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Supplementary Statement of the Shadow Financial Regulatory Committee

on

Regulatory Proposals for Risk-Related Capital Standards

May 18, 1987

On March 31, 1987, the FDIC published for public comment a jointly sponsored proposal with the Federal Reserve Board, the Office of the Comptroller of the Currency and the Bank of England to establish risk-based capital adequacy standards to be applied to banks and consolidated bank holding companies. The Shadow Financial Regulatory Committee commented previously on these proposals, and a modified version of our previous statement is attached. There are two additional points that should be considered before the proposals are adopted.

Risk Taking Incentives

To control excessive risk taking incentives inherent in the present flat rate deposit insurance system, regulators need to rely upon regulation and capital policy. To the extent that the proposed risk-weights do not reflect market-determined risk pressure or the risks are too broad, incentives are created to avoid the proposed capital constraints and increase risk exposure.

In the present proposal, all loans are treated the same, regardless of whether the borrower is a AAA or BBB. Thus, an AAA credit would bear the same capital requirement as a BBB credit. To avoid inducing institutions to decrease their holdings of lower risk relative to higher risk loans, there need to be more explicit considerations that some loans, by virtue of their terms, maturity and credit quality, have different exposures to risk than others, and hence, should bear different capital requirements.

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The proposal may also discourage securitization of assets, since partial guarantees would have the same capital requirement as if the loan had been retained on the books, regardless of the extent of the guarantee. However, some of the loss guarantees on securitized transactions cover losses up to a fixed proportion of assets. Under normal circumstances, these percentages may exceed historic loss rates on such assets, and in such instances, we feel that treating such guarantees as equivalent to loans is entirely appropriate.

Bank Holding Company Capital Policy

The proposals pose an interesting set of problems in view of a recent policy of the Federal Reserve announced on April 24, 1987 concerning bank holding company responsibility for maintaining the financial strength of bank subsidiaries. The policy of drawing on the parent company and its nonbank subsidiaries to prop up ailing bank subsidiaries makes bank capital adequacy determination a function of not only the risks within subsidiary banks but also of the capital strength of the rest of the organization as well. In addition, such a policy means that the agencies must not only monitor the condition of bank subsidiaries but the rest of the company to determine capital adequacy of bank subsidiaries.

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