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Statement No. 50

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Statement of the Shadow Financial Regulatory Committee

on

Federal Reserve Board Proposed Transition

Capital Standards for Member Banks

December 4, 1989

The Federal Reserve Board's proposal for a 3% minimum leverage requirement, to supplement risk-based capital standards for commercial banks, provides yet another example of the banking authorities' continued resistance to raising bank capital requirements. The Committee is convinced that common adoption of the 3% minimum leverage requirement will foster an undesirably low level of capital in the banking system. The Committee previously noted in its proposal for restructuring the banking system (Statement No. 41, February 13, 1989) that the major problem in the banking system is inadequate capital at even the strongest banks. We have repeatedly argued that capital ratios for all institutions should be raised above their current levels.

By introducing a supplementary requirement, the banking regulators implicitly recognize that their risk-based capital system may not provide sufficient capital to secure their safety and soundness objectives. A well-conceived, risk-based standard would not require an additional leverage constraint.

The Board's proposal fails to address at least two other important issues. First, as emphasized in the Committee's policy statement on the Comptroller of the Currency's proposed minimum leverage standard (Statement No. 44, September 18, 1989), capital is still being based on historical costs rather than being measured in current market value terms. Institutions with a low positive book value of equity could even have negative economic net worth. Consequently, this mismeasurement problem would permit institutions, lightly capitalized in economic terms, to leverage themselves excessively and pose great risks to the deposit insurance

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fund. Second, meaningful capital standards would indicate precisely the actions regulators must take when institutions fail to meet the standard. As the S&L debacle demonstrates, unmet capital requirements must be followed immediately with effective regulatory responses such as mandatory recapitalization or reorganization. Otherwise they are equivalent to no capital standards at all.