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Statement No. 40

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Statement of the Shadow Financial Regulatory Committee on

Risk-Based Capital and Early Intervention Proposal of Federal Home Loan Bank Board

February 13, 1989.

The Federal Home Loan Bank Board has proposed capital requirements for savings and loan associations that are based on the associations' risk exposure. More importantly, they would define a minimum level of capital for purposes of intervention to force reorganization of undercapitalized associations. This proposal represents a first step in the right direction.

The risk-based capital proposal follows the lead of the bank regulatory agencies, which have imposed similar requirements on commercial banks. In its past policy statements, the Committee has criticized aspects of the banking agencies' proposal: in particular, its failure to use market values in sorting institutions into risk classes. This failure leads to arbitrary incentives for institutions to direct credit to or away from particular sectors. The same problem exists with the Bank Board's proposal. Unlike the bank regulatory agencies, however, the Board explicitly recognizes interest rate risk, for which it is to be commended.

An early intervention rule is more important than risk-based capital standards and represents good public policy. Suitably modified, implementation of the Board's proposal would simplify and enhance the supervisory process, and could make the risk-based capital standards unnecessary. The 1.5 percent capital/asset ratio, measured by GAAP, that may initiate regulatory intervention by the Board is too low. Because of the differences between GAAP valuation and market

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valuation, the institution may at the proposed intervention point actually be insolvent on a market value basis and thus impose losses on the FSLIC. In addition, because of delays and inaccuracies in monitoring, by the time that this level of capital is recognized by the Federal Home Loan Bank Board and action can be taken, the institution may have depleted its capital further. Thus, the threshold capital/asset ratio should be increased substantially.

To make the intervention process more effective, it is desirable to introduce a structure of explicit capital/asset tranches, requiring progressively increasing supervision and more restricted operations by the institution. This would establish predictable regulatory discipline and discourage institutions from reducing their capital to low levels. An example of such a structure is provided in the Shadow Financial Regulatory Committee's February 13, 1989 Policy Statement No. 41, "An Outline of A Program for Deposit Insurance and Regulatory Reform." It is important that the tranches be very specific, that enforcement be mandatory and that forbearance from intervention not be granted.