Shadow Financial Regulatory Committee

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Statement No. 29

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Statement of the Shadow Financial Regulatory Committee

on

Regulatory Proposal for Risk-Related Capital Standards

February 8, 1988

On January 27, 1988, the federal bank regulatory agencies released a revised proposal concerning risk-based capital adequacy standards. This new proposal, which is very similar to one put forward in February 1987, follows as a response to the December 1987 Basle Committee proposal for risk-based international capital standards. The chief differences between the present proposal and its predecessor are its focus on core capital, a relaxation of capital requirements applied to particular assets, and imposition of an additional minimum standard to be phased in by 1992.

These capital proposals have two objectives: (1) to increase the level of capital in banking organizations and (2) to reduce supposed inter-country competitive advantages created by differential regulatory capital standards.

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On the first point of increasing the level of capital, which the Committee believes is the more important and pressing issue, the impact of implementing the standard is unclear. No evidence or analysis is provided on the net effects of application of the proposed standards on the existing adequacy of capital (as defined) in the banking industry or on the distribution of equity across different classes of banks.

On the issue of competitive equity, the committee questions whether it will be achieved by the proposal, given the arbitrary way that weights are assigned on asset classes. Furthermore, individual country supervisors have substantial discretion to determine which assets belong to which particular risk classes and to define supplementary capital.

In commenting on the previous proposal, the Committee noted several other weaknesses and problems. Some of these have been addressed in this proposal, other problems remain, and some new issues have arisen.

First, a proper 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 the assets less the market value of non subordinated liabilities. The proposed guidelines are based on

historical values of assets and capital and are therefore defective.

Second, the proposals still assign essentially arbitrary weights to risk classes which are not supported with evidence on either market valuations of risk or historical loss experience in different classes of assets. Arbitrary asset weights become the basis for non-market credit allocation.

Third, the proposal focuses only on credit risk. Efforts should also proceed to recognize the importance of interest rate risk. Interest rate risk has been a substantial problem in the past and remains a significant concern.

Fourth, the risk ratings of particular asset categories do not sufficiently reflect the wide dispersion of risks that may exist within a given risk class. This is particularly a problem for the treatment of the lower weights assigned to municipal obligations.

Finally, the proposed weighting scheme does not recognize the value of diversification. The risk borne by a financial institution can be changed by diversification as well as by the choice of individual projects and leverage.