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Statement of the Shadow Financial Regulatory Committee

Whatever Becomes of Basel II, Prompt Corrective Action and the Leverage Ratios Should be Preserved

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Last spring, 26 of the largest US financial holding companies completed a survey designed to measure the quantitative impact of the evolving Basel II proposal on risk-adjusted capital requirements for banks. The results of this fourth quantitative impact study (known as QIS4) proved troubling in at least two respects. First, despite the Basel Committee's announced intent to maintain the average required level of capital in the system, QIS4 revealed a surprisingly large drop at many banks in the amount of capital that the Basel formulas would require. Indeed, relative to levels of capital dictated by Basel I (the original Accord), under Basel II capital requirements would fall by more than 25 percent for more than half of the banking organizations in the survey. Second, the dispersion of results across banks and across portfolio types was much larger than anticipated. This wide variation in effects raised concerns about unfair regulatory-induced distortions of competition and about the adequacy of the models and data used. These concerns led the U.S. federal bank regulatory agencies to defer the notice of proposed rule-making necessary to implement Basel II until the results of QIS4 could be better understood and a fifth impact study undertaken.

Before the results of the QIS4, the Federal Reserve Board had expressed doubts about whether the current leverage requirements would have a role to play once Basel II was fully implemented. Indeed, one governor—Governor Bies—was quoted as saying "The leverage ratio down the road has got to disappear."

Eliminating the current leverage-ratio requirements would greatly alter the character of the current Prompt Corrective Action (PCA) rules. The rules established in the FDIC Improvement Act of 1991 require U. S. bank capital positions to meet three tests: an overall leverage test based on the ratio of Tier 1 capital (primarily stockholder equity) to total assets and two ratios based on risk-weighted assets (the risk-based capital tests). The variation shown in Basel II risk-based capital requirements implies that if Basel II were adopted, the leverage test would become the binding constraint for many institutions. In fact, Federal Deposit Insurance Corporation (FDIC) analysis of the QIS4 survey data shows this. If the 26 bank holding companies in the survey met only their Basel II requirements, 17 of the 26 organizations would be undercapitalized based on current PCA leverage requirements for their banks. This suggests that the Basel II framework is likely to ease capital standards if the leverage ratio were abandoned.

Last month, during Senate hearings regarding the QIS4 and Basel II, Governor Bies joined leaders of three other regulatory agencies in endorsing the need to continue to apply the current leverage-ratio requirements. Moreover, in the joint advance notice of proposed rulemaking regarding modifications of Basel I, issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC and the Office of Thrift Supervision, the agencies stated that they "are not proposing revisions to the existing leverage capital requirements."

The Shadow Financial Regulatory Committee applauds this reaffirmation of the importance of numerical thresholds in the leverage-ratio tests and the associated PCA triggers. We believe that the PCA system and the leverage-ratio tripwires remain fundamental to assuring that authorities respond effectively to any deterioration in the health of the US banking system. Indeed, we urge the Basel Committee to adopt a Prompt Corrective Action system for internationally active banks and to encourage individual countries to enforce it.