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Statement No. 88

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Statement of the Shadow Financial Regulatory Committee

on

Proposed Rule on Interbank Exposure

September 14, 1992

The Shadow Financial Regulatory Committee has expressed its concern in past policy statements that the FDIC Improvement Act (FDICIA) grants the bank regulatory agencies excessive discretion with respect to when to trigger prompt corrective action and how to determine the least-cost method of insolvency resolution (Statement No. 76, December 16, 1991). Most worrisome is the discretion to declare a bank a source of systemic risk, which can be used to justify protecting all depositors, including other banks, at institutions the FDIC considers "too important to fail." This latitude provides the rationale for regulating limits on interbank exposure. The Committee urges the regulators to foreswear the use of this discretion so that such regulations would not be necessary. Indeed, banks whose funds are at risk are, by their very nature, well suited to monitor other banks.

To implement Section 308 of FDICIA, federal bank regulatory agencies have proposed limits, effective at year-end 1992, on a bank's credit exposure (principally interbank placements, correspondent balances and sales of federal funds) to other banks that are not classified as "well capitalized." This classification is currently defined as risk-based capital in excess of 10 percent and tier 1 leverage in excess of 5 percent. Banks are restricted to having an exposure of no more than 50 percent of their total capital to banks that are "adequately capitalized" (currently defined as risk-based capital of 8 to 10 percent and tier 1 leverage of

4 to 5 percent) and to having no more than 25 percent of capital to "undercapitalized banks" (less than 8 percent risk-based capital and 4 percent tier 1 leverage). Adequately and undercapitalized banks account for some 10 percent of all banks, holding about 45 percent of total bank assets.

Unfortunately, the proposal specifies these lending restrictions in terms of the book value of a bank's net worth. The Committee has repeatedly emphasized that to be effective all restrictions related to capital need to be expressed in terms of the market value of a bank's net worth.

In general, the proposed regulations do not appear to impose undue burdens on the banks relative to the potential cost savings to the FDIC fund. They also encourage large banks that are not well capitalized to strengthen capital positions in order to maintain their interbank business.