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Statement of the Shadow Financial Regulatory Committee

on

Using Risk-Related Capital Standards to Promote Housing

February 17, 1992

In several previous statements (No. 6, June 9, 1986; No. 18, May 18, 1987; and No. 29, February 8, 1988) the Shadow Financial Regulatory Committee commented on banking agency proposals to increase bank capital requirements and to establish risk-related capital standards. We urged modifying the proposed risk-based standards because assets were assigned to risk classes by arbitrary weights based neither on reproducible market valuations nor on historical loss experience. In the absence of truly market-based risk measures, the Committee worried that the standards might result in government credit allocation and induce banks to take greater risks.

These concerns have been realized. The recently passed "Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991" (Pub. L. 102-233)[1] attempts to stimulate housing construction by lowering bank capital requirements for several types of real estate loans. Specifically, the

[1] House Banking Committee Chairman Gonzalez's recently introduced bill, The Emergency Community Development Act of 1992 (H.R. 4073), contains similar language.

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regulatory agencies are directed to place single-family "presold" home construction loans and loans to finance multifamily properties in the 50-percent risk category instead of the 100-percent category. The effect is to lower the required amount of capital to be held against these loans from 8 percent to 4 percent.

Proponents of this legislation offer no evidence that these loans are less risky than other loans in the 100 percent risk category. In fact, both types of loans can be very speculative investments. "Presold" home construction loans are too often made with minimal down payments and often default at the very time the commitments have to be funded. During the current recession, multifamily construction has experienced significant default rates due to speculative overbuilding.

Setting capital requirements at inappropriately low levels amounts to mandatory capital forbearance and credit allocation. We oppose congressional attempts to relax prudential standards by legislatively assigning assets to risk classes to promote macroeconomic policy objectives. Such efforts represent an undesirable intrusion into and redirection of the supervisory activities of the banking agencies.

Reduced capital requirements on certain assets can induce increased risk taking with all its undesirable consequences, including increased costs to taxpayers and a general weakening of depository institutions. Such attempts are an undesirable government intervention in credit allocation. We believe that better and more direct methods exist to stimulate housing construction -- if that were desirable -- that would not place the taxpayer at greater risk by perverting the supervisory objectives of the banking agencies.