, the Board noted that certain accounting adjustments had been made, apparently with favorable results, to reflect U.S. banking practices. Finally, the Board mentioned the service nature of the nonbanking organization being acquired and the relatively small size of Creditanstalt-Bankverein's investment.

64. Id.
3. Industrial Bank of Japan, 1985

On November 29, 1985, the Board approved an application of The Industrial Bank of Japan, Ltd., Tokyo, Japan, to acquire up to 75.1 percent of the voting shares of J. Henry Schroder Bank & Trust Company, New York, New York. IBJ was a U.S. bank holding company as a result of its ownership of the Industrial Bank of Japan Trust Company in New York. Thus the application was under section 3(a)(3) of the Bank Holding Company Act.

IBJ was the largest of three-long term credit banks in Japan, and the fifteenth largest banking organization in the world. It had assets equivalent to approximately $85.7 billion. In addition to the New York trust company, it had a branch in New York and an agency in Los Angeles.

J. Henry Schroder Bank & Trust Company was the twenty-fourth largest commercial bank in New York State and had total assets of approximately $1.9 billion. Initially, IBJ was seeking to acquire 51 percent of J. Henry Schroder Bank & Trust from its parent holding company, Schroders plc, London, England. An additional 24 percent would be acquired within 18 months. As part of the transaction, IBJ was acquiring two other organizations. One was J. Henry Schroder Banking Corporation, an investment company chartered under Article XII of the New York Banking Law. This acquisition was under section 4(c)(8) of the Bank Holding Company Act. The other organization being acquired was an Edge Act corporation of J. Henry Schroder Bank & Trust. This acquisition was under the Edge Act, section 25(a) of the Federal Reserve Act.

Regarding the capital aspects of the transaction, the Board noted that IBJ’s primary capital ratio “as publicly reported is below the minimum capital guidelines established by the Board for U.S. bank holding companies.” As has come to be the norm, however, mitigating circumstances were found. IBJ was in compliance with the capital and other financial requirements of the Japanese supervisory authorities. Historically, it had experienced relatively low loan losses and had maintained a strong liquidity position. It had a substantial and relatively stable funding base of government and corporate deposits and medium- and long-term debentures that, as a long-term credit bank, it was permitted to issue under Japanese law. It had a substantial portfolio of securities of publicly held Japanese companies that it carried at cost, which was substantially below their current market value. Finally, the Board expressed satisfaction with IBJ’s existing U.S. operations and an expectation that IBJ would maintain J. Henry Schroder Bank & Trust among the more strongly capitalized banking organizations of comparable size in the United States.

As for the general problem of the capital positions of certain foreign banking organizations, the Board noted that work was currently in progress among the foreign and domestic bank supervisory officials in various countries to develop "more fully the concept of the functional equivalency of capital ratios." Pending the outcome of these efforts, the Board stated it would continue to judge foreign bank applications on a case-by-case basis.

Vice Chairman Preston Martin and Governor Emmett Rice concurred in the decision but emphasized their concern about foreign banking organizations with publicly reported capital below the Board's capital guidelines. They said that permitting acquisitions by foreign banking organizations with capital lower than U.S. peers would give these foreign organizations an advantage in such areas as the pricing of services and the bidding for domestic bank acquisitions. They concurred in the decision, however, because they apparently concluded that IBJ's capital position, after appropriate adjustments were made for differences between foreign and domestic regulatory and banking practices and requirements, was in line with the capital positions of similar U.S. banking organizations.

Governor Martha Seger dissented. She also expressed concern about foreign banking organizations with publicly reported capital below the levels of U.S. peers. Her main concern, however, seemed to be the issue of reciprocity. U.S. banking organizations are in effect not permitted to acquire sizable Japanese banking organizations. Consequently, Governor Seger apparently did not feel that sizable Japanese banking organizations should be able to acquire U.S. banking organizations.

H. 1986 Risk-based Capital Proposals

The three federal banking agencies—the Federal Reserve Board, the OCC, and the FDIC—issued a joint statement on January 15, 1986, in which they expressed the intention of seeking comments on proposed standards for measuring capital on a risk-adjusted basis. The Federal Reserve Board was first out of the blocks with its proposal, issuing them for comment on the same day. One reason given by the Board for the issuance of the proposal was to bring the U.S. capital adequacy policies more in line with those of other countries. The Board noted that many European countries have developed risk-based capital measures, and that Japanese supervisory authorities were moving in a similar direction.

67. *Id.*


I. Current Status

The Board's approach to the capital positions of foreign banking organizations with U.S. operations thus is still very much open. Consultations with banking supervisors in other countries are in process. A goal of these consultations appears to be the "functional equivalency of capital ratios of different countries." Given the complexity of the issue and the divergent approaches among the various nations, any sort of international agreement would not appear to be on the near horizon. Tying required capital levels to the riskiness of assets as called for in the Board's risk-based capital proposal, however, might produce a greater degree of similarity among the bank capital adequacy standards of the industrialized countries than now exists.

II. Increased Interest in Capital Adequacy

The increased interest on the part of the Federal Reserve Board in the capital positions of foreign banking organizations with U.S. banking operations is not an isolated phenomenon. It is a reflection of the increased interest in capital in general on the part of the three federal banking regulators and the U.S. Congress.

A. 1981

Capital adequacy standards were adopted by the three federal banking regulators—the Federal Reserve Board, the OCC and the FDIC—in 1981. The adoptions were against the background of rising Congressional clamor on the subject. The Federal Reserve Board and the OCC joined together in announcing capital adequacy standards. The FDIC, with its eye toward the large number of relatively small banking organizations in its constituency, went a somewhat different route.

In their guidelines, the Federal Reserve Board and the OCC looked at two ratios of capital. These were (1) primary capital to total assets and (2) total capital to total assets. Primary capital consisted of common stock, perpetual preferred stock, capital surplus, undivided profits, reserves for contingencies and other capital reserves, mandatory convertible instruments, the allowance for possible loan and lease losses, and any minority interest in the equity accounts of consolidated subsidiaries. Total capital included the primary capital components plus limited life preferred stock and qualifying notes and debentures.

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70. The Federal Reserve Board and the Office of the Comptroller of the Currency announced capital adequacy guidelines on December 17, 1981. The Federal Deposit Insurance Corporation's guidelines were effective December 17, 1981.
Institutions affected by the standards were categorized as regional organizations and community organizations. Regional organizations were all institutions with assets in excess of $1 billion, except for the very largest institutions, called multinational organizations. Community organizations were institutions with less than $1 billion in assets.

The Federal Reserve Board made another exception for bank holding companies with assets of under $150 million. For these institutions, the guidelines applied only if:

1. the company did not engage directly or indirectly in any nonbanking activity involving significant leverage; and
2. no significant amount of debt of the parent company or any nonbank subsidiary was held by the general public.

The guidelines established a minimum level of primary to total assets of 5 percent for regional banks and 6 percent for community banks. For total capital to total assets, the guidelines set forth the following zones:

<table>
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<tr>
<th>Region</th>
<th>Primary Ratio</th>
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<tbody>
<tr>
<td>Regional</td>
<td>Above 6.5%</td>
</tr>
<tr>
<td>Zone 1</td>
<td>5.5% to 6.5%</td>
</tr>
<tr>
<td>Zone 2</td>
<td>Below 5.5%</td>
</tr>
<tr>
<td>Community</td>
<td>Above 7.0%</td>
</tr>
<tr>
<td>Zone 1</td>
<td>6.0% to 7.0%</td>
</tr>
<tr>
<td>Zone 3</td>
<td>Below 6.0%</td>
</tr>
</tbody>
</table>

For banking institutions that operated in Zone 1, the regulator presumed that capital was adequate if the primary capital ratio was acceptable and above the minimum level. For institutions in Zone 2, the regulator presumed that an institution was undercapitalized, particularly if the primary and total capital ratios were at or near the minimum guidelines. And for institutions in Zone 3, the regulator strongly presumed that there was undercapitalization.

In contrast to the Federal Reserve Board and the OCC, the FDIC looked at only one capital ratio. This was adjusted equity capital to adjusted total assets. Adjusted equity capital was equity capital minus assets classified “loss” and one half of assets classified “doubtful.” Adjusted total assets were total assets minus assets classified “loss” and one half of assets classified “doubtful.” Equity capital included common stock, perpetual preferred stock, capital surplus, undivided profits, contingency reserves, other capital reserves, mandatory convertible instruments, and reserves for loan losses. Limited life preferred stock and subordinated notes and debentures were not considered in evaluating capital adequacy.

The FDIC established the following adjusted equity capital to adjusted total assets ratios:

- Threshold level—6%
- Minimum acceptable level—5%

The ratios applied to all banks of which the FDIC was the primary regulator, regardless of size. The threshold level triggered a requirement for
the submission by the bank of a comprehensive capital plan acceptable to the FDIC and the state banking department. The minimum acceptable level meant that the FDIC would insist on a specific program for promptly remedying the equity capital deficiency.

B. 1982

In May of 1982, the Federal Reserve Board and the OCC issued criteria on the classification of mandatory convertible securities as primary capital. The criteria were in response to increasing use of such securities by banking organizations. The two regulators stated that as a general matter, the principal factor determining whether an issue qualified as primary capital was the certainty with which it would be replaced by permanent equity. In addition, the aggregate amount of mandatory convertible securities qualifying as primary capital could not exceed 20 percent of the other components of primary capital.

The OCC and the Board identified two types of mandatory convertible securities as primary capital: securities with mandatory stock purchase contracts and securities payable from the sale of common or perpetual preferred stock. The former were also called equity notes and obligated the holders to purchase stock in the issuing institution. To be considered primary capital according to the OCC and the Board, equity notes had to mature in twelve years or less. Further, if the stock purchase contracts could be separated from the securities, a holder of a contract had to provide sufficient collateral to the issuer to assure that the stock would be purchased.

The second type of mandatory convertible securities—those payable from the sale of common or perpetual preferred stock—involved notes that obligated the issuer to sell stock in sufficient amounts to replace the debt obligations. These securities, called equity commitment notes as distinguished from equity notes, also had to mature within twelve years. An issuer had to establish a sinking fund that would be added to in one-third increments over the maturity period of the securities. That is, by the time one-third of the life of the securities had run, the issuer had to have paid into the fund from the sale of common or perpetual preferred stock an amount equal to one-third of the securities’ principal. A similar amount in the fund was due at the two-thirds mark, and the final third was due at least 60 days prior to maturity of the securities. The amount of equity commitment notes counted as primary capital could not exceed 10 percent of the other components of primary capital.

C. 1983

In 1983, two events of interest in the U.S. capital adequacy situation occurred. On June 13, 1983, the Federal Reserve Board and the OCC announced capital adequacy guidelines for multinational banking organizations. The guidelines were the same as those adopted in 1981 for regional banking organizations: a minimum primary capital to total assets ratio of 5 percent, a minimum total capital to total assets ratio of 5.5 percent, and the zone concept for judging higher total capital to total assets ratios. In conjunction with this action, the Board also added long-term debt issued by parent bank holding companies or their nonbank subsidiaries to the definition of total capital. Prior to this, only subordinated debt issued by bank subsidiaries could be counted as a component of holding company capital.

The second major 1983 action was the enactment of the International Lending Supervision Act on November 30, 1983. This law was aimed at the activities and operations of banking organizations engaged in international lending and was in large measure a response to the international debt crisis that had surfaced the previous year. The more important topics covered by the act were reserves against questionable international loans, fees charged in connection with the restructuring of international loans, data collection and disclosure, capital adequacy, and foreign loan evaluations.

The capital adequacy provision was section 908(a) of the act. This section, as noted above, directs the federal banking agencies to “cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by using such other methods as the appropriate Federal banking agency deems appropriate.” Failure of a banking institution to maintain capital at or above the minimal level may be deemed by the appropriate banking agency to constitute an unsafe and unsound practice. The section also provides that a regulator may issue a directive to a noncomplying banking institution. Such a directive can require the bank to submit a plan describing the means by which, and the timing within which, the institution is to achieve the required capital level. Progress in adhering to such a plan can be considered by the regulator when it is asked to rule on any proposal that would divert earnings, diminish capital, or otherwise impede the banking institution’s efforts to achieve its minimal capital level.

D. 1984–1985

In part as a result of the impetus provided by the International Lending Supervision Act, the three federal banking regulators proposed new capital adequacy standards in the summer of 1984.\textsuperscript{75} The OCC and the FDIC released their final capital adequacy regulations on March 11, 1985.\textsuperscript{76} The final version of the Federal Reserve Board’s guidelines was published on April 24, 1985.\textsuperscript{77} The Board did not raise its standards to the level of regulations but kept them in guideline form.

Probably the most significant aspect of the new standards of the three agencies is a general raising of the minimum acceptable capital ratios. The minimum ratio of primary capital to assets is now 5.5 percent. The minimum ratio of total capital to assets is now 6 percent. The standards apply to all banks regardless of size. Thus the Federal Reserve Board and the OCC have rejected their previous size distinctions. In its previous guidelines, the FDIC did not make distinctions based on size.

Only the Federal Reserve Board now has a zone concept for the total capital ratio. Previously, both the Board and the OCC used the concept. The Board’s new zones are as follows:

<table>
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<tr>
<th>Total Capital to Assets</th>
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<tbody>
<tr>
<td>Zone 1</td>
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<tr>
<td>Zone 2</td>
</tr>
<tr>
<td>Zone 3</td>
</tr>
</tbody>
</table>

Institutions in Zone 1 are generally considered by the Board to be adequately capitalized. Institutions in Zone 2 may be considered to be adequately capitalized if other relevant financial and managerial factors are found to be fully satisfactory. And institutions in Zone 3 are considered to be undercapitalized, absent extenuating circumstances.

All three agencies look at two types of capital: primary capital and secondary capital. Primary capital consists of (1) common stock, (2) perpetual preferred stock, (3) capital surplus, (4) undivided profits, (5) contingency and other capital reserves, (6) certain mandatory convertible instruments, (7) the allowance for possible loan and lease losses, and (8) minority interests in equity accounts of consolidated subsidiaries. Concerning mandatory convertible instruments, no more than 20 percent of primary capital may consist of these obligations. The OCC and the FDIC also include net worth certificates in capital.


The FDIC and the OCC deduct all intangibles other than purchased mortgage servicing rights from primary, and total, capital. For state member banks, the only intangible the Board specifically deducts is goodwill. Thus the Board not only excludes purchased mortgage servicing rights from the deduction from capital, but also excludes other intangibles, such as favorable leases. The Board does say that it may make adjustments to a bank's capital ratios in instances where the amount of intangible assets is in excess of 25 percent of tangible primary capital. For the guidelines of all three agencies, the major import of the deduction of intangibles from capital is that goodwill, which is an accounting result of most mergers and acquisitions, is not counted as capital.

For bank holding companies, the Federal Reserve Board does not automatically exclude any intangible assets, including goodwill, from capital. Nevertheless, those holding companies with aggregate intangible assets in excess of 25 percent of tangible primary capital, or these institutions with lesser, although still significant, amounts of goodwill will be subject to "close scrutiny." The Board states that it might make adjustments to an organization's primary or total capital on a case-by-case basis when the amount of intangible assets is in excess of 25 percent of tangible primary capital. In reviewing acquisition proposals, the Board takes a more stringent, although still unquantified, position. Its guidelines state: "in reviewing acquisition proposals, the Board will take into consideration both the stated primary capital ratio (that is, the ratio without any adjustment for intangible assets) and the primary capital ratio after deducting intangibles."79

The components of secondary capital for the three agencies are (1) limited life preferred stock and (2) bank subordinated notes and debentures. The Board also includes unsecured long-term debt of the parent holding company and its nonbank subsidiaries. The OCC and the FDIC, and the Board for state member banks, limit the amount of secondary capital that can be counted as total capital to 50 percent of primary capital. For all three agencies, secondary capital instruments must have a weighted average maturity of at least seven years.

The OCC and the FDIC now exclude equity commitment notes—previously considered by the two agencies as a form of mandatory convertible instruments—from primary capital. The Board, however, only makes the exclusion for state member banks. Bank holding company primary capital can still include equity commitment notes, to the extent of 10 percent of primary capital. The 10 percent limitation was also in the Board's prior guidelines.

79. Id.
A principal characteristic of equity commitment notes is that an issuer must replace them by the issuance of common or perpetual preferred stock. The replacement must occur before the notes are repaid. The OCC and the FDIC concluded that a troubled bank might not be able to issue stock to replace the equity commitment notes. Thus, the notes' status as capital is debatable, in their view.

Under the prior guidelines the FDIC was sort of the "odd man out." The Federal Reserve Board now holds that distinction. The capital guidelines of the OCC, the FDIC, and in the case of state member banks, the Board, are substantially identical. The Board, on the other hand, has not promulgated its guidelines in the form of regulations, still maintains the zone concept, and in the case of bank holding companies, does not exclude equity commitment notes from primary capital or automatically deduct goodwill from capital.

E. 1986

One of the criticisms of the 1985 capital adequacy standards is that they take no explicit account of the riskiness of a bank's assets. In early 1986, the three federal banking agencies moved to tie required levels of bank capital to asset riskiness. The Federal Reserve Board issued on January 15, 1986, for public comment, a proposal on the subject.\(^8\) And on the same day, the three agencies issued a joint statement in which they all expressed the intention of seeking comments on proposed standards for measuring capital on a risk-adjusted basis.

One reason for the interest of the U.S. banking regulators in risk-based capital measures is the growth in off-balance-sheet activities by banking organizations. As their name implies, such activities do not result in increases in a bank's balance sheet, specifically the balance sheet's asset side. Consequently, more off-balance-sheet activities do not result in the need for more capital under the 1985 standards. According to the Board, the amount of one type of off-balance-sheet activity, standby letters of credit, increased for multinational banks from 5.8 percent of aggregated assets at the end of 1981 to 11.4 percent of aggregated assets at mid-year 1985.

The Board's proposal calls for a risk-sensitive capital measure that would supplement the 1985 capital adequacy standards. A new ratio of primary capital to total assets adjusted for risk would be considered in tandem with the 1985 minimum primary and total capital ratios. Under the proposal, assets, both on and off the balance sheet, would be placed in one of four categories: cash and cash equivalents; money market risk;

moderate risk; and standard risk. The risk weight assigned to each of the
categories would be as follows: cash and cash equivalents—0; money
market risk—0.30; moderate risk—0.60; and standard risk—1.00. Off-
balance-sheet activities appear in each of the last three categories.

F. Conclusion

The Federal Reserve Board's interest in the capital adequacy of foreign
banking organizations with banking operations in the United States thus
is merely an aspect of a more general concern about capital adequacy.
This general concern is held not just by the Board but also by the other
two federal banking regulators and by the U.S. Congress. Consequently,
the Board’s attitude in the future concerning foreign bank capital adequacy
will be heavily influenced by domestic developments.

This influence of the domestic situation on the banking regulators' view
of foreign institutions is evidenced by a regulatory amendment the FDIC
made in conjunction with its new capital regulations. The amendment
concerns the capital equivalency ledger account that U.S. branches of
foreign banks must maintain as a result of the International Banking Act
of 1978. Effective April 18, 1985, the capital equivalency ledger account
was raised from a minimum of 5 percent to 6 percent of a branch’s lia-
Bilities. In the words of the FDIC, "This change corresponds to the
capital adequacy requirement of six percent of total assets being required
of well-managed domestic banks."82

III. The International Arena

Interest in the capital positions of banking organizations has not been
limited to the U.S. Congress and the regulatory and supervisory author-
ities in the United States. The difficulties of the first half of the 1980s
have caused banking authorities in a number of other countries to pay
more attention to capital levels. In the fall of 1984, the Basle Committee
on Banking Regulations and Supervisory Practices called for more strin-
gent capital guidelines. The Basle Committee, also known as the Cooke
Committee, had its origins in the Franklin National Bank crisis of 1974.

One motivating factor for concern about capital levels for foreign banks
was the appreciation, until early 1985, of the dollar. Many foreign inter-
national banks have sizeable dollar assets and liabilities on their books.
Since their capital is usually denominated in the currencies of their home

83. Andrews, The Desperate Search for Capital, INSTITUTIONAL INVESTOR (Int'l ed.),
countries, these banks experience declining capital to asset ratios when the dollar appreciates.

Increased concern about capital on the part of banking authorities in many countries does not mean that agreement on appropriate capital levels and how to achieve them is imminent. The difficulties arise from the significantly different approaches to defining capital and to calculating capital ratios in the various countries. For one thing, in many industrialized countries, assets in capital to assets ratios are weighted according to risk. A few countries, however, most notably the United States, use unweighted assets as the denominator of capital to assets ratios, although, as discussed in Part II.E, above, the U.S. banking regulators are investigating the use of weighted assets.

As also indicated in the discussion in Part II.E of the Federal Reserve Board's risk-based capital proposal, a growing matter of concern is off-balance-sheet exposures, or contingent liabilities. These terms encompass such things as standby credit lines, letters of credit, loan commitments, prearranged note issuing facilities, revolving underwriting facilities, and exposures in foreign exchange, futures, and options. Some foreign regulators require certain contingent liabilities to be added to assets in arriving at the denominator of the capital to assets ratio. The United Kingdom and West Germany require 50 percent of certain guarantees to be included in asset totals. In France, the proportion ranges between 25 and 50 percent. Canada requires 100 percent inclusion. 84

The definitions of capital among the various countries is similarly characterized by considerable variation. In some countries, such as West Germany, subordinated debt is not included within the definition of capital. As discussed in Part II, above, in the United States subordinated debt is counted as capital, but only as secondary capital and only to the extent of 20 percent of primary capital. The Bank of England limits the amount of debt that can be counted as capital to 33 percent of total capital. Switzerland limits the amount to approximately 10 percent of equity capital and taxed reserves. 85

Another item on which there is disagreement as to whether and to what extent it should be included in capital is the loan loss reserve. Banks in the United States can include loan loss reserves in capital. In other countries, however, such reserves are not given the full capital treatment. 86 And to mention just one more item concerning which there is disagreement, to avoid double counting capital, the Bank of England requires

84. Id. at 56.
85. Id. at 55.
86. Id. at 56.
banks to deduct from their capital the subordinated debt they hold of other banks.87

Thus there is a considerable lack of harmony among the capital requirements of the banking authorities in the various nations of the world. This lack of harmony is reflected in differing capital to assets ratios among international banks. An accompanying table from an International Monetary Fund (IMF) publication gives some indication of both the differing capital ratios and the divergent methods by which they are calculated. One commentator has summed up the situation thusly: "one country may require a lower ratio, but its banks are not necessarily weaker; they may operate under a stricter definition of capital or their regulators might include different factors in their asset totals."88

Despite the difficulties in achieving a degree of harmony among the differing approaches toward capital, the banking authorities in a number of countries seem to be working toward that goal. And indeed, as indicated above, the U.S. Congress has instructed the Federal Reserve Board to pursue cooperative measures concerning capital with banking authorities in other countries. This instruction was contained in section 908(b) of the International Lending Act of 1983.89 The accompanying IMF table indicates that there has been improvement in the capital positions of banks in some countries. But a threshold issue remains, and that is whether capital warrants the attention it is receiving.

IV. Some Thoughts on the Proper Role for Capital in Bank Supervision and Regulation

In promulgating its capital adequacy regulations, the FDIC stated that capital performs "several very important functions in banking institutions."90 According to the FDIC, capital absorbs fluctuations in income to sustain banking institutions through periods of losses. It provides a measure of assurance to the public. Supposedly, the public believes that an institution with an appropriate level of capital, whatever that may be, will continue to provide financial services during periods of financial distress. Consequently, capital helps to maintain confidence in individual banking institutions and in the banking system as a whole. Capital serves to support prudent growth. A corollary is that capital requirements serve to restrain imprudent growth. And capital "provides protection to depositors in the event of a threatened insolvency."91

87. Id.
88. Id. at 57.
91. Id.
These justifications are not universally accepted. Some commentators have questioned whether the raising of required capital levels from, say, 5 percent to, say, 7 percent of assets really makes any difference. Capital's ability to absorb losses and to protect depositors from insolvency is negated to a large extent if supervisory authorities do not let capital fall below certain minimum levels. In other words, a minimum required level of capital means that a bank with a lower ratio is, at least in the eyes of the supervisors, approaching insolvency.

In the view of some, the quality of assets and the abilities of management are much more appropriate focuses for regulatory and supervisory authorities. An institution with a high capital ratio may actually be more unstable and prone to troubles than an institution with a lower ratio if the higher capital ratio institution has a larger percentage of questionable assets. For example, a bank that invests only in U.S. Treasury bills would appear to be a safe and sound institution even if it has close to zero capital. The risk-based capital proposals put forth by the U.S. banking agencies in early 1986 constitute one attempt to tie required capital levels to the riskiness of a bank’s assets. One early criticism of the proposals, however, was that they do not focus on a particular bank’s assets but on broad asset categories and thus would only be marginally effective.

V. Conclusion

In a number of instances since 1983, the Federal Reserve Board has expressed considerable concern about the capital positions of certain foreign banking organizations with operations in the United States. The Board has not, however, rejected on capital adequacy grounds any applications by major foreign banking organizations.

The Board has indicated that it is investigating the matter of capital with banking authorities in other countries. The results of this investigation could lead to some sort of quantitative capital standards for multinational banking organizations. Thus far, however, the Board has eschewed the use of a single capital standard in judging foreign banking organizations. A case-by-case approach has been followed. In view of the considerable differences concerning banking capital standards among the major countries of the world, it would appear that a case-by-case approach will continue to be desirable.

This conclusion might be particularly attractive to those observers who believe that the importance of capital has been overemphasized. At the current time, the Board, and its fellow banking regulators, are enamored

### Capital-Asset Ratios of Banks in Major Financial Market Countries, 1977–83\(^1\)

(In percent)

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</thead>
<tbody>
<tr>
<td>Canada(^2)</td>
<td>3.40</td>
<td>3.27</td>
<td>3.16</td>
<td>2.98</td>
<td>3.46(^3)</td>
<td>3.65</td>
<td>4.06</td>
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<tr>
<td>France(^4)</td>
<td>2.36</td>
<td>2.08</td>
<td>2.43</td>
<td>2.22</td>
<td>1.99</td>
<td>1.87</td>
<td>1.76</td>
</tr>
<tr>
<td>Germany, Federal Republic of(^1)</td>
<td>3.41</td>
<td>3.32</td>
<td>3.31</td>
<td>3.27</td>
<td>3.26</td>
<td>3.31</td>
<td>3.34</td>
</tr>
<tr>
<td>Japan(^5)</td>
<td>5.28</td>
<td>5.12</td>
<td>5.13</td>
<td>5.28</td>
<td>5.25</td>
<td>5.03</td>
<td>5.22</td>
</tr>
<tr>
<td>Luxembourg(^6)</td>
<td>. .</td>
<td>. .</td>
<td>. .</td>
<td>3.52</td>
<td>3.45</td>
<td>3.50</td>
<td>3.59</td>
</tr>
<tr>
<td>Netherlands(^8)</td>
<td>4.41</td>
<td>3.86</td>
<td>4.29</td>
<td>4.20</td>
<td>4.33</td>
<td>4.60</td>
<td>4.68</td>
</tr>
<tr>
<td>Switzerland(^9)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Largest 5 banks</td>
<td>6.09</td>
<td>6.20</td>
<td>6.11</td>
<td>6.18</td>
<td>5.78</td>
<td>5.51</td>
<td>5.36</td>
</tr>
<tr>
<td>All banks</td>
<td>5.59</td>
<td>5.68</td>
<td>5.63</td>
<td>5.66</td>
<td>5.36</td>
<td>5.19</td>
<td>5.09</td>
</tr>
<tr>
<td>United Kingdom</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Largest 4 banks(^10)</td>
<td>5.90</td>
<td>6.30</td>
<td>6.10</td>
<td>5.80</td>
<td>5.20</td>
<td>4.88</td>
<td>4.99</td>
</tr>
<tr>
<td>All banks(^11)</td>
<td>5.20</td>
<td>5.20</td>
<td>5.10</td>
<td>5.00</td>
<td>4.47</td>
<td>4.14</td>
<td>4.35</td>
</tr>
<tr>
<td>United States</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Largest 10 banks(^12)</td>
<td>4.17</td>
<td>4.06</td>
<td>3.95</td>
<td>4.02</td>
<td>4.23</td>
<td>4.70</td>
<td>5.41</td>
</tr>
<tr>
<td>Largest 25 banks(^12)</td>
<td>4.52</td>
<td>4.41</td>
<td>4.31</td>
<td>4.39</td>
<td>4.57</td>
<td>4.98</td>
<td>5.58</td>
</tr>
<tr>
<td>Large banks with foreign offices(^13,14)</td>
<td>. .</td>
<td>4.58</td>
<td>4.47</td>
<td>4.49</td>
<td>4.54</td>
<td>4.62</td>
<td>4.48(^13)</td>
</tr>
</tbody>
</table>

Sources: Fund staff calculations based on data from official sources, as indicated in footnotes.

\(^1\)Given the problems of consistency across banks and over time in the accounting of bank assets and capital, aggregate figures such as the ones in this table must be interpreted with caution.

\(^2\)Ratio of equity plus accumulated appropriations for losses (beginning with 1981, appropriations for contingencies) to total assets (Bank of Canada Review).

\(^3\)The changeover to consolidated reporting from November 1, 1981 had the statistical effect of increasing the aggregate capital-asset ratio by about 7 percent.

\(^4\)Ratio of reserves plus capital to total assets excludes cooperative and mutual banks (Commission de Contrôle des Banques, Rapport).
Ratio of capital including published reserves to total assets (Deutsche Bundesbank, Monthly Report).

Ratio of reserves for possible loan losses, specified reserves, share capital, legal reserves plus surplus and profits and losses for the term to total assets (Bank of Japan, Economic Statistics Monthly).

Ratio of capital resources (share capital, reserves excluding current-year profits, general provisions, and eligible subordinated loans) to total payables. Eligible subordinated loans are subject to prior authorization by the Institut Monétaire Luxembourgeois and may not exceed 50 percent of a bank’s share capital and reserves. Data in the table are compiled on a nonconsolidated basis and as a weighted average of all banks (excluding foreign bank branches). An arithmetic mean for 1983 would show a ratio of 7.58 percent. Inclusion of current-year profits in banks’ capital resources would result in a weighted average of 3.91 percent for 1983. Provisions for country risks, which are excluded from capital resources, have been considerably increased in the last three years, including an approximate doubling of the level of provisions in 1983.

Ratio of capital, disclosed free reserves, and subordinated loans to total assets. Eligible liabilities of business members of the agricultural credit institutions are not included (De Nederlandsche Bank N.V., Annual Report).

Ratio of capital plus reserves to total assets (Swiss National Bank, Monthly Report).

Ratio of share capital and reserves, plus minority interests but excluding loan capital, to total assets (Bank of England).

Ratio of capital and other funds (sterling and other currency liabilities) to total assets (Bank of England). Note that these figures include U.K. branches of foreign banks, which normally have little capital in the United Kingdom.

Ratio of primary capital to total assets (Comptroller of the Currency).

Banks with foreign offices with assets of $100 million or over—in 1981 there were 190 such banks (Board of Governors of Federal Reserve System, Federal Reserve Bulletin).

Ratio of total equity capital to total assets.

Through September 30, 1983.

with capital. Nevertheless, views on the role that capital is supposed to play in the safety and soundness of banks might change in the years ahead. If this occurs, a hard and fast agreement among the banking regulators and supervisors in the various countries might become somewhat of an embarrassment.