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Statement of the Shadow Financial Regulatory Committee on
**Regulatory Responses to the Current Crisis Have Undermined the
Integrity of Tier 1 Capital and Tier 1 Capital Requirements**

December 8, 2008

From the beginning the Basel Accord sought to identify a source of capital (core capital or Tier 1 capital) that would serve as a buffer in times of stress without adding to financial pressures on the survival of an institution. For that reason, the original definition was properly restrictive. It included shareholders' equity and other instruments with characteristics so similar to shareholders' equity that it made no practical difference. For example, non-cumulative, perpetual preferred shares counted as Tier 1 capital because they were both a permanent part of the institution's liability structure and the institution could skip one or more dividend payments when it was under pressure without triggering bankruptcy. Over time, however, a number of hybrid capital instruments were authorized by regulators in individual countries that weakened the ability of Tier 1 capital to represent the institution's capacity to absorb losses.

Recent regulatory interventions to inject capital into leading banks have further undercut the meaningfulness of the Tier1 capital designation. For example, the U.S. authorities injected *cumulative* perpetual preferred into the nine largest U.S. banking organizations and defined it as Tier 1 capital. And the French injected subordinated debt into some of their leading banks and defined it as Tier 1 capital. This not only undermines the original definition and rationale for Tier 1 capital, but also undermines the integrity of Tier 1 capital ratios, which are widely relied upon by bank analysts to gauge the solvency of banks.

Another pernicious deterioration of Tier 1 capital standards can be attributed to accounting practices that permit a bank to show unrealized losses on securities classified as “available for sale” separately on the balance sheet and exclude them from the calculation of the Tier 1 capital ratio. Freddie Mac’s most recent balance sheet shows assets of \$879 billion, liabilities of \$866 billion and equity of only \$13 billion. Most analysts would regard this as 98.5% debt finance or a 76:1 leverage ratio. But for Tier 1 ratio calculations, it was allowed to include \$21 billion of fair value losses on available for sale assets in its equity base, making its reported leverage ratio only 26:1.

Because of these and other problems with the definition of Tier 1 capital ratios, they have provided an unreliable guide to market perceptions of capital adequacy during the financial crisis. Moreover, by scaling down the denominator of capital ratios by risk weighting individual assets, Basel II diverts attention from an institution’s traditional leverage ratio adjusted for off-balance-sheet exposures. Yet experience over the past year has shown that these risk weights are often inaccurate. Moreover, even if risk weights were accurate, as the Committee has noted frequently (see, for example, Shadow Statement No. 160, “Reforming Bank Capital Regulation,” March 2, 2000), leverage ratios may have more importance in the market place than risk-weighted measures. Market participants appear to lack confidence in the computations that underlie risk-weighted capital ratios, especially in a volatile marketplace. When counterparties become concerned about the riskiness of a bank, experience has shown that the market becomes acutely interested in the bank’s leverage ratio (counterparties’ demand for equity capital may sharply exceed regulatory requirements). The authorities should not be surprised that modest injections of actual Tier 1 capital, much less modest injections of phony Tier 1 capital, into banks that have suffered large losses do not lead to a substantial increase in lending. These institutions are experiencing market pressures because their solvency is still in doubt. Their first priority is to restore their capacity to bear loss to achieve a better balance with their risk exposures.

Moreover, even to the extent that regulatory, as opposed to market, requirements constrain a bank’s capital position, the use of leverage ratios can reduce regulatory compliance risk, both for the bank and for the macroeconomy. From the standpoint of the individual bank, risk-sensitive capital requirements, the primary aim of the Basel II approach, have proven to be very pro-cyclical, while leverage ratios (which are invariant to risk over the cycle) are much less so. Simulations of the effects of adding a leverage ratio limit on top of risk-based capital requirements, as is currently the case in the U.S., indicate that doing so would substantially reduce the procyclical effects of capital requirements¹. Less procyclicality permits banks to maintain more stable balance sheet positions over the cycle. From the standpoint of the macroeconomy, that translates into more stable credit supply over the cycle.

¹ See Rafael Repullo and Javier Suarez, “The Procyclical Effects of Basel II,” (presented at the 9th Jacques Polak Annual Research Conference hosted by the International Monetary Fund, Washington, D.C., November 14, 2008), available at <http://www.imf.org/external/np/res/seminars/2008/arc/pdf/rs.pdf>.