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Statement of the Shadow Financial Regulatory Committee on Safety and Soundness Standards

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The four federal banking agencies last month issued a proposed rule on safety and soundness standards for insured depository institutions, as required by Section 132 of the FDIC Improvement Act (FDICIA) of 1991. Section 132 was included in the Act largely to supplement the capital standards for prompt corrective action. The standards cover three areas: operations and management; asset quality, earnings and stock valuation; and employee compensation.

Both during consideration of FDICIA by Congress and after its enactment, the banking agencies displayed a marked lack of enthusiasm for the requirement to promulgate standards. The agencies and the banking industry deplored the possible transformation of supervisors into micro-managers of banks as unworkable and counter-productive.

The proposed rule negates that possibility by staying away from detailed or specific requirements, and prescribing the use of common sense and good judgment. Thus, internal controls must be "appropriate," the internal audit system must be "adequate," loan documentation should enable an "informed" lending decision, and credit underwriting practices should be "prudent." There is a prohibition of "unreasonable" or "disproportionate" employee compensation. It is hard to disagree, but it is also hard to find much of operational value in such guidance.

Only in one area -- that of asset quality, earnings and stock valuation -- is there any use of quantitative standards. The standard for the maximum ratio of classified (substandard and doubtful) assets to total capital plus loan loss reserves is set at the rather generous level of 100%, while the minimum earnings standard is only that one year of losses could be followed by another of the same amount without causing the institution to fail its minimum capital requirements. As for the statutory suggestion of establishing a minimum market value to book value ratio, it is dismissed as not feasible and indeed perverse.

The proposed rule avoids the extreme on one end of micro-management by going generally to the extreme on the other end of vaporousness. Those were never the only two choices. The point is illustrated by the one area (of asset quality and earnings standards) where the rule becomes clearer and more precise. Failure to meet such a standard is not visited with any draconian sanction, but merely becomes a signal of a possible problem, requiring the institution to submit, and the agency to review, a plan that explains and addresses the problem. Similarly, the failure to meet a prescribed minimum ratio (say, 75%) of market-to-book value of stock could have been used as a signal that the agency would undertake to inquire into the reasons that the trading market seriously disagreed with the accounting values shown on the institution's financial statements.

The point is that clearer standards, rather than confining the discretion of the bank's management, could be used to clarify the thinking, procedures and responses of the supervisors. Indeed, in the hearings on FDICIA Congress displayed considerable concern with how the supervisory agencies had exercised (or failed to exercise) their power and discretion in the past. That is the issue that the banking agencies could have addressed in their proposed standards. Unfortunately, they have failed to take any advantage of that invitation, and issued instead a proposed rule largely devoid of meaning.