institutions to meet a minimum Tier 1 capital ratio of 3 percent. For all other institutions, these standards generally require an additional cushion of at least 100 to 200 basis points, i.e., a minimum leverage ratio of at least 4 to 5 percent, depending upon an organization's financial condition.

As required by FIRREA, the OTS has established a 3 percent core capital ratio and a 1.5 percent tangible capital leverage requirement for thrift institutions. However, the OTS has not yet finalized a new leverage rule, which has been under consideration for some time. This leverage rule is intended to conform to the leverage rules of the three banking agencies. The differences that will exist after the OTS has adopted its new standard pertain to the definition of core capital. While this definition generally conforms to Tier 1 bank capital, certain adjustments discussed in this report apply to the core capital definition used by savings associations. In addition, core capital as currently defined by the OTS includes qualifying supervisory goodwill. By the end of 1994, such goodwill will be phased out of thrift core capital. Therefore, beginning with the first quarter of 1995, the treatment of goodwill for thrift institutions will be consistent with that of the banking agencies.

Risk-Based Capital Ratios

The three banking agencies have adopted risk-based capital standards consistent with the Basle Accord. These standards, which were fully phased in at the end of 1992, require all commercial banking organizations to maintain a minimum ratio of total capital (Tier 1 plus Tier 2) to risk-weighted assets of 8 percent. Tier 1 capital includes common stock and surplus, retained earnings, qualifying perpetual preferred stock and surplus, and minority interests in consolidated subsidiaries, less goodwill. Tier 1 capital must comprise at least 50 percent of the total risk-based capital requirement. Tier 2 capital includes such components as general loan loss reserves, subordinated term debt, and certain other preferred stock and convertible debt capital instruments, subject to appropriate limitations and conditions. Risk-weighted assets are calculated by assigning risk weights of 0, 20, 50, and 100 percent to broad categories of assets and off-balance sheet items based upon their relative credit risks. The OTS has adopted a risk-based capital standard that in most respects is similar to the framework adopted by the banking agencies.

All the banking agencies view the risk-based capital standard as a minimum supervisory benchmark. In part, this is because the risk-based capital standard focuses primarily on credit risk; it does not take full or explicit account of certain other banking risks, such as exposure to changes in interest rates. The full range of risks to which depository institutions are exposed are reviewed and evaluated carefully during on-site examinations. In view of these risks, most banking organizations are expected to operate with capital levels well above the minimum risk-based and leverage capital requirements.

Efforts to Incorporate Non-Credit Risks

The Federal Reserve has for some time been working with the other U.S. banking agencies and the regulatory authorities on the Basle Supervisors' Committee to develop possible methods to measure and address certain market and price risks. In April, 1993, the Basle Supervisors' Committee issued a consultative paper that addresses, among other items, proposals to include certain risks into the framework of the Basle Accord. These include interest rate risk arising from imbalances between the maturity of debt instruments held as assets and issued as liabilities and market risk associated with holdings of traded debt and equity securities. One important reason for addressing these risks on an international level is to develop supervisory approaches that do not undermine the competitiveness of U.S. banking organizations.

Aside from this initial international effort, the OTS capital standards for some time have taken into account interest rate risk, and, in August, 1992, the FRB, OCC, and FDIC sought public comment on a proposed framework for incorporating into their capital standards interest rate risk, as required under section 305 of FDICIA. In response to concerns raised and recommendations made by commenters, on September 14, 1993, the three banking agencies issued for public comment a substantially modified proposal on interest rate risk. Throughout 1994, the agencies have been meeting to review the public comments and consider the alternative approaches offered by the commenters. It is anticipated that the banking agencies will issue a revised notice of proposed rulemaking in early 1995 that will provide certain modifications and enhancements to the proposal to address concerns expressed by public commenters. The approach ultimately adopted by the banking agencies could differ from that already taken by the OTS.

Section 305 of FDICIA also requires the banking agencies to amend their risk-based capital rules to take into account concentrations of credit risk and nontraditional activities. The agencies proposed an amendment implementing this requirement in February, 1994. On August 3, 1994, the Federal Reserve approved an amendment to its risk-based capital guidelines to identify explicitly concentrations of credit risk and an institution's ability to manage them as important factors in assessing an institution's overall capital adequacy. The amendments also indicate that an institution's ability to adequately manage the risks posed by nontraditional activities affects its risk exposure.

Recent Interagency Efforts

In addition to coordinating efforts to incorporate noncredit risks, the agencies worked together during 1994 to issue proposals for public comment that would amend the agencies' respective risk-based capital standards with respect to: (1) The sale of assets with recourse; (2) the recognition of bilateral netting arrangements for derivative contracts; (3) higher capital charges for long-dated derivative contracts and reduced capital charges for the potential future exposure of contracts that are affected by netting arrangements; and (4) the definition of the OECD-based group of countries for the purpose of specifying country transfer risk. The agencies also coordinated efforts to make modifications in their capital guidelines in light of recent changes in accounting standards.

Recourse

The agencies issued a joint proposal on May 24, 1994, that would amend their respective risk-based capital guidelines with regard to assets sold with recourse and direct credit substitutes. This publication, which included a notice and an advanced notice of proposed rulemakings, was a culmination of several attempts by the agencies to resolve important differences on this issue. The notice of proposed rulemaking is intended to allow banking organizations to maintain lower amounts of capital against low-level recourse transactions. The advanced notice of proposed rulemaking is a preliminary proposal to use credit ratings to match the risk-based capital assessment more closely to an institution's relative risk of loss in certain asset securitizations. The comment period for these proposals