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Minimum Capital Requirements for Banks Under Risk-Based Capital Standards

Statement of
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Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss our views on minimum capital requirements for the banking industry.

During the first quarter of 1989, the three federal bank regulatory agencies (the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, and the Federal Deposit Insurance Corporation (FDIC)) adopted final risk-based capital standards. These standards specify the amount of capital, classified as Tier 1 and Tier 2, that banks must hold as of December 31, 1992. However, banks holding low-risk or riskless assets, as defined under the risk-based capital definitions, could meet the 8 percent requirement but still have a very low capital-to-total-assets ratio. The agencies agree that a minimum capital-to-total-assets ratio or "leverage constraint", should be established to work in conjunction with the risk-based capital standard. However, they disagree about how high this floor should be set.

On September 8, 1989, the Comptroller of the Currency proposed that the risk-based capital guidelines be supplemented with a 3 percent Tier 1 capital-to-total-assets floor.

The FDIC opposes the OCC proposal. FDIC maintains that risk-based capital, even with the proposed capital floor, may increase the risk of loss to the deposit insurance fund by effectively allowing some banks to reduce capital from the levels required under the current standard. The FDIC has indicated that it would prefer to set the capital floor higher than 3 percent by adding some level of supplementary (Tier 2) capital to the 3 percent Tier 1 capital floor proposed by the Comptroller.

In describing the effects of risk-based capital standards, the three regulators indicate that in most cases banks with greater than $1 billion in assets will find it necessary to increase capital to meet the risk-based capital requirements. These banks would be generally unaffected by the OCC proposed requirement for at least a 3 percent capital-to-total-assets ratio. This results primarily from the considerable off-balance sheet assets held by the larger, multinational institutions. On the other hand, smaller banks would generally not have to raise capital to meet the risk-based capital standard. These banks, could, in the aggregate, reduce capital and meet the standard. The FDIC believes that this would still be true even after imposing a 3 percent minimum capital-to-total assets ratio.

The OCC believes that one important reason for implementing risk-based capital standards is to reward less risky banks with lower capital requirements. The FDIC, on the other hand, believes that banking is increasingly risky today and, therefore, minimum capital standards should not be reduced for any bank. In their opinion, risk-based capital standards were designed primarily to force risky banks, especially large international banks, to raise capital.

Attempts have been made to prove the validity of one position or another by demonstrating how many banks would be affected under different capital standards or combinations of standards. The numbers show relatively little difference in the number of banks affected by modest variations in the capital floor to accompany the risk-based standards. These analyses do not, in our view, fully resolve the issue. Banks do not currently report sufficiently detailed information to calculate their risk-based capital positions accurately. Moreover, banks are likely to adjust their asset portfolios in response to the incentives built into the risk-based standards. Thus, any snapshot taken today is unlikely to remain valid in the future.

After reviewing the issues, we conclude that capital requirements should not be lowered for any banks in the process of converting to the risk-based capital standards. This view reflects the following considerations:

-- Bank regulators have not demonstrated that they have sufficient expertise and resources to exercise adequate oversight and supervision in a world of risk-based capital standards.

-- Banks are conducting business in an increasingly competitive environment.

-- In the aftermath of the thrift disaster, neither the public nor the banks should be given a signal by the regulators that lower capital levels are acceptable.

-- The risk-based capital standards do not address some significant risks, i.e. interest risk faced by banking institutions. Because credit risk will now have a higher cost (because of the increased capital requirement), banks may well change the composition of their asset portfolios to include more interest-rate sensitive assets in the future. This may actually increase the exposure of the deposit insurance fund to losses unless banks have sufficient capital.

-- FDIC's insurance reserves are at historically low levels.

Once risk-based capital standards have been fully implemented, and we have experience with the banking industry's adjustment to the standards, the minimum capital requirement can be reassessed and adjusted, if appropriate. However, in our view, there should be no reduction until:

-- The bank regulators have sufficient resources and have demonstrated the ability to oversee and enforce the relatively more complicated risk-based capital standards.

-- The FDIC's insurance reserves have increased to the minimum levels suggested in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

Other issues that should be considered when reassessing the minimum capital requirement include:

-- whether adequate provisions can be developed to include other appropriate risks, such as those arising from interest rate fluctuations, in the standards, and

-- whether a means can be found to eliminate or reduce some of the other incentives for unsound practice found in our deposit insurance system.

In the final analysis, adequate capitalization is the first line of defense of any financial institution. Any proposal that could yield a reduction in that capitalization should be viewed with great caution.

That concludes my prepared statement. My colleagues and I will be happy to answer questions.