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Shadow Financial Regulatory Committee

Comments on Federal Loan Bank Board (FHLBB) Proposed Rules on Regulatory Capital and Nationwide Lending by Insured Savings and Loan Associations

August 5, 1987

The FHLBB has proposed rules that would: (1) change the way insured savings and loan associations' (SLAs') capital is measured; Increase the equity capital required of SLAs to six percent over six years, (3) impose additional capital requirements on certain activities, and (4) regulate and restrict their lending to 100 miles from their office location. We share the FHLBB's concern that some SLAs take risks that impose potentially large losses on the already inadequate Federal Savings and Loan Insurance Corporation (FSLIC) fund. Ultimately these losses may be borne by the taxpayers. But we disagree with some important portions of the proposed rules.

We applaud the FHLBB's move towards measuring capital with generally accepted accounting principles (GAAP). We urge, though, that this change be accompanied by recourse to more realistic and useful market-value accounting. We also applaud the FHLBB's program to increase significantly the level of capital for SLAs. SLA managers and owners who have substantial amounts of their own capital invested tend to be relatively more prudent in the activities they undertake. Consequently, there is less need to regulate them closely. We urge that the FHLBB also give greater consideration to developing deposit insurance premiums that reflect the risks taken by SLAs, as discussed in our June 8, 1987 comment, "Proposals for Risk-Related Capital Guidelines."

Unfortunately, the FHLBB seems unwilling to rely primarily on the higher capital requirements it has proposed. Instead it would impose additional regulations that arbitrarily restrict direct investments (DI) and nonresidential construction and land loans (NRCLL). The proposed rule would impose an additional 10% capital requirement on DIs (for a total of 16%) and 4% on NRCLLs (for a total of 10%), while continuing a previously enacted regulation that limits DIs to 10% assets or twice equity absent the specific approval by the agency. The implicit risk-rating inherent in these percentages is arbitrary and is unsupported by empirical research or practical experience. While restrictions on those SLAs without adequate real capital may be warranted, adequately capitalized and managed SLAs should be allowed to

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function without special constraints; it is sufficient that such firms merely be subject to oversight by state and federal regulators and supervisors. Imposition of restrictions on specific assets is counterproductive because it (1) inhibits well-capitalized and well-managed SLAs' pursuit of profitable and potentially risk-reducing activities, (2) is insufficient to control the other SLAs whose managers have incentives to "bet the bank," for which purpose they can use a wide range of unconstrained activities, and (3) interferes with the efficient allocation of resources. On the other hand, insolvent institutions should be closed and near-insolvent SLAs should be specially monitored.

The proposal to restrict nationwide lending suffers from the same defects. We acknowledge that some loan participations and sales can present serious problems. But the proposed rule overly constrains well-capitalized and well-managed SLAs and importantly limits potentially risk-reducing geographical diversification, while inadequately controlling SLAs predisposed to take excessive risks. It also would impose costs on the free and effective movement of capital, that would hurt both borrowers and depositors. We suggest that the Bank Board can deal with the problem by adopting a policy statement requiring adequate documentation and monitoring for all loan participations, similar to that adopted by the Office of the the Comptroller of the Currency.

Indeed, we urge that the Bank Board not try to attempt to adopt rules that restrict the activities of all associations. Rather, general policies should be adopted that provide associations with incentives and opportunities to increase their capital and reduce potential costs to the FSLIC.