Statement No. 109

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Statement of the Shadow Financial Regulatory Committee

on

Financial Accounting Standard 115

May 23, 1994

Some banking representatives are campaigning to keep the market value requirements of FAS 115 from affecting the determination of bank capital ratios for purposes of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

The Shadow Financial Regulatory Committee views this campaign as part of a general effort to thwart the mandatory prompt corrective action provisions of FDICIA. Banking regulatory agencies demonstrated in the 1980s a general lack of political will to face up to widespread problems, so legislation to reduce discretion and mandate agency action was deemed desirable. The Committee continues to endorse that judgment.

FAS 115 requires banks to divide their securities portfolios into three categories -- trading account, available for sale, and held to maturity -- and applies different accounting rules to each. Securities held in trading accounts must be marked to market, and unrealized gains and losses are recorded in the institution's income statement and then flowed through to the capital account. Securities held for sale must be marked to market with unrealized gains and losses passed through directly to the capital account. Securities held to maturity are not marked to market but are valued at amortized historical cost; unrealized market gains and losses are not recorded at all.
The stated concern of some bankers is that, under a pending regulatory proposal, loss of value from interest rate increases in securities held for trade or sale would cause a number of banks to fall to a lower Tier 1 capital ratio category. Under FDICIA, this should trigger more stringent supervisory intervention, and even supervisory takeover if equity capital fell to as little as 2 percent.

The Committee believes the FAS 115 is open to valid criticism, for example on the grounds that it ignores loss of value in securities being held to maturity and applies to only one part of one side of the balance sheet. But that is no reason to undercut what it does accomplish, which is at least partial recognition of changes in the bank's economic capital.

Federal Reserve Board Chairman Greenspan has referred to such changes in a bank's economic capital as "short-run effects." The Committee regards the assumption of quickly self-reversing interest rate changes as imprudent. Any interest rate shift may reverse, go further, or be stable for a significant period of time. A bank should have sufficient capital to deal with all these contingencies, not just the most favorable one.

The Committee supports adoption of the pending regulatory proposal to reflect FAS 115-required changes in Tier 1 bank capital for purposes of prompt corrective action. The Committee also hopes that this proves a step toward a broader use of mark-to-market valuation.