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Statement of Shadow Financial Regulatory Committee

on

Values of Bank Capital Tripwires for Prompt Corrective Action and Least Cost Resolution

December 11, 1995

The FDIC Improvement Act (FDICIA) of 1991 emphasizes the importance of capital tripwires for federally insured banks and thrifts for purposes of prompt corrective action and least cost resolution to reduce both the frequency and cost of bank failures and to protect the deposit insurance fund. Capital provided by private shareholders serves as a layer of self insurance and reduces the potential need for tapping public capital provided by taxpayers.

FDICIA establishes five capital categories corresponding to increasingly stringent supervisory measures. The levels for each relevant capital category are determined by the appropriate federal banking agency. In 1992, the regulatory agencies set the following capital levels:

CAPITAL RATIOS
(Percent)

	Risk-Based[a]		Leverage[b]
	Total	**Tier 1[c]**	**Tier 1[c]**
Well capitalized	>10	>6	>5
Adequately capitalized	>8	>4	>4
Undercapitalized	<8	<4	<4
Significantly undercapitalized	<6	<3	<3
Critically undercapitalized			<2[d]

[a] Risk weights determined by banking agencies.
[b] Capital-to-assets ratio.
[c] Basically equity.
[d] Tangible equity.

In part, the values of these capital tripwires were constrained by the poor financial condition of the institutions in 1991. At that time, banks holding 25 percent of all commercial banking assets were classified as undercapitalized, and thrift institutions were in even poorer condition. The Shadow Financial Regulatory Committee criticized these threshold values on the grounds that they were below the levels that the market would require uninsured institutions to maintain and focuses on book (historical acquisition cost) value to measure capital rather than on the more relevant market (current) value (see Statements 84, 95, and 112). But, the financial condition of insured depository institutions has improved greatly since 1992. At mid-year 1995, a negligible percentage of both banking and thrift institution assets were held by institutions classified as undercapitalized.

The levels of accounting capital currently maintained by most institutions are considerably greater than the tripwire values for well capitalized institutions. This provides an opportunity to raise the levels of the capital tripwires closer to those that the market would demand of noninsured institutions to prevent troubled institutions from imposing losses on creditors. For these institutions, use of accounting leeway makes accounting capital increasingly overstated as its reported value shrinks. Accordingly, the Committee recommends that the values of the capital tripwires for each category be raised by at least one percentage point effective mid-year 1996.

The recommended increase would demote only few institutions into the undercapitalized category and these are the institutions that pose the greatest threat of escalating losses for the Fund. Increasing capital ratios at the nation's undercapitalized institutions will better protect the deposit insurance fund and reduce cross-subsidization of troubled institutions by financially healthy institutions.

The need to raise the values of the capital ratios for both prompt correction action and least cost resolution purposes is particularly important given the FDIC's decision to effectively eliminate insurance premiums for well-capitalized and well-managed BIF insured institutions (see Statement 127).