Shadow Financial Regulatory Committee
Administrative Office:
Th Mid America Institute
5 South Harper Street
Suite 107
Chicago, Illinois 60615
(312) 493-9800

Committee Members:
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Co-Chair
Prather, Seeger, Doolittle, & Farmer
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Stanford Law School

Statement by the

Shadow Financial Regulatory Committee

on

Proposals for Risk-Related Capital Guidelines

June 9, 1986

The Federal Reserve, the FDIC and the Comptroller of the Currency have proposed risk-based capital adequacy guideline for bank holding companies and for member and non-member banks. Concern with this issue is welcome.

First, any risk-related capital or insurance premium system must be based on an effective system for monitoring capital. The proper measure of capital is the market value of assets less the market value of nonequity liabilities. The proposed capital guidelines are based on historical values of assets and capital and are, therfore, deficient. Reporting of current market values should be the first step in the development of capital guidelines.

Second, the proposals assign arbitrary weights to risk classes instead of weights reflecting the market valuation of risk. The more that market valuations are used, the more objective and reliable risk-based capital standards become. The use of market values also inhibits the tendency for asset weights to become the basis for non-market credit allocation.

Third, the proposal should require the quantification of interest rate risk and should use these measures to develop capital guidelines. Maturity or duration-based systems for quantifying interest rate risk exposure are now in use in many institutions and should be adopted by regulators.

Fourth, the proposed weighting scheme does not adequately recognize diversification, a fundamental principle of finance. The risk borne by a financial institutuion can be changed by diversification as well as by the choice of individual projects, and be leverage. The proposed weighting system concentrates on interaction between leverage and the risk of individual projects but neglects the role of diversification within and among assets groups.

Fifth, the proposals make a useful first step toward recognizing some important risks that do not appear on current balance sheets. Such risks are equivalent to risks on the balance sheet and should be treated symmetrically.

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