NEW PRUDENTIAL GUIDELINES FOR BANKS

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The Reserve Bank guidelines on capital adequacy are of great importance to banks because first the extent of a bank's capital base will determine the nature and size of its business and secondly the requirement for capital backing for a bank's "on" balance sheet assets and "off" balance sheet business will affect pricing.

These guidelines are important for banking lawyers because they lead to the development of new funding instruments for banks and new concepts in banking contracts.

BACKGROUND

The first formal Australian guidelines, introduced in February 1985, stipulated that banks were required to maintain a minimum ratio of shareholders' funds to assets of 5 per cent. Assets were defined as only those "on" balance sheet.

September 1986 saw the definition of capital, for this purpose, widened and the ratio requirements increased to 6 per cent of "on" balance sheet assets.

Meanwhile work was proceeding at an international level to establish a set of capital adequacy guidelines for banks. In July 1988 the Committee on Banking Regulations and Supervisory Practices of the Bank for International Settlement issued its final proposals entitled "International Convergence of Capital Measurement and Capital Standards".

On 23 August 1988 The Reserve Bank of Australia issued its guidelines for the measurement of capital adequacy of Australian banks. These guidelines are consistent in all substantial respects with the proposals of the Bank for International Settlements.

FRAMEWORK

The Reserve Bank has introduced a "risk based" approach to the supervision of banks' capital adequacy. The arrangements specifically deal with banks' "off" balance sheet business and

take account of the varying degrees of risk associated with both "on" and "off" balance sheet businesses of banks.

Balance sheet assets and "off" balance sheet exposures are weighted according to broad categories of risk mainly based on the nature of the customer or counterparty. The higher the risk, the greater is the capital backing required. "Off" balance sheet transactions are converted to balance sheet equivalents and allocated to a risk category.

A bank's capital adequacy is measured by its risk ratio which is the ratio of the bank's capital base to the total of its risk weighted assets and its risk weighted "off" balance sheet business.

The new ratio guidelines focus on credit risk - the risk of default by a borrower or counterparty. However the Reserve Bank in its assessment of individual banks will also have regard to the quality of a bank's assets, its profitability, liquidity, loan exposures and provisions as well as the bank's effectiveness of management systems for monitoring and controlling risks.

The first element of a bank's risk ratio is its capital base. The capital base comprises two tiers. Tier 1 (or "core capital") comprises the highest quality capital elements. Tier 2 (or "supplementary capital") is the financial resources of a bank which, while they fall short of some of the characteristics of Tier 1 or core capital, contribute to the overall strength of a bank as a going concern.

The total of Tier 2 components is limited to a maximum of 100 per cent of the total of Tier 1 elements. Term subordinated debt, which is one of the Tier 2 components, is limited to a maximum of 50 per cent of Tier 1 capital.

The Reserve Bank now requires that banks maintain a risk ratio of 8 per cent. This means that a bank's capital base, must be at least 8 per cent of the aggregate of the risk weighted "on" balance sheet assets and "off" balance sheet business. At least 4 per cent must be Tier 1 capital.

TIER 1 CAPITAL

Tier 1 or core capital consists basically of shareholders' funds. The Reserve Bank has said that shareholders' funds:

> "represent a permanent and unrestricted commitment of funds; they are available to meet losses enabling a bank to continue operating whilst any problems are redressed; and they do not impose unavoidable charges against earnings. Shareholders' funds therefore represent capital resources which can best contribute resilience and flexibility to a bank experiencing financial difficulties."

Thus Tier 1 capital includes paid up capital, non repayable share premium account, general reserves, retained earnings/including current year earnings, non cumulative irredeemable preference shares and, for a consolidated group, minority interests in subsidiaries which are consistent with these other components. Goodwill and similar intangible assets will be disregarded.

Tier 1 capital is easily recognised. The Melbourne Age noted that "The Latrobe Valley Express reports this week that a persistent flasher has been exposing himself to teenage girls in the Traralgon area, wearing a sugar bag over his head and nothing else. The police are reported to be preparing an identikit picture".

TIER 2 CAPITAL

Tier 2, or supplementary, capital consists of other capital elements which impart strength to a bank's position but fall short of core capital or Tier 1 capital.

Tier 2 capital includes the following:

General provisions for doubtful debts

Until the end of 1990 general provisions for doubtful debts may be included to a maximum of 1.5 per cent of risk-weighted assets. After the end of 1992 the maximum will be 1.25 per cent. The amount to be included is after deduction of any associated future income tax benefits. The Reserve Bank has said that it will seek to develop a "definition of general provisions for doubtful debts free of amounts which reflect diminution in value of assets or latent losses".

This will be an interesting exercise. There can be no argument that any identified diminution in asset value should not be reflected in a provision for doubtful debts. But what about the exclusion of "latent losses"?

In pure accounting terms, the creation of a doubtful debt provision is a recognition of the fact that the balance sheet value of a loan portfolio is greater than its actual value because of the existence of debts which have the potential to become bad debts. This writing down of loan values in anticipation of bad debts represents an anticipated reduction in the net worth of the bank. This expectation is shown in the profit and loss account as an operating expense at the time of creating the provision. Accordingly a general provision is not included in a balance sheet as shareholders' funds.

But if the provision for doubtful debts cannot include "latent losses", which I assume means debts which are not currently recognised as doubtful but which have the potential to become bad debts, what should be included in the provision?

If this provision does not include "latent losses", it would not represent an anticipated reduction in the net worth of the bank. Accordingly its creation should not be shown as an expense in the profit and loss account and the provision should be included in the balance sheet as shareholders' funds. It would be a reserve - part of a bank's general reserve - and therefore part of a bank's Tier 1 capital.

Asset revaluation reserves

Asset revaluation reserves both for a bank's premises and other assets may be counted as part of Tier 2 capital. For bank premises a bank may include 100 per cent of the results of revaluation. For other assets the Reserve Bank points out that there is a need to recognise market volatility and that tax would apply if the assets were realised. Accordingly only 45 per cent of the effect of revaluing securities may be counted.

Irredeemable cumulative preference shares

Irredeemable cumulative preference shares are included provided that the bank has the option to defer or reduce dividends where so required by its profitability. If this option does not exist these shares will be treated in the same way as a term subordinated debt which I will mention shortly.

Perpetual subordinated debt and mandatory convertible notes

Perpetual subordinated debt and mandatory convertible notes may be part of Tier 2 capital. The market for perpetual debt collapsed in early 1987 and further issues seem unlikely in the near future. Perpetual debt, issues by my bank in 1986, is now selling for 89 per cent of its issue price, having fallen to a low of 72. We are now told that a new issue may be possible at Libor plus 60 to 70. Our 1986 issue was at Libor plus 15. Perpetual debt is very close to capital. It is an odd debt concept because there is no date for repayment and the creditor can never demand repayment although he may petition for a winding up. Interest may be deferred if the bank does not pay dividends on its shares. Mandatory convertible notes are unlikely instruments while the Tax Act denies deductibility of interest to the issuer because the holder does not have the choice of redemption or conversion of the notes.

Term subordinated debt

Finally term subordinated debt and similar instruments may be included in Tier 2 capital but only to a maximum of 50 per cent of Tier 1 capital. To be included, term subordinated debt must have an original maturity of at least seven years and during the last five years to maturity the amount to be counted as capital will be reduced by 20 per cent each year. Term subordinated debt must also meet the Reserve Bank's requirements regarding subordination. The Reserve Bank has not published details of its requirements, however the following matters seem to be required:

1. The debt must be subordinated to all liabilities of the bank which are not pari passu with or junior to it. In the event of the winding up of the bank the subordinated debt is not repayable until the senior liabilities of the bank are paid. The subordination must encompass, not only payments of principal and interest, but also any indemnity to the lender for increased costs to the lender of maintaining the loan, as well as any other indemnities given by the bank to the lender.

2. The only remedy of the lender can be to petition for a winding up of the bank. The lender cannot sue for the loan.

3. The bank may only pay interest and repay principal if it is solvent both before and after payment. However interest may accrue if the bank is insolvent, although the interest is not to be payable during insolvency. Interest may accumulate until the bank again becomes solvent. The lender may prove for accrued, but unpaid, interest in a winding up of the bank.

4. The borrower bank cannot have a right of repayment at its option because this option would destroy an essential feature which makes subordinated term debt akin to capital. There can be a right of repayment on the basis of an increase in the amount payable or the cost of the borrowing as a result of a change in taxation laws or other factors. However this limited right of repayment must be expressed to be subject to the prior consent of the Reserve Bank.

5. The contract may provide that if it becomes illegal for the lender to maintain the loan, the parties may negotiate to find a way whereby the maintenance of the loan becomes legal. If these negotiations fail there may be a right of prepayment. However the bank's right to prepayment must again be expressed to be subject to the prior consent of the Reserve Bank. The right of prepayment must be that of the borrowing bank and not the lender. In deciding whether or not to give its consent the Reserve Bank will deal only with the borrowing bank and not any third party lender.

6. No change to the subordination arrangements may be made without the prior consent of the Reserve Bank.

The basic concept of contractual debt subordination is simple - an unsecured creditor agrees not to be repaid until another unsecured creditor is repaid in full. Thus the structure of a debt subordination should be simple. However there are a couple of problems in Australia which require consideration.

What is the effect of s.440 of the Companies Code on a subordination agreement? How can the senior creditors enforce the provisions of the subordination agreement between the borrowing bank and the subordinated lenders whilst the bank remains solvent?

> have earlier said, the performance of the agreement between the three parties can in no way affect the entitlement of creditors not party to that agreement ... I regard British Eagle as distinguishable. As I have said, here, to give effect to the agreement of the parties is in no way to cause detriment to a creditor not a party to that agreement."

Thus in Australia on the question of the efficacy of subordination, a subordination agreement, which by its very nature cannot cause detriment to other creditors, will be given effect to in a liquidation notwithstanding s.440 of the Companies Code. However because of the decision in Halesowen it may not be possible to contract out of the provisions dealing with set-off in insolvency. Thus, until the High Court decides to the contrary, the liability to a bank of a subordinated creditor perhaps may be set off against the creditor's subordinated debt.

Coming to the conclusion on subordination and associated set-offs I suppose is somewhat like the shelter near Yeovil in Sommerset, designed to keep council leaders safe from fall out during a nuclear emergency which only has an outside loo.

The Law Reform Commission stated in 1988:

> "The issue is whether the terms of a contract providing for subordination will or should prevail over the clear mandate of s.440 ... The relevant Australian case law provides no firm guide in this regard ... The Commission recommends that the operation of ss.440 and 441 should not prevent a creditor's debt being deferred until another creditor's debts is paid in full or part".

In the current draft of the Corporations Legislation there is no such provision.

The other problem to which I referred is how the subordination provisions can be enforced if the senior creditor is not a party to the subordination agreement. In the United States this problem is solved by a doctrine which allows third parties to enforce contracts made for their benefit.

In the United Kingdom and Australia the rule of privity of contract still exists so that a third party senior creditor could not enforce the subordination arrangements or prevent them being amended in the absence of a trustee for senior creditors. However perhaps the rule of privity of contract is now less rigid. In England Denning L.J. in Drive Yourself Hire Co (London) Ltd v. Strutt [1954] 1 QB 250 held that the rule of privity of contract did not prevent a third party from suing on a contract made for his benefit where the contract related to property in the widest sense.

In Australia, despite the rule of privity of contract, the High Court in Trident General Insurance Co Ltd v. McNeice Bros Pty Ltd

80 (1988) ALR 574 allowed third parties, who were not parties to a contract of insurance, to maintain a claim against an insurer where the insurance contract was for their benefit. It is far from clear that all members of the majority in this case were prepared to relax the rigidity of the rule of privity of contract.

Practically in the Australian context of term subordinated debt for banks, these considerations should not be a concern because the consent of the Reserve Bank is required before there is a departure from, or amendment to, the subordination arrangements. However I do not go so far as to say the Reserve Bank holds the benefit of the subordination covenants in trust for the senior creditors.

RISK WEIGHTING

Despite my flight into a discussion of subordination, we have dealt with the capital base element of the risk ratio. The other element is the aggregation of risk weighted assets and "off" balance sheet business, converted to balance sheet equivalents, and weighted according to risk.

There are five categories of risk weight - 0, 10, 20, 50 and 100 per cent. The central focus is credit risk (the potential risk of default) including country risk. The risk weights also take some account of the interest rate risk in holding government and other securities.

Attachment 1 of my paper sets out details of the Reserve Bank's risk weightings. They range from cash and claims on the Reserve Bank which attract a zero weight to 100 per cent weight for claims on non-bank private sector clients.

Claims which are guaranteed by or secured against claims on another party have the risk weight appropriate for that party such as governments or banks. For example a loan to a public company would carry a risk weight of 100 per cent. But if that loan were guaranteed by a State Government the risk weight would be only 10 per cent.

The approach to both credit risk and country risk is illustrated in the risk weighting accorded to dealings with merchant banks.

A risk weight of 20 per cent will apply to claims on merchant banks if guaranteed by a bank incorporated in OECD countries and countries which have concluded special lending arrangements with the IMF associated with the Fund's General Arrangements to Borrow (presently only Saudi Arabia). Twenty per cent also applies to claims with a residual maturity not exceeding one year which are guaranteed by a bank incorporated outside the OECD. It is interesting to speculate on what will be the nature and form of a general guarantee which the Reserve Bank will accept in this context. In the absence of a trustee, who can enforce a

guarantee? This question of course would not arise if the guarantee were a specific guarantee to the bank concerned.

Claims on merchant banks not covered by these arrangements are weighted at 50 per cent if:

1. the parent bank has provided the Reserve Bank with a letter of comfort committing support for the merchant bank, and

2. the parent bank's banking supervisor has confirmed that the parent bank and its merchant bank subsidiary are supervised according to the Basle capital adequacy framework.

Claims on the other merchant banks will attract a weight of 100 per cent.

Parentage is of enormous importance, which leads to another newspaper quote, this time from the West Yorkshire Chronicle and Echo.

> "Leeds Liberal MP Michael Meadowcroft wanted to table a question to the Home Secretary demanding to know how many men convicted of incest were related to their victims. The Table Office asked him to go away and think about it."

Off balance sheet business

Measurement of "off" balance sheet business involves two steps. First, the principal or face value amounts will be converted into "on" balance sheet equivalents ("credit equivalent amounts") by the application of a credit conversion factor. Attachment 2 sets out these credit conversion factors. Secondly, the resulting credit equivalent amounts will be risk weighted appropriate to the counterparty, or if relevant, the weight assigned to the guarantor or the collateral security.

A conversion factor of 100 per cent applies to obligations, such as financial guarantees or standby letters of credit serving as guarantees, which carry the same risk as a direct extension of credit. On the other hand documentary letters of credit, which are normally secured against an underlying shipment of goods, are self-liquidating and of fairly short term, are assigned a 20 per cent credit conversion factor.

The credit risk on interest rate, foreign exchange rate, and other market-related contracts is the cost to a bank of replacing the cash flow specified by the contract in the event of counterparty default. There are two ways of calculating the credit equivalent amounts for these contracts. First a current exposure on "mark to market" approach where the contracts are revalued regularly and secondly the original exposure or "rule of thumb" method. The types of contract and the two methods of calculation are set out in the Attachment 3.

EFFECT ON BANK PRICING

The introduction of risk based capital adequacy will affect the pricing of bank loans and "off" balance sheet business. But it also gives major borrowers the opportunity to structure their loan requirements to minimize cost impacts. Some banking services will cost more, others less.

Because banks need to earn a rate of return on capital which meets the expectations of shareholders, bank pricing will be affected by the amount of capital backing required for various services. Thus bank pricing will be affected by four factors:

1. the customer's risk weighting eg. government, bank or private sector;

2. the weighting of the "on" balance sheet asset or "off" balance sheet risk;

3. the term of the commitment (capital is required to support the undrawn portion of commitments extending beyond one year; the undrawn portion of such commitments is risk weighted at 50 per cent);

4. the weighting of any security.

Customers can minimize the impact of the new guidelines principally by shortening the term of the commitments they are seeking from their bank and by providing security, or in the language of the Reserve Bank collateral, which attracts a lower weighting than that accorded to a company.

Customers may consider these options:

1. shortening the maturity of revolving lines of credit (eg. overdrafts) to 12 months, reviewable annually, to avoid the cost imposed on the unused portion of facilities committed for a longer term;

2. structuring revolving requirements by segregating the fluctuating component (where a 12 month commitment, reviewable annually, could be appropriate) from core usage (where a longer commitment may be required);

3. lodgment of low risk weighted assets such as government securities as security for credit facilities, instead of borrowing on an unsecured basis. The Reserve Bank does not accept that the lodgment of bank bills as security will reduce the risk weighting.

INCREASED COST CLAUSES

The last question which should be considered is whether "increased cost clauses" apply to facilities where banks assess

that their costs of providing the facility have been increased as a result of their compliance with the Reserve Bank's capital adequacy guidelines.

Obviously the answer depends upon the wording of each particular clause. There are several observations to be made.

The Reserve Bank's guidelines do not have force of law, but compliance with such guidelines is in accordance with the practice of responsible bankers in Australia.

Does a clause which refers to "reserve or deposit requirements" being required by government policy, apply in a case where the policy of a central bank stipulates capital backing?

As the guidelines are still being developed, banks should not be prepared to give up increased costs which flow from the 23 August 1988 announcement.

In enforcing such clauses there may be difficulty for banks in quantifying increased costs to a particular transaction or indeed, determining the appropriate method of compliance with the guidelines in any particular case.

Does the clause impose an obligation on the bank to mitigate the effect of increased costs? If so is there an alternative method which would reduce the cost?

Finally these guidelines will develop and we must have the flexibility to respond to changes.

ATTACHMENT 1

RISK WEIGHTS

0% WEIGHT	-	CASH
	-	GOLD
	-	BALANCES WITH RESERVE BANK
	-	COMMONWEALTH GOVERNMENT SECURITIES NOT EXCEEDING 12 MONTHS
	-	LOANS FULLY SECURED BY CASH OR CGS
10% WEIGHT	-	OTHER COMMONWEALTH GOVERNMENT SECURITIES
	-	STATE GOVERNMENT SECURITIES
	-	LOANS TO, FULLY SECURED BY OR GUARANTEED BY COMMONWEALTH OR STATE GOVERNMENTS
	-	LOANS TO AUTHORISED MONEY MARKET DEALERS
	-	LOANS TO, SECURED BY OR GUARANTEED BY CENTRAL GOVERNMENTS AND CENTRAL BANKS OF OECD
	-	LOANS TO FOREIGN CENTRAL GOVERNMENTS AND FOREIGN CENTRAL BANKS DENOMINATED IN LOCAL CURRENCY FUNDED BY LOCAL CURRENCY LIABILITIES
20% WEIGHT	-	LOANS TO OR GUARANTEED BY AUSTRALIAN LOCAL GOVERNMENTS AND PUBLIC SECTOR ENTITIES (EXCEPT THOSE THAT HAVE A CORPORATE STATUS OR OPERATE ON A COMMERCIAL BASIS)
	-	LOANS TO OR GUARANTEED BY NON-COMMERCIAL PUBLIC SECTOR ENTITIES IN OECD COUNTRIES (EG. GAS, POST)
	-	LOANS TO OR GUARANTEED BY AUSTRALIAN AND OECD BANKS (CAPABLE OF EXTENSION ON A CASE-BY-CASE BASIS WITHIN ASIA-PACIFIC AREA)
	-	LOANS TO OR GUARANTEED BY NON OECD BANKS NOT EXCEEDING 12 MONTHS TO MATURITY
	-	LOANS TO, SECURED BY OR GUARANTEED BY INTERNATIONAL BANKING AGENCIES AND REGIONAL DEVELOPMENT BANKS
	-	CASH ITEMS IN THE PROCESS OF COLLECTION

50% WEIGHT - HOUSING LOANS WHERE LOAN IS FULLY SECURED BY MORTGAGE OVER THE PROPERTY AND PROPERTY IS OCCUPIED BY BORROWER OR IS RENTED

100% WEIGHT - CORPORATES

- PUBLIC SECTOR COMMERCIAL COMPANIES

- NON OECD BANKS EXCEEDING 12 MONTHS

- FIXED ASSETS

- INVESTMENTS

- OTHER ASSETS

RISK WEIGHTS IN RESPECT OF MERCHANT BANKS

20% WEIGHT - IF GUARANTEED BY AN OECD PARENT BANK

50% WEIGHT - COMFORT LETTER FROM PARENT BANK

- IF PARENT BANK AND ITS MERCHANT BANK SUBSIDIARY OPERATE UNDER BASLE CAPITAL ADEQUACY FRAMEWORK

100% WEIGHT - OTHER MERCHANT BANKS

- NON-BANK FINANCIAL INSTITUTIONS

OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

MEMBERS:

AUSTRALIA
AUSTRIA
BELGIUM
CANADA
DENMARK
FINLAND
FRANCE
GERMANY
GREECE
ICELAND
IRELAND
ITALY
JAPAN
LUXEMBOURG
NETHERLANDS
NEW ZEALAND
NORWAY
PORTUGAL

SPAIN
SWEDEN
SWITZERLAND
TURKEY
UNITED KINGDOM
UNITED STATES

and countries which have concluded special lending arrangements with the IMF associated with the Fund's General Arrangements to Borrow - currently Saudi Arabia.

The Reserve Bank indicated on 23 August 1988 that it would be prepared to consider, on a case-by-case basis, agreeing to comparable treatment being extended to banks incorporated in non-OECD countries of the Asian-Pacific area. Accordingly on 19 April 1989 the Reserve Bank announced that Hongkong and Shanghai Banking Corporation would attract the same risk weighting as OECD banks.

ATTACHMENT 2

OFF-BALANCE SHEET BUSINESS

CONVERTED TO ON-BALANCE SHEET EQUIVALENTS USING A CREDIT CONVERSION FACTOR

THEN ASSIGN RISK WEIGHT APPROPRIATE TO
- COUNTERPARTY
- GUARANTOR
- SECURITY

	CREDIT CONVERSION FACTOR
DIRECT CREDIT SUBSTITUTES	
GUARANTEES	100%
STANDBY LETTERS OF CREDIT SERVICING AS FINANCIAL GUARANTEES	100%
ENDORSED BILLS	100%
TRADE AND PERFORMANCE RELATED CONTINGENT ITEMS	
WARRANTIES, INDEMNITIES, PERFORMANCE BONDS AND STANDBY LETTERS OF CREDIT RELATED TO PARTICULAR TRANSACTIONS	50%
DOCUMENTARY LETTERS OF CREDIT SECURED AGAINST UNDERLYING SHIPMENT OF GOODS	20%
COMMITMENTS	
SALE AND REPURCHASE AGREEMENTS WHERE CREDIT RISK REMAINS WITH THE BANK	100%
FORWARD ASSET PURCHASES, AMOUNTS OWING ON PARTLY-PAID SHARES AND SECURITIES WHICH REPRESENT COMMITMENTS WITH CERTAIN DRAWDOWN	100%
NOTE ISSUANCES FACILITIES (NIFS) & REVOLVING UNDERWRITING FACILITIES (RUFS)	50%
FORMAL STANDBY FACILITIES AND CREDIT LINES	50%
- ONE YEAR OR LESS, OR WHICH CAN BE UNCONDITIONALLY CANCELLED AT ANY TIME	0%
- OVER ONE YEAR	50%

ATTACHMENT 3

INTEREST RATE/FOREIGN EXCHANGE RATE CONTRACTS AND OTHER MARKET-RELATED CONTRACTS (OFF-BALANCE SHEET)

- SINGLE CURRENCY INTEREST RATE SWAPS;
- BASIS SWAPS;
- FORWARD RATE AGREEMENTS;
- INTEREST RATE FUTURE CONTRACTS;
- INTEREST RATE OPTIONS PURCHASED;
- FOREIGN CURRENCY OPTIONS PURCHASED;
- CROSS-CURRENCY SWAPS (INCLUDING CROSS-CURRENCY INTEREST RATE SWAPS);
- FORWARD FOREIGN EXCHANGE CONTRACTS;
- CURRENCY FUTURES CONTRACTS;
- HEDGE CONTRACTS;
- CURRENCY OPTIONS PURCHASED;
- STOCK INDEX FUTURES; AND
- ANY OTHER INSTRUMENTS OF SIMILAR NATURE THAT GIVE RISE TO CREDIT RISKS, EG. FORWARD GOLD CONTRACTS WHICH WOULD BE TREATED AS A FOREIGN EXCHANGE INSTRUMENT).

THE FOLLOWING TYPES OF INSTRUMENTS ARE EXCLUDED:

- FOREIGN EXCHANGE CONTRACTS WITH ORIGINAL MATURITY OF FOURTEEN DAYS OR LESS; AND
- INSTRUMENTS TRADED ON FUTURES AND OPTIONS EXCHANGES THAT ARE SUBJECT TO DAILY MARK-TO-MARKET AND MARGIN PAYMENTS.

FOREIGN EXCHANGE, INTEREST RATE AND OTHER MARKET RELATED OFF-BALANCE SHEET TRANSACTIONS METHODS OF CALCULATION

CURRENT EXPOSURE METHOD (MARK-TO-MARKET APPROACH)

CREDIT EQUIVALENT AMOUNTS ARE REPRESENTED BY THE SUM OF CURRENT CREDIT EXPOSURE AND POTENTIAL CREDIT EXPOSURE:

(i) CURRENT CREDIT EXPOSURE

THIS IS THE MARK-TO-MARKET VALUATION OF ALL CONTRACTS WITH A POSITIVE REPLACEMENT COST.

(ii) POTENTIAL CREDIT EXPOSURE

THIS IS CALCULATED AS A PERCENTAGE OF THE NOMINAL PRINCIPAL AMOUNT OF A BANK'S PORTFOLIO OF INTEREST RATE AND EXCHANGE RATE RELATED CONTRACTS SPLIT BY RESIDUAL MATURITY AS FOLLOWS:

REMAINING TERM TO MATURITY OF CONTRACTS	INTEREST RATE CONTRACTS	EXCHANGE RATE CONTRACTS
LESS THAN ONE YEAR	NIL	1.0%
ONE YEAR OR LONGER	0.5%	5.0%

ORIGINAL EXPOSURE METHOD (RULE-OF-THUMB APPROACH)

CREDIT EQUIVALENT AMOUNTS WOULD BE CALCULATED BY APPLYING CREDIT CONVERSION FACTORS TO THE PRINCIPAL AMOUNTS OF CONTRACTS ACCORDING TO THE NATURE OF THE INSTRUMENT AND ITS ORIGINAL MATURITY.

ORIGINAL MATURITY OF CONTRACTS	INTEREST RATE CONTRACTS	EXCHANGE RATE CONTRACTS
LESS THAN ONE YEAR	0.5%	2.0%
ONE YEAR AND LESS THAN TWO YEARS	1.0%	5.0% (ie. 2% + 3%)
FOR EACH ADDITIONAL YEAR	1.0%	3.0%