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

Statement of the

Shadow Financial Regulatory Committee

on

Regulatory Proposals for Risk-Related Capital Standards

February 9, 1987
(Revised May 18, 1987)

The Federal Reserve Board, the FDIC, Office of the Comptroller of the Currency and the Bank of England have published proposals for public comment to establish risk-based capital adequacy standards to be applied to consolidated bank holding companies and to banks. In commenting on a similar proposal in June 1986, the Shadow Financial Regulatory Committee applauded the agencies' concern with this issues.

The new proposal makes an important additional advance by including the Bank of England as a participant in the program. The move to standardize the definition of primary capital and international supervisory policies is an important one reflecting the increased internationalization of the world financial system. Moreover, the proposals make a further advance in addressing important risk posed by off-balance-sheet items. In addressing these risks, the agencies correctly recognize that such risks are equivalent to risks on the balance sheet and treat them symmetrically.

In commenting on the previous proposal, the Committee noted several weaknesses and problems. The regulators have addressed some, others remain, and a few new issues have arisen.

MARKET VALUE REPORTING

Any risk-related capital or insurance premium system must be based on an effective system for monitoring capital. The proper measure of capital for regulatory purposes should be the market value of assets less the market value of nonsubordinated liabilities. The proposed capital guidelines are based on historical values of assets and capital and are therefore deficient.

MARKET DETERMINED RISK WEIGHTS

The proposal assigns weights to risk classes which do not necessarily reflect risk premioums determines in financial markets. The more that market-determined risk premiums are used, the more objective and reliable risk-based capital standards become. Their use also inhibits the tendency for asset weights to become the basis for non-market credit allocation, a tendency that would be fostered by the present proposal.

INTEREST RATE RISK

The proposal should include procedures for quantifying interest rate risk. While the agencies indicate that such a program is under development, the Committee supports the Comptroller of the Currency and the FDIC in opposing the categorical assignment of specific assets to a risk class because of interest rate risk characteristics rather than credit risk concerns. The degree of an institution's exposure to interest rate risk does not depend upon having particular assets in its portfolio. Rather, it is determined by the relative interest sensitivity of the institution's assets and liabilities considered together.

PORTFOLIO DIVERSIFICATION

The proposed scheme does not yet adequately recognize the value of diversification which is a function of the combination of assets and liabilities in a bank's portfolio. The weights to be given to individual assets and liabilities must take into account their marginal contributions to overall portfolio risk.
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