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Statement of the Shadow Financial Regulatory Committee on

Final Rules on Incorporating Concentrations of Credit Risks Into Risk-Based Capital Standards

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The federal banking agencies and the Office of Thrift Supervision recently promulgated a final rule implementing the requirement of Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This rule requires that the risks from credit concentration be incorporated into the risk-based capital standards. The method adopted relies upon examiner discretion to consider these risks subjectively rather than upon specification of numerical risk weights that would parallel the Basle approach to credit risk.

Two reasons are advanced for taking a discretionary approach.\(^1\) The first is that current methods for identifying and measuring concentration risks are not sufficiently advanced to justify their use. The second is that sufficient data for estimating risk weights are not available.

Whatever the merits of these problems, the Shadow Financial Regulatory Committee believes that the proposed reliance upon examiner discretion should be, at best, an expedient and temporary solution. It should not be a permanent substitute for a more considered approach to encouraging adequate diversification -- the obverse of concentration -- for insured institutions.

\(^1\) The rule also treats the risks of new activities in the same way but provides little discussion in its accompanying statement.
At a certain level of abstraction, risk should be defined in terms of the expected covariances of cash flows across assets and liabilities. Unfortunately, as mentioned previously, the current lack of adequate historical data on asset returns, loss experience and liability costs makes development of reliable risk weights impossible. Several alternatives could and should be explored over time, which might reduce examiner discretion and make the implementation of concentration guidelines more transparent and replicable.

The agencies should continue to research the feasibility of measuring covariance effects using samples of assets and liabilities and their performance. At the same time, interim measures of asset risk concentrations should be explored on the basis of existing available asset and liability categories to aid in the identification of potential problems within institutions. Finally, methods for determining the vulnerability of an institution's capital to alternative adverse shocks to its loans, in particular lines of business or within specific geographic areas -- so called stress tests -- should be further developed as tools for examiners.

The problem of ensuring adequate diversification raises different, but important, issues for large banks than for small banks. For large banks the issues center primarily on devising methods to measure and economically monitor the effects of concentration on an institution's net worth.

For smaller banks, whose business is almost by definition concentrated, the problem is not one of measuring diversification but devising methods to encourage diversification. This need exposes fundamental conflicts between taxpayers' interests in ensuring bank safety and soundness and other public policies designed expressly to promote asset and geographic concentrations to achieve what are apparently viewed as socially desirable allocations of credit, such as the Community Reinvestment Act, the Qualified Thrift Lender test, and the remaining limitations on interstate banking. Legislated mandates to serve "local" communities can prevent diversification and impose unrecognized costs, which can extend beyond bank stockholders to the taxpayer in the event of failure. Such exposures need to be measured and managed explicitly.