Statement of the
Shadow Financial Regulatory Committee
on
Regulatory Proposals
for Risk-Related Capital Standards

February 9, 1987
(Revised May 18, 1987)

The Federal Reserve Board, the FDIC, Office of the
Comptroller of the Currency and the Bank of England have
published proposals for public comment to establish risk-
based capital adequacy standards to be applied to
consolidated bank holding companies and to banks. In
commenting on a similar proposal in June 1986, the Shadow
Financial Regulatory Committee applauded the agencies' con.
cern with this issue.

The new proposal makes an important additional advance by
including the Bank of England as a participant in the
program. The move to standardize the definition of primary
capital and international supervisory policies is an
important one reflecting the increased internationalization of
the world financial system. Moreover, the proposals make
a further advance in addressing important risk posed by off-
balance-sheet items. In addressing these risks, the agencies
correctly recognize that such risks are equivalent to risks
on the balance sheet and treat them symmetrically.

In commenting on the previous proposal, the Committee noted
several weaknesses and problems. The regulators have
addressed some, others remain, and a few new issues have
arisen.

MARKET VALUE REPORTING

Any risk-related capital or insurance premium system must be
based on an effective system for monitoring capital. The
proper measure of capital for regulatory purposes should be
the market value of assets less the market value of
nonsubordinated liabilities. The proposed capital guidelines
are based on historical values of assets and capital and are
therefore deficient.

MARKET DETERMINED RISK WEIGHTS

The proposal assigns weights to risk classes which do not
necessarily reflect risk premiums determined in financial
markets. The more that market-determined risk premiums are
used, the more objective and reliable risk-based capital
standards become. Their use also inhibits the tendency for asset weights to become the basis for non-market credit allocation, a tendency that would be fostered by the present proposal.

INTEREST RATE RISK

The proposal should include procedures for quantifying interest rate risk. While the agencies indicate that such a program is under development, the Committee supports the Comptroller of the Currency and the FDIC in opposing the categorical assignment of specific assets to a risk class because of interest rate risk characteristics rather than credit risk concerns. The degree of an institution's exposure to interest rate risk does not depend upon having particular assets in its portfolio. Rather, it is determined by the relative interest sensitivity of the institution's assets and liabilities considered together.

PORTFOLIO DIVERSIFICATION

The proposed scheme does not yet adequately recognize the value of diversification which is a function of the combination of assets and liabilities in a bank's portfolio. The weights to be given to individual assets and liabilities must take into account their marginal contributions to overall portfolio risk.