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Statement of the Shadow Financial Regulatory Committee

on

Regulatory Agency Measurement of Bank Capital for Prompt Corrective Action

December 12, 1994

The bank regulatory agencies recently ruled that banks need not include changes in the market value of their securities held-for-sale in calculating their regulatory capital position. By contrast, the Financial Accounting Standards Board (FASB) has required in its Statement 115 that securities classified as being available-for-sale be marked to market. In the absence of the agencies' ruling, therefore, banks would have been required to include unrealized gains and losses in their available-for-sale portfolios in the calculation of their regulatory (Tier 1) capital. Furthermore, Statement 115 requires companies to disclose the market value of securities that they presumably will hold to maturity. These reported changes could (and should) also enter into the calculation of regulatory capital.

The Shadow Financial Regulatory Committee believes that the accounting treatment of available-for-sale securities by the agencies is dangerous. The primary role of bank capital is to absorb losses before they endanger the par value of deposits. Losses, whether realized or not, reduce the availability of capital to protect depositors. Failure to require an accurate measure of capital for purposes of prompt corrective action weakens the effectiveness of such measures and increases the probability of bank failures, with

potential attendant losses to the deposit insurance fund.

The regulators supported their ruling by arguing that most decreases in the market value of debt securities are due to increases in interest rates, which, they presume, are only temporary and likely to be reversed. Thus, they argue, the use of market value accounting introduces "significant and unnecessary" volatility in the measurement of bank capital. The Committee believes that the proposed regulatory accounting treatment of securities portfolios does nothing to eliminate the true underlying volatility in the portfolio. Rather, it represents a type of forbearance reminiscent of similar arguments that were made by the regulators in the early 1980s as justification for refusing to require a rebuilding of capital by much of the savings and loan industry, whose economic capital had been effectively wiped out by a sharp rise in interest rates. This forbearance contributed to the eventual $150 billion loss to the former Federal Savings and Loan Insurance Corporation (FSLIC) that had to be paid by the taxpayers. It should now be obvious that regulators have no greater insights into future rate movements than other market participants.

Some regulators also argue that marking only part of one side of the balance sheet to market is inappropriate and misleading. The Committee agrees and believes that all assets and liabilities should be marked to market and that marking securities available-for-sale to market represents a useful step.