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

Statement by the

Shadow Financial Regulatory Committee

on

Proposals for

Capital Forbearance Policy for Agricultural and Energy Banks

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In response to the financial difficulties in the agricultural and energy sectors of the economy, the Federal Reserve Board, Federal Deposit Insurance Corporation, and Comptroller of the Currency have recently announced a joint program of capital forbearance for agricultural and energy banks in which the agencies will not enforce the 5 1/2 percent minimum primary capital-to-asset requirement for qualifying banks for up to seven years if the ratio does not decline below 4 percent. This program permits lowering capital requirements precisely when they are most needed. Because bank capital is already low by historical and regulatory standards, we believe that this program is unwise and will prove counterproductive in the long run.

Bank capital represents funds that shareholders have at risk and which they attempt to protect by exerting discipline on bank management. Such discipline is particularly important at smaller banks whose deposits fall almost entirely within the FDIC's $100,000 insurance limit and thus are not subject to market discipline by uninsured depositors. As recent experience from the thrift industry clearly indicates, when capital declines to the point where owners have very little to lose, institutions are encouraged to "go-for-broke" in an attempt to replenish equity quickly. Few such gambles pay off, and losses to the federal deposit insurance agencies, and eventually the taxpayer, will be larger than otherwise.

A requirement for eligibility in the program is that a bank be both well managed and experiencing temporary losses. Such banks, however, should have little difficulty in raising additional capital, particularly if shareholders and management are provided with the incentive to do so by fear of losing control of the bank. Raising additional capital may take some time, and during this time it is appropriate for a bank to be permitted to operate with lower capital. But the time permitted to replenish capital should be closer to seven weeks that to seven years as permitted under the program. Longer-term capital forbearance is a program of forbearance for bank management and owners. It is of little benefit for bank customers.

We also see little value in Statement of Financial Accounting Standards No. 15 (FAS 15), which forestalls recognition of losses on restructured troubled loans as long as the total of future payments, as rescheduled, is not less that the recorded principal value of the loan. This primarily substitutes future income losses for current capital losses. We favor prompt recognition of losses by banks even if this results in lowering recorded net worth and we support actions by the bank regulatory agencies to this end.