Risk-Based Capital Adequacy Guidelines: A Sound Regulatory Policy or A Symptom of Regulatory Inadequacy?

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RISK-BASED CAPITAL ADEQUACY GUIDELINES: A SOUND REGULATORY POLICY OR A SYMPTOM OF REGULATORY INADEQUACY?

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INTRODUCTION

Most commentators agree that the current capital adequacy guidelines are flawed.1 Yet, the belief that prudent bank supervision demands some form of capital requirements prevails.2 Accordingly, the Office of the Comptroller of Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation continue to expand and refine their capital adequacy guidelines ("CAGs").3


3. CAGs are a set of regulations mandated by Congress and promulgated by the regulators that require depository institutions to hold minimum amounts of capital in relation to their risk-weighted assets. See discussion supra part I.B. This Note concentrates on the OCC, the Fed, and the FDIC as the "Regulators." The three organizations proposed the CAGs jointly and have, with few exceptions, maintained their uniformity. The OCC's regulations most often will be referred to for the sake of simplicity. The Office of Thrift Supervision has implemented risk-based CAGs pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No 101-73, 103 Stat. 183 (1989) (codified in scattered sections of 12 & 15 U.S.C.), which, while different in some respects, are based on the same principles underlying the other banking agencies' CAGs. For a discussion of these risk-based capital standards see Anthony C. Providenti Jr., Note, Playing with FIRREA, Not Getting Burned: Statutory Overview of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, 59 Fordham L. Rev. S323, S330-32 (1991); Stuart D.
Through the 1980s and early 1990s, banks yielded to "financial fragility," a deterioration of asset quantity, quality, and earnings. Banks in the United States were in poor health. In the past two years, however, the economy has revitalized the banking industry. Banks posted record earnings and the Bank Insurance Fund has been recapitalized. Regulators and commentators credit CAGs with this recovery, but after five years of profoundly affecting bank asset portfolios, the value of CAGs has yet to be tested, mostly because of the favorable upswing in the economy most of the country experienced in the first half of this decade. This Note examines the contributions of CAGs to the current condition of the banking industry and their value as a cornerstone of regulatory policy. Part I introduces the CAGs and provides some background on their evolution and intended purpose from the regulators' perspective. Part II examines the effects of CAGs on banks, depositors, and taxpayers. Part II also investigates the degree to which these effects advance or undermine the regulators' objectives. Part III considers the current CAGs and describes recent and proposed developments. Part III also looks ahead to assess the value of CAGs as an effective regulatory policy for the future of banking.

This Note concludes that CAGs do not guarantee bank soundness and, in most instances, fall short of their stated objectives. The CAGs' weaknesses outweigh their utility, and a better way to manage bank risk is available. CAGs are fundamentally defective for a number of reasons. The banking system and credit availability will suffer when poor economic conditions combine with a regulatory environment that does not allow banks to compete effectively. Nevertheless, since the economy has been growing for the past two to three years, banks have not experienced the problems capital guidelines pose when the economy is in recession. Also, capital requirements that are supposed to stabilize the banking system may ultimately change banking substantially. The consolidation and shrinkage occurring in United States banking is a product of the regulatory environment epitomized by the CAGs.

The survival of banking will depend on regulators shifting their narrow focus away from a system of prudential regulation and micro management toward a broad perspective that emphasizes reforming the method and structure of banking regulation.

5. See infra notes 298-99 and accompanying text.
6. As of June 30, 1994, the Bank Insurance Fund balance was $17.5 billion, near the all time high mark of $18.3 billion. Bank Insurance Fund Increased to $17.5 Billion at Mid-Year 1994, Aug. 9, 1994, available in WESTLAW, 1994 WL 415748.
I. REGULATORY CAPITAL

Capital's role in controlling corporate and bank activity has developed since the origination of those institutions. A brief deviation into the evolution of capital requirements and the sources of the current CAGs is necessary in order to understand the regulators' justifications for CAGs as well as the criticisms of the CAGs that will follow.

A. The History of Capital Requirements for Banks

Regulating capital is a common device for defining an institution's ability to meet its obligations. For example, corporate law often restricts the dividends a corporation may distribute based on the corporation's capital position. This use of capital, known as "legal capital" or "stated capital," however, has lost its usefulness as a protector and indicator of corporate health. Originally, legal capital signified an absolute minimum amount of resources creditors could rely on and was a factor creditors could use in deciding whether, or on what terms, to extend credit. This measure of shareholder commitment was a useful tool as corporate law developed in the latter nineteenth century. Modern corporate practices, however, have rendered legal capital obsolete as a measure for corporate risk taking.

Most banks are corporations, yet while private industry has largely done away with minimal capital requirements, banks, under

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8. Legal capital was ... regarded as the quid pro quo for granting limited liability to shareholders. Technically, 'legal capital' or 'stated capital' refers to the sum of the 'par values' of all of the outstanding stock of a corporation, or, if the corporation's stock is 'no par,' the 'stated capital' refers to an amount that the directors decide to attribute to all the outstanding stock.
9. Id. § 14.3, at 611.
10. Id. § 17.1.2, at 708.
11. The whole concept of capital is itself an anachronism. In the words of Manning, legal capital is 'a) a number expressed in dollars, b) initially the product of par value, c) on the right hand ... side of the balance sheet, d) that can at best be read to convey a message ... about an historical event ...,' and has no relation to the present economic condition of the enterprise.
12. William L. Cary & Melvin A. Eisenberg, Corporations 1437-38 (6th ed. unabridged 1988) (quoting B. Manning, Legal Capital 21 (2d ed. 1981) (emphasis omitted); see generally id. at 1416-1440 (discussing introduction of no-par stock, which was first authorized in New York in 1912, as well as the problems of watered and discount shares and the difficulty of determining the value of property and services received in consideration for stock).
14. Most states have abandoned statutory minimum capital requirements. William P. Hackney & Tracey R. Benson, Shareholder Liability for Inadequate Capital, 43 U. Pitt. L. Rev., 837, 852, 897-98 (1982) (arguing, however, that to afford creditors some protection, the law should require a capitalization standard that provides for a reasonable business chance, but not a likelihood of success).
the control of federal regulators, are subject to capital measures far stricter than the "legal capital" statutes. This is understandable because unlike most corporations whose liabilities consist of equity and bondholder debt, banks operate predominantly on deposits. Banks are, therefore, more highly leveraged than most corporations because they have a higher ratio of debt to equity.

Before the 1980s, regulators enforced capital requirements informally. Until World War II, the measure was a capital-to-deposits ratio. For a time after the war, the Fed and the FDIC used a capital-to-assets ratio. The Comptroller of Currency's bank rating system considered capital in assessing a bank's health. This system became the interagency standard to evaluate the financial health of banks under the direction of the Federal Financial Institutions Examination Council, formed in 1979.

In 1981, banking regulators responded to disintegrating capital positions by promulgating explicit capital standards. These standards were inadequate because they did not account for the varying amount of risk in bank portfolios. They required more capital than was necessary for safe banks and not enough for unsafe banks. To customize capital requirements to an individual bank's risk level, Congress adopted the Capital Adequacy Guidelines that have contributed to the microscopic regulation of the banking industry.

One of the rare successful judicial challenges to regulatory enforcement of capital requirements came in 1983, when the Fifth Circuit overturned the Comptroller's determination that a bank was unsafe.
and unsound based on poor capital structure. Congress quickly stepped in and superseded the decision, enacting the International Lending Supervision Act of 1983. ILSA established the regulators' authority and duty to utilize capital ratios.

Not until 1985 did regulators adopt common standards for defining bank capital. Historically, banks circumvented capital requirements by holding high risk assets or off-balance sheet assets. In response to such practices, federal regulators proposed risk-based CAGs in 1988.

1. The Basle Agreement

The current guidelines are a product of the Basle Agreement adopted by the G-10 countries in 1988. The CAGs were phased in over a two year period. As of December 31, 1989, the fifty largest United States banks had capital-to-total assets ratios of five percent. All national banks had to comply with the risk-weighted CAGs by

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25. See infra note 39 and accompanying text. For a brief discussion of the extent of the enforcement authority of the FDIC, see Thomas M.L. Metzger, FDIC Capital Directive Procedures: The Unacceptable Risk of Bias, 110 Banking L.J. 237, 237-38 (1993) (arguing that the Fifth Circuit's decision in FDIC v. Bank of Coushatta, 930 F.2d 1121 (5th Cir.), cert. denied, 112 S. Ct. 170 (1991), which held that the FDIC's capital directive procedures are not subject to judicial review, is a violation of due process rights). To illustrate the enforcement power of the CAGs, under ILSA, if a regulator finds a bank is undercapitalized it "may be deemed [in] . . . an unsafe and unsound practice within the meaning of section 1818." 12 U.S.C. § 3907(b)(1) (1988 & Supp. V 1993). In addition to the remedies under § 1818, § 3907 gives the regulator authority to issue a "capital directive." Id. § 3907(b)(2)(A) (1988 & Supp. V 1993). The capital directive forces the bank to submit to a plan the regulator finds acceptable "describing the means and timing by which the banking institution shall achieve its required capital level." Id. § 3907(b)(2)(B)(i) (1988 & Supp. V 1993). Under § 1818(i) and Bank of Coushatta, the bank is not allowed judicial review of the regulator's decision.
27. James L. Pierce, The Future of Banking 93 (1991). For a definition of off and on-balance sheet items see infra notes 61-63, 90-91 and accompanying text. Before risk-weighted CAGs, regulators only took into account assets that were recorded on a bank's balance sheet. To avoid holding capital, banks would concentrate funds to off-balance sheet items. For a discussion of how these are incorporated into the CAGs see infra notes 90-111 and accompanying text.
30. The G-10 countries are: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States, and Luxembourg. Id. ¶ 5403, at 3309 n.1.
31. See United States Department of the Treasury, Modernizing the Financial System: United States Treasury Department Recommendations for Safer, More Compet-
December 31, 1990, but were required to hold only 7.25 percent of capital. As of December 31, 1992, federal regulations required all depository institutions to hold a minimum of eight percent of capital in relation to their risk-weighted assets.

The Basle Agreement guidelines were principally designed to level the playing field among international banks. They were established to "strengthen the soundness and stability of the international banking system" and to diminish "competitive inequality among international banks." The Basle Guidelines were not specifically tailored to the needs of the United States banking system or any particular national banking system, rather, they were the product of a broad compromise among nations. United States banking regulators implemented the Basle Agreement guidelines with few differences among the agencies. The regulators issued three officially stated goals of the nationally implemented CAGs: (1) to make capital requirements more sensitive to the differences in risk profiles among banks; (2) to take off-balance sheet items into account when assessing the amount of capital a bank should hold; and (3) to minimize disincentives to holding fluid, low risk assets. The guidelines may or may not achieve the international goals; however, they do fall short of the stated national agenda.

2. Statutory Mandate

Congress has granted regulators enormous power to create and implement regulations to enforce CAGs. The power granted to federal
regulators is evident from the effects of the redefinition of capital.\textsuperscript{39} The concept of capital was fairly simple before regulators transformed it into "regulatory capital."\textsuperscript{40} Bank capital is no longer the difference between assets and liabilities.\textsuperscript{41} Now it is determined by an abstruse formula designed to ensure a sufficient balance of stockholder and debtholder funds against the loans and securities of a bank.\textsuperscript{42} Adherence to this strict regulatory policy ensures that the financial liability of owners increases in proportion to the risks they take with depositors' money.

CAGs have become a foundation of regulatory policy,\textsuperscript{43} and Congress continues to direct that the regulators use capital as the basis for many of the decisions they make concerning banks.\textsuperscript{44} Congress' original mandate came with ILSA in 1983 and was reinforced by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.\textsuperscript{45}

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deems to be necessary or appropriate in light of the particular circumstances of the banking institution."

The OCC's regulations, implemented pursuant to this congressional mandate, are promulgated at 12 C.F.R. pt. 3 and apply to national banks; the Fed's regulations are promulgated at 12 C.F.R. pt. 208 and apply to state member banks; and bank holding companies' regulations are promulgated at 12 C.F.R. pt. 225. The FDIC's regulations are promulgated at 12 C.F.R. pt. 325 and apply to FDIC insured state charted banks that are not members of the Federal Reserve System. The CAGs have been most recently modified by the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991) (codified as amended in scattered sections of 12 U.S.C.) [hereinafter FDICIA]. For more discussion of enforcement powers under ILSA, see supra note 25.

39. The most obvious effect has been a shift in the assets banks hold. See infra part II.B.3. Part II of this Note will also discuss other consequences of the CAGs such as their affect on credit availability and bank safety.

40. Capital has different meanings for different people: there is accounting capital (capital as net worth, the difference between assets and liabilities on a balance sheet), market capital (the value of the company to the shareholders), and capital as a legal concept (money or property owners may invest as equity, not as loans). For a discussion of these definitions of capital and more, see Norton, supra note 1, at 1302-06.


42. See id. at 830-38.

43. See infra note 57 and accompanying text. The regulatory policy is fairly simple. From the OCC view point, it includes "maintaining the safety and soundness of the banking industry as a whole, providing support for the industry's efforts to provide credit and other financial services to its communities, and maintaining and enhancing a risk-focused, differential and proactive approach to the supervision of national banks." 59 Fed. Reg. 57,168, 57,170 (1994) (unified agenda outlining the Treasury Department's regulatory plan for the 1995).

44. Capital adequacy is mentioned in many sections of the federal regulations pertaining to depository institutions. Examples are 12 C.F.R. § 5.20 (organization of a national bank); 12 C.F.R. § 5.5 (change in bank control); 12 C.F.R. pt. 6 (prompt corrective action); 12 C.F.R. § 211.5 (investments and activities); 12 C.F.R. § 225.22 (nonbanking activities).

In 1991, Congress reiterated the CAGs' goals—to strengthen and maintain the safety of the banking system—by enacting the Federal Deposit Insurance Corporation Improvement Act of 1991.** Driven by these powerful Congressional mandates, regulators continually modify CAG regulations to account for more of the elements of risk involved in banking operations.

3. CAGs as a Reaction to Deregulation

Banking, a very profitable industry, started to become much less profitable when nonbank firms, realizing the profits to be made from depositors' money, started offering individual and corporate investors higher rates of return on time deposits than banks could offer.** This resulted in substantial decreases in the market share and asset quality of banks.** Congress and the regulators implemented deregulation in response to the problems caused by nonbank competition. In addition to hastening disintermediation,** traditional regulation caused too much regulatory inefficiency that hampered innovation and increased operating costs.** Congress relaxed regulation to allow banks to compete freely with other financial institutions that were offering bank depositors more lucrative places to store their money.** Deregulation closure of still-solvent banking institutions that fall below certain capital thresholds.”’ John P. Danforth, *Who Pays for the High Cost of Excessive Bank Regulation?*, 12 No. 9 Banking Pol'y Rep. 1, 3 (1993). Along with these new enforcement powers has come a change in the relationship between regulators and banks. Under FIRREA, Congress “ordered the banking agencies to use these powers ‘aggressively.’” Baxter, *supra* note 18, at 509. Under FDICIA, “Congress forced the agencies to take early and decisive action against troubled banking institutions, their owners, directors, and employees.” *Id.*


47. See Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 Fordham L. Rev. 501, 521-29 (1989) [hereinafter Garten, *Growing Pains*]. Four reasons are suggested for the new competition to banks: (1) regulators prevented banks from paying depositors as much as nonbank firms could pay due to the Banking Act of 1933, which (a) prevented banks from paying interest on demand deposits and (b) allowed the Fed to set maximum interest rates on time deposits; (2) the development of financial instruments allowed individuals to tap directly into the capital market; (3) technical innovation allowed rapid movement of money; and (4) businesses of all sizes had improved money management skills. *See id.* at 522.

48. *Id.* at 523-24.

49. Intermediation is when a bank transfers funds from a lender to a borrower and acts as an intermediary facilitating the movement of funds. Banking Terminology 193 (3d ed. 1989). Disintermediation is the removal of funds from this system and can ostensibly occur for a number of reasons, but, at bottom, is caused by the prohibitive cost and inefficiency of intermediation. *See id.* at 118.


51. One way in which banking was deregulated was that the limits on the amount of interest banks could pay on time deposits was removed. Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 3503 (1988); Lawrence J. White, *The S&L Debacle*, 59 Fordham L. Rev. S57, S64-65 (1991).
promised to shape more efficient banks and thus a more stable banking system. Unfortunately, deregulation was no panacea. Commentators identified deregulation as one of the primary factors that led to the failure of many banks and saving and loan associations in the 1980s. Banks and S&Ls had no incentive to put their own capital at stake, and when they developed liquidity problems, they responded by making riskier loans in the hope of producing cash flow to cover their impending insolvency. This worsened their financial difficulties considerably.

Regulators reacted to the failures of the past decade by increasing prudential regulation. In a conservative reaction to deregulation, Congress and the regulators have returned to a traditional yet more sophisticated approach to maintaining the safety and soundness of the banking system by relying primarily on risk-weighted capital adequacy guidelines. These CAGs are "the single most important regulatory response to the breakdown of the credit system."

B. How the Current CAGs Work

CAGs differ from other regulations in that they are rigidly quantitative. Their purpose is to "tailor an institution's minimum capital requirement to broad categories of credit risk embodied in its assets and

53. See, e.g., White, supra note 51, at S63-66 (describing how deregulation led to the collapse of the savings and loan industry).
54. See id. at S65-66.
55. Id.
56. Prudential regulation is distinguished from prophylactic regulation. The latter is associated with traditional regulation in that it creates "a series of barriers or prohibitions, designed to control entry into banking and to channel banks and thrifts into certain activities." Baxter, supra note 18, at 511. Prudential regulation is associated with safety and soundness measures. It was typically enforced informally through "discussion, persuasion, and other non-adversarial methods for deterring . . . imprudent activities." Id. at 512. Since deregulation, prudential regulation has taken the forefront over traditional regulation and has assumed a more formal character. See id. at 514. CAGs are an example of this shift in regulatory method.
58. Many aspects of a bank's performance, such as capital, assets, earnings, and liquidity, are quantitative. Much regulation, however, deals with qualitative characteristics such as management experience, character and general fitness, and the convenience and needs of a community. Regulations also attempt to quantify characteristics that are very difficult to measure accurately such as risk assessments. A complaint about quantitative regulation is that it is "substantially incomplete, misleading, and short-sighted. Accepting it as a decision guide is to misunderstand banking fundamentals by neglecting banking's underlying foundation as a service business." Bruce W. Morgan, Comment: Camel Ratings Ignore Relationships, The Bedrock That Banks Are Built On, Am. Banker, June 27, 1994, at 15.
off-balance sheet instruments.”59 They do have a prudential element as well. Regulators use a set of qualitative standards to determine the capital a bank must hold above the eight percent minimum.60

The quantity and quality of a bank’s assets will determine the amount of capital a bank must hold. The minimum amount of capital a bank must have is greater or equal to eight percent of its risk-weighted assets. Therefore, it makes sense to identify assets first. Unfortunately, determining a bank’s assets is not simply a matter of adding up the value of a bank’s loans, securities, and cash.

1. Assets

CAG classifications identify and segregate assets based on whether they are “on-balance sheet items” or “off-balance sheet items.”61 On-balance sheet items include traditional assets such as loans and securities. Off-balance sheet items are lines of credit, guarantees, or credit exposures of the bank that are not normally recorded as current assets on a balance sheet. Regulators take particular interest in accounting for and measuring the risk of off-balance sheet items because they can expose banks to significant interest rate and foreign exchange rate risk.62


60. Factors considered may include:

(a) [t]he conditions or circumstances leading to the Office’s determination that higher minimum capital ratios are appropriate or necessary for the bank; (b) [t]he exigency of those circumstances or potential problems; (c) [t]he overall condition, management strength, and future prospects of the bank . . . ; (d) [t]he bank’s liquidity, capital, risk asset and other ratios compared to the ratios of its peer group; and (e) [t]he views of the bank’s directors and senior management.

12 C.F.R. § 3.11 (1994).

61. On-balance sheet items are simply items that bank accountants would record in the bank accounts according to Generally Accepted Accounting Principles such as cash, securities, and loans. Off-balance sheet items consist of credit available to a customer that is not currently being used but may be at a future time. Off-balance sheet items may also be commitments for which there is no GAAP standard. Examples of off-balance sheet items are commercial and standby letters of credit, banker’s acceptances, options, forwards, and swaps. Banking Terminology 249 (3d ed. 1989).

62. Normally, credit exposures are recorded on the right hand side of a balance sheet. They increase the balance of a liability or decrease the balance of an asset. The credit exposure of an off-balance sheet item is usually not recorded because it is not feasible or reliable. The reliability of the accounting process is very important to both shareholders and corporate management because the financial statements influence their decisions. See Charles T. Horngren et al., Financial Accounting 9 (5th ed. 1993).

CAPITAL ADEQUACY GUIDELINES

a. **On-balance Sheet Items**

There are four risk categories for on-balance sheet items: zero percent (riskless: banks do not need a dime of capital to protect these assets), twenty percent (a little bit of risk, but not too much), fifty percent (riskier), and one hundred percent (demands at least the full eight percent of capital backing it up). At first glance, four categories do not seem excessively elaborate, but after examining the components of each category, the complexity of on-balance sheet assets will become apparent. An explanation of each category follows.

i. **Zero Percent Category**

The zero percent category consists of the most fungible and creditworthy assets. The first elements in this category constitute the foundation of the United States banking system and include cash,\(^\text{64}\) gold, deposit reserves at Federal Reserve banks,\(^\text{65}\) and the book value of Federal Reserve stock.\(^\text{66}\) In addition, this category includes unconditionally guaranteed claims against the United States government,\(^\text{67}\) its agencies,\(^\text{68}\) or the central government\(^\text{69}\) of an OECD country,\(^\text{70}\) as


\(^{67}\) Treasury Bills are the prime example, but more broadly this category includes securities, leases, and loans in the form of debt obligations. 12 C.F.R. pt. 325 app. A (II)(C) at 168 (1994).

\(^{68}\) Here, United States agency means an agency whose obligations are fully guaranteed by the full faith and credit of the United States government; these include the Government National Mortgage Association, the Veterans Administration, the Federal Housing Administration, the Export-Import Bank, the Overseas Private Investment Corporations, the Commodity Credit Corporation and the Small Business Administration. See 12 C.F.R. pt. 208 app. A, at 235 n.27 (1994). This does not include privately issued mortgage backed securities issued by GNMA, FNMA, and FHLMC. Such securities are given a 20% risk weight. 12 C.F.R. pt. 325 app. A (II)(C) at 169 & n.23 (1994).

\(^{69}\) Central government includes the departments, ministries, and agencies of the central government, and the central bank. The United States Central Bank includes the 12 Federal Reserve Banks, but does not include state, provincial or local governments or commercial enterprises owned by the central government. 12 C.F.R. pt. 3 app. A § 1(c)(5) at 20 (1994).

\(^{70}\) OECD (Organization for Economic Cooperation and Development) countries include Australia, Austria, Belgium, Canada, Denmark, Finland, France, West Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. 12 C.F.R. pt. 325 app. A (II)(B) at 167 n.12 (1994). In May 1994, Mexico was accepted in the OECD and Saudi Arabia has a special lending arrangement. See 59 Fed. Reg. 52,100 (to be codified at 12 C.F.R. pts. 3, 208, & 225) (proposed Oct. 14, 1994) (concerning the loss of OECD status with regard to CAGs if a country restructures its debt).
well as unconditionally guaranteed claims on non-OECD governments.\footnote{71} The last element of the zero percent category is claims collateralized by cash on deposit or by securities issued by the United States government, its agencies, or the central government of an OECD country for which a positive margin of collateral is maintained daily.\footnote{72}

Assigning these items a zero percent risk weight indicates that regulators consider these assets virtually riskless. They are all very liquid, and because the full taxing power of the United States and other economically stable central governments guarantees their payment, it is assumed they are risk free.\footnote{73}

\section*{ii. Twenty Percent Category}

The twenty percent category contains assets that have elements of risk, but the risk is low because the asset is either collateralized or conditionally guaranteed by a secure institution such as a federal agency. Specifically, this category includes assets collateralized by United States government or agency debt,\footnote{74} or by the central government of an OECD country;\footnote{75} assets conditionally guaranteed\footnote{76} by the United States Government, its agencies, or an OECD government;

\footnote{71} Claims of governments other than OECD governments are unconditionally guaranteed provided that such claims are funded in local currency by local liabilities. 12 C.F.R. pt. 3 app. A § 3(a)(1)(v) at 24 (1994).

\footnote{72} This collateral requirement, until recently, did not apply to national banks, but applied only to state member banks and bank holding companies. Report to Congressional Committees Regarding Differences in Capital and Accounting Standards Among the Federal Banking and Thrift Agencies, 60 Fed. Reg. 3227, 3230 (1995); 59 Fed. Reg. 66,642 (1994) (discussing OCC's final rule lowering the risk weight of collateralized transactions that became effective Dec. 31, 1994) (to be codified at 12 C.F.R. pt. 3). It still does not apply to state nonmember insured banks that are supervised by the FDIC. 12 C.F.R. pt. 325 app. A (II)(C)(1) & (2) at 168-69 (1994) (addressing 0% and 20% categories for FDIC regulated banks). In December 1994 the OCC lowered its risk weight category from 20% to 0% for collateralized transactions that pose minimal credit or operational risk. 59 Fed. Reg. 66,642 (1994). The collateral must be a positive margin of cash or OECD government securities that are controlled by the bank. Id. at 66,642.


\footnote{74} The only forms of collateral recognized are: cash on deposit in the bank, securities issued or guaranteed by an OECD government, United States agencies, and United States sponsored agencies. 59 Fed. Reg. 66,642, 66,644 (1994). A perfected security interest is not required. Id. If only a portion of the asset is collateralized that portion is assigned to the 20% category while the remainder is assigned to its appropriate risk weight category. See 12 C.F.R. pt. 208 app. A (III)(B)(1), at 233-34 (1994).

\footnote{75} These assets apply to state nonmember banks only. See supra note 72 and accompanying text.

\footnote{76} A conditional guarantee requires some affirmative action for the promise to be valid, as in servicing requirements. See 12 C.F.R. pt. 3 app. A § 1(c)(8) at 20 (1994). That portion of an asset not fully guaranteed is assigned to its appropriate risk weight, and a claim covered by guarantees of different risk weights should be apportioned between the risk weights. See 12 C.F.R. pt. 208 app. A (III)(B)(2) at 234 (1994).
and claims on United States government sponsored agencies;\textsuperscript{77} and certain privately issued securities representing ownership in government agencies.\textsuperscript{78} Also included in the twenty percent category are most forms of senior United States and OECD bank debt.\textsuperscript{79} Regulators can afford banks this low risk weight for these assets because regulators closely monitor and control their financial condition. They also want to encourage interbank lending as a means of achieving bank liquidity. Also in this category, are the general obligations of states and municipalities as well as OECD local governments.\textsuperscript{80} Finally, this category includes two assets that have some element of collection risk: cash items in the process of collection\textsuperscript{81} and assets collateralized by cash on deposit.\textsuperscript{82}

\textbf{iii. Fifty Percent Category}

The fifty percent category is somewhat anomalous. It provides a low risk weight for certain assets, not because a fifty percent risk weight accurately reflects the danger of default, but because encouraging banks to hold these assets advances the public policy goal of encouraging the creation and ownership of residential housing. The main components of this category include consumer first mortgage debt that is not past due, loans to builders to finance construction of presold homes,\textsuperscript{83} and privately issued mortgage backed securities. Congress consolidated these three residential housing assets within the same category in an effort to alleviate the inefficiency created by

\textsuperscript{77} Government sponsored agencies differ from government agencies in that their obligations are not explicitly backed by the full faith and credit of the United States Government. See 12 C.F.R. pt. 208 app. A, Attachment III, at 246 n.2 (1994).

\textsuperscript{78} See \textit{supra} notes 68 and 77 for a discussion of government agencies.


\textsuperscript{81} Cash items in the process of collection are comprised of checks or drafts drawn on another bank that are payable upon presentation to that bank's clearing office. 12 C.F.R. pt. 3 app. A § 1(c)(4) at 20 (1994); 12 C.F.R. pt. 3 app. A § 3(a)(2)(iii) at 28 (1994).

\textsuperscript{82} Collateralization only applies to state nonmember banks that are supervised by the FDIC. The OCC and the Fed put assets collateralized by cash on deposit in the 0\% risk category. See \textit{supra} notes 72 and 74. The FDIC is also considering a reduction in the risk weight associated with certain collateralized transactions. Report to Congressional Committees Regarding Differences in Capital and Accounting Standards Among the Federal Banking and Thrift Agencies, 60 Fed. Reg. 3227, 3230 (1995).

\textsuperscript{83} 58 Fed. Reg. 12,149 (1993) (implementing § 618(a) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991, Pub. L. No. 102-233, 105 Stat. 1761 (1991) [hereinafter RTCRRIA], which required all agencies to lower single family residential construction loans from the 100\% to the 50\% category in order to facilitate lending to creditworthy builders).
the reporting burden these regulations place on banks. This category also contains credit equivalents of interest rate and exchange rate contracts, OECD public sector project financed debt, and revenue bonds of state and local governments.

iv. One Hundred Percent Category

The one hundred percent category, the default category, includes most bank assets. Most notably, this category includes all commercial and private sector loans. All other assets and claims of a bank that do not fit into the zero, twenty, or fifty percent categories are assigned a one hundred percent risk weight. Banks must hold a minimum capital cushion of eight percent against these assets, which include the bank premises, fixed assets, real estate, unsecured and most secured loans. Also, state or local obligations repayable solely by a private party must meet the full eight percent capital requirement.

b. Off-Balance Sheet Items

Off-balance sheet items are current commitments that do not involve a transfer of funds until some later date and are not reflected on

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85. The credit equivalent of these contracts refers to the process by which off-balance sheet items are converted into on-balance sheet items. See supra note 90.

86. Public sector entities include states, towns or other municipal corporations, and any public entity that is the instrument of these political subdivisions, but does not include commercial companies owned by the public sector engaged in activities involving trade, commerce, or profit generally performed in the private sector. See 12 C.F.R. pt. 3 app. A § 1(c)(5) & (18) at 21 (1994).

87. These are included in the 50% category because the government entity is only obligated to pay out of the revenues generated from the financed project rather than from tax funds. See 12 C.F.R. pt. 325 app. A (II)(C)(3) at 170-71 (1994).

88. 12 C.F.R. pt. 3 app, A § 3(a)(4) (1994) (enumerating items in the 100% category for national banks).

89. Id. Most business loans are either unsecured or secured with personal property. Commercial banks, for example, have dominated the installment credit markets in recent decades. E. Allen Farnsworth et al., Commercial Law 751 (5th ed. 1993). Also, a large portion of consumer credit is unsecured debt. Id. at 748. Certainly collateralized loans, however, fall into the zero percent risk weight. See supra note 72, 74, and accompanying text.

90. A summary of the credit conversion factors for off-balance sheet items are as follows: One Hundred Percent Credit Conversion: (1) Direct credit substitutes, such as standby letters of credit where a bank will indemnify a third party if its customer fails to perform a contract; regulators are currently proposing to amend the CAGs to allow less capital to be held against low level recourse transactions. See 59 Fed. Reg. 27,116 (1994) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325 & 567) (proposed May 25, 1994) (proposing OCC, Fed, and FDIC rules concerning recourse and direct credit substitutes and market risk). (2) Risk participations in bankers' acceptances and in direct credit substitutes, for example, a time draft drawn on and accepted by the bank on which it was drawn, bankers' acceptances resemble commercial paper in that they
the balance sheet. These items include general guarantees and guaranty type instruments such as standby commitments and letters of credit.91 Depending on the amount of assets outstanding, off-balance sheet items can significantly affect the risk exposure of the bank.92 Determining the value of off-balance sheet items is a two-step process. First, the bank multiplies the item by a conversion factor that converts it into an on-balance sheet equivalent. Then, the new on-balance sheet equivalent can be placed in its proper risk category as would any other asset.

2. Capital

The previously discussed assets are funded mostly with capital and deposits.93 The total of these two sources of funds is typically far less than the assets a bank holds.94 To prevent banks from becoming too highly leveraged on depositor funds alone, regulations require banks

are short term and sold at a discount. They differ in that they are backed both by the goods they finance in addition to the bank that issued them. See Marcia Stigum, The Money Market 57-58 (3d ed. 1990). (3) Repurchase agreements, which are agreements to repurchase securities at a fixed price and date, are often done overnight; "repos" are essentially loans with the securities acting as collateral. See id. at 44-46. (4) Futures contracts, which are agreements to buy or sell securities in the future at a specified price. See Banking Terminology 166 (3d ed. 1989). (5) Indemnification of customers whose securities the bank lends as agent; for example, if the bank lends its own securities (as in a repurchase agreement) or those of a customer whom it must indemnify, the conversion factor will be 100% and assigned to the proper risk weight category. See Legal Developments, 75 Fed. Reserve Bull. 153, 167 (1989). These assets are given a 100% risk weight so the full value of the assets is transferred to the balance sheet and assigned to its proper risk weighted category discussed above. See supra parts I.B.I-a.i-iv.

Fifty Percent Credit Conversion: (1) Performance bonds, which are issued to guarantee the insured will perform work within the terms of the contract, see Banking Terminology 264 (3d ed. 1989), and performance based standby letters of credit. (2) Available credit with a maturity exceeding one year; commitments of one year or less have a zero percent conversion factor and so are not taken into account. (3) Revolving underwriting facilities and note issuance facilities, which are arrangements where borrowers can issue short term paper in their own names and the paper is guaranteed by the bank or group of banks. See id. at 247, 310. Twenty Percent Credit Conversion: Commercial letters of credit, which are simply letters of credit issued by a bank for its customer promising to pay the seller upon presentation of documents that represent receipt of goods. See id. at 70. Zero Percent Credit Conversion: (1) Unused portion of commitments with an original maturation period of one year or less. (2) Unused portion of commitments with an original maturity of greater than one year if unconditionally cancelable at the option of the bank where the bank makes a credit decision before each drawing or at least an annual credit review. (3) Unused portion of credit card lines unconditionally cancelable by banks. These are deemed to be short term commitments if the bank has the right to cancel the line of credit at any time. Legal Developments, 75 Fed. Reserve Bull. 153, 169 (1989).

93. Stigum, supra note 90, at 121.
94. Id.
to maintain a capital cushion equal to eight percent of risk-weighted assets. The CAGs divide this eight percent into two classes of capital, Tier 1 and Tier 2, which, when added together, comprise Total Capital.95

a. Tier 1 Capital

Tier 1 must comprise at least fifty percent of Total Capital.96 Tier 1 capital is secure capital in the traditional sense in that it may include only the following three components, none of which may contain goodwill or the value of any intangible asset, with some exceptions.97 The first component of Tier 1 capital incorporates the initial investment of a bank's common stockholders.98 The second component is the more modern, yet safe, noncumulative perpetual preferred stock99 and related surplus.100 Finally, regulators allow minority interests in the equity accounts of consolidated subsidiaries to be counted as Tier 1 capital.101

97. 12 C.F.R. pt. 3 app. A § 2(c)(1)(i) & (ii) at 23 (1994). Generally, all intangible assets must be deducted from Tier 1 capital. Intangible assets include goodwill, defined as the value given to "such considerations as a firm's strong reputation, favorable location, and good relations with [ ] customers." Banking Terminology 170 (3d ed. 1989). Other intangible assets include purchased mortgaging rights and purchased credit card relationships, which need not be deducted from Tier 1 capital if no more than 50% of Tier 1 capital is intangible assets and no more than 25% is purchased credit card relationships. See 12 C.F.R. pt. 3 app. A § 2(c)(2) at 23 (1994). The intangibles included in Tier 1 are valued at the lesser of 90% of market value or 100% of book value determined quarterly. See 12 C.F.R. pt. 3 app. A § 2(c)(2)(i) at 23 (1994).
98. While regulators allow noncumulative perpetual preferred stock and minority interests in consolidated subsidiaries, it is "desirable from a supervisory standpoint that voting common stockholders' equity remain the dominant form of Tier 1 capital." Legal Developments, 75 Fed. Reserve Bull. 153, 158 (1989). Nonvoting common stock, noncumulative perpetual preferred stock, and minority interests in consolidated subsidiaries are allowed in Tier 1, but "voting common stockholders' equity generally will be expected to be the dominant form of Tier 1 capital." 12 C.F.R. pt. 325 app. B (IV) at 179 (1994).
99. Preferred stock receives dividends before other equity securities. It has a par value, a stated dividend rate, and usually has optional redemption provisions similar to debt. John D. Finnerty, Corporate Financial Analysis 346-47 (1986). Perpetual preferred stock means preferred stock that has no maturity date and cannot be redeemed at the option of the holder. 12 C.F.R. § 325.2(p) (1994). Noncumulative means the dividends on the stock can be waived and do not accumulate to future periods or represent a contingent claim on the issuer. 12 C.F.R. § 325.2(o) (1994).
100. Surplus is generally the amount paid for stock that exceeds the par value of the stock. See Banking Terminology 334 (3d ed. 1989).
101. See 12 C.F.R. pt. 3 app. A § 2(a)(3) at 22 (1994). An unconsolidated investment in a subsidiary occurs when a parent has not eliminated its investment in the subsidiary company on its balance sheet as required by GAAP. Dictionary of Accounting (3d ed. 1989). If the subsidiaries are not consolidated for supervisory purposes the minority equity interests will not be included in Tier 1 or Tier 2 capital. Pulito, supra note 92, at 352. This element is included in Tier 1 because it represents
b. Tier 2 Capital

Tier 2 capital consists of four principal items. The smallest component is loan loss reserves. These are allowed to reach a maximum of 1.25% of risk-weighted assets. Second, Tier 2 capital includes a high paying form of stock, cumulative perpetual preferred stock, as well as intermediate preferred stock and related surplus. The third constituent are hybrid capital instruments, but these instruments must meet a host of specifications to ensure they will be available to offset a bank's losses. Finally, debt instruments, which differ from equity in that they have a contractual preference on earnings, are allowed to form part of Tier 2 capital as long as they are subordinate to the claims of general creditors.

What is most noticeable about the elements of Tier 1 and Tier 2 capital is the relatively small role stockholder equity actually plays. With an eight percent minimum capital-to-risk-weighted assets ratio and only fifty percent of that eight percent having to be Tier 1 capital, it is possible that less than four percent of total capital will be stockholder equity. As discussed previously, public policy historically dictated minimum levels of corporate capital that were set forth in state statutes. Traditionally, capital was associated with stockholder equity—the amount of money stockholders invest and risk losing in a
corporate entity.\textsuperscript{109} Allowing shareholder equity to compose such a small percentage of regulatory capital seems to subvert the goal of increasing owner liability as risk increases. An increase in financial risk, however, also increases the risk for debtholders.\textsuperscript{110} Thus, when bondholders agree to subordinate their claims to the claims of creditors and depositors, debt performs the same function as equity.\textsuperscript{111}

C. Justification for Regulation and CAGs

This section will set out various justifications for the imposition of CAGs on banks. The most prevalent justification for banking regulation is to maintain the efficient flow of funds from those with a funds surplus to those with a funds deficit. Banks accomplish this essential function by transferring unused depositors' funds to individuals and businesses in the form of loans. This transfer and the augmentation of capital it produces forms the basis of our economy. The additional justifications for CAGs are corollaries to this primary concern. They include curbing bank expansion, increasing public confidence in banks, mitigating moral hazard problems, improving liquidity, and standardizing regulation so banks can compete on an equal footing with other financial institutions.

1. Essential Function of Financial Intermediaries

A strong rationale for the imposition of strict capital requirements comes from the uniquely public attributes of banks as "the holders of the national savings; the transmitters for monetary policy; the primary vehicles for effecting an efficient payment system through the economy; and the main source of backup liquidity in the economy."\textsuperscript{112} Banks provide an efficient payment system that, despite its costs, allows the rest of the economy to operate more efficiently.\textsuperscript{113} Banks and S&Ls are the principal financial intermediaries in our economy. They solicit funds in the form of demand deposits and time deposits

\textsuperscript{109} See supra notes 7-12 and accompanying text.

\textsuperscript{110} Finnerty, supra note 99, at 177.

\textsuperscript{111} Id. at 189-92. For banks, the benefit of subordinated debt is that the interest payments are tax deductible. Id.; see generally Douglas D. Evanoff, Preferred Sources of Market Discipline, 10 Yale J. on Reg. 347, 350 (1993) (recommending an increased role for subordinated debt in bank's capital structure). Cf. Richard Posner, Economic Analysis of Law 449 (1992) (noting that a better method of protecting banks would be to forbid them to have any debt at all).

\textsuperscript{112} Norton, supra note 1, at 1349. Commercial banks are the principal financial intermediaries in the country. Stigum, supra note 90, at 15. Other examples of financial intermediaries include S&Ls, insurance companies, pension and retirement funds, finance companies, money market and mutual funds, and securities brokers and dealers. Id.

from individuals with a surplus of savings and pass these funds on in
the form of loans and investments to companies and individuals who
have a deficit of funds. By acting as intermediaries, banks augment
capital, creating money without changing the amount of currency in
circulation thereby enabling the economy to grow. Normally, com-
petition is desirable because it promotes efficiency; banking is the
exception to this rule. For example, prohibitive regulation, such as
restricting entry into the banking system, prevents competition that
would threaten the reliability of banks. Similarly, regulators im-
pose CAGs to ensure that banks do not risk depositors' funds without
an adequate capital cushion; in doing so, regulators protect the sound-
ness of the banking system. The positive effects CAGs produce for
the rest of the economy justify the inefficiency and costs that such
regulations impose on the banking industry.

2. Regulatory Restraints on Unjustified Expansion

Increasing capital prohibits banks from avoiding financial difficul-
ties or insolvency by making more loans to produce more income.
Troubled banks are not able to leverage more, and probably riskier,
assets on their existing capital because CAGs prohibit them from ad-
dding assets without raising capital in the form of equity or debt.
From the stockholder's point of view, the essence of banking is to
raise the return on equity through leverage. CAGs curb this ten-
dency to leverage more and more. This restraint allows well-endowed
banks to increase the assets on their balance sheets or branch and
prohibits marginal institutions from growing or branching.

114. See Stigum, supra note 90, at 13-19.
115. Id. at 17.
116. Posner, supra note 111, at 449. Cf. Gowland, supra note 2, at 9 (challenging the
assumption that regulation of financial markets is necessary).
117. Lovett, supra note 2, at 1373.
118. See id.; Taylor, supra note 2, at 96-97.
119. See Gowland, supra note 2, at 41.
121. See supra notes 54, 55 and accompanying text.
122. Federal agencies are required to review capital requirements together biennu-
to file certain financial data annually, biannually, or quarterly. See, e.g., 12 C.F.R.
§ 18.4 (1994) (requiring certain financial data be filed annually); 12 C.F.R. § 8.2
(1994) (requiring certain financial data be filed biannually); 12 C.F.R. § 4.11 (1994)
(requiring that certain financial data be submitted quarterly to the OCC and that
examinations of the bank must be made twice annually). If a weakness is found in an
institution, prompt corrective action ("PCA") is to be taken. Under PCA, within 45
days after becoming less than adequately capitalized, a bank must submit a plan
(which is accepted or rejected within 60 days) to meet its capital requirements. See
Stephen K. Huber, The Federal Deposit Insurance Corporation Improvement Act of
123. Stigum, supra note 90, at 185.
124. Frederick D. Lipman, Guest Headnote: New Risk-Based Capital Guidelines
3. Bolstering Public Confidence

In theory, increased capital levels at banks will settle the minds of depositors who know that there is a larger cushion between poor bank loans and their deposits. Federal deposit insurance, however, has removed the incentive for depositors to examine the capital structure of individual banks. Consequently, the main effect of CAGs on the public is systemic: increased capital results in fewer bank failures, producing a stronger feeling that banks are safe places for individuals to keep their savings. The 1980s taught regulators that systemwide risk can be even more devastating than poor management, excessive risk taking, or fraud. Loans to Latin American countries, agriculture interests, real estate interests, and oil interests increased bank risk throughout the United States. The strengthened role of capital provides a larger cushion against systemic as well as systemwide risks such as inflation, war, and recession.

4. Mitigating the Moral Hazard Problem

In banking, the problem of moral hazard is particularly evident. If an institution is highly leveraged, a great incentive to engage in riskier investments exists because of the potential for big gains. If the worst occurs, and a bank becomes insolvent, federal deposit insurance bears the burden of paying depositors while limited corporate liability protects management in the absence of actual fraud. The disincentive to participate in risky activities exists only to the extent that management has an ownership interest in the bank or management fears losing their employment. Unfortunately, bonuses compensating managers for profitable performance counteract this disincentive.

125. See Jackson, supra note 1, at 587.
126. See Jonathan R. Macey, The Political Science of Regulating Bank Risk, 49 Ohio St. L.J. 1277, 1280 (1989) (“In the absence of deposit insurance, of course, bank depositors would face potential losses whenever the banks in which they had deposits become insolvent. . . . [I]n the presence of deposit insurance theses depositors are completely insulated from the consequences of bank failure . . . .”).
127. The Comptroller of Currency distinguished systemic risks from systemwide risks.

The first involves a sudden, usually unexpected, collapse of confidence in a significant portion of the banking or financial system with potentially large real economic impacts. Let us call these ‘systemic’ risks. The second involves macro-economic cycles, new product trends and other developments that may not be sudden, but that affect large portions of the industry and carry substantial safety and soundness implications. Just to confuse you, I will call these ‘systemwide’ risks.

128. See Lovett, supra note 2, at 1377-79.
129. See id. at 1378.
CAGs attempt to mitigate this hazard. Without the imposition of CAGs, banks would not have incentive to hold enough capital to cover the public costs of bank failure.\textsuperscript{130} This is true because deposits, as an alternative to capital, are a much less costly liability to incur.\textsuperscript{131} Capital is more expensive because shareholders demand a higher return on their investment than do depositors. A shareholder's money remains completely at risk, while the FDIC guarantees depositors funds up to $100,000.\textsuperscript{132} Deposit insurance, therefore, subsidizes banks by allowing them to pay a low interest rate for federally guaranteed deposits.

As a result of the availability of inexpensive deposits, capital levels at banks have traditionally been the lowest among financial institutions.\textsuperscript{133} "Securities firms, insurance companies, and finance companies all have capital ratios of fifteen percent or more."\textsuperscript{134} These two factors, low capital investment and federally insured funds, put both bank management\textsuperscript{135} and owners in a position where they have little at stake but much to gain from risky investments.\textsuperscript{136} As capital levels decrease, the moral hazard becomes greater because investors have less to lose. Regulators respond to this problem by raising capital requirements. If a bank holds high risk assets, CAGs demand that a minimum of eight percent of the stockholders and subordinated debt holders' money be on hand to absorb unexpected losses. This capital cushion protects both the depositors and the taxpayers who ultimately pay for failed banks.\textsuperscript{137}

5. Liquidity

CAGs give banks incentive to hold liquid, safe investments by lowering the amount of capital they must hold in relation to these assets. In some cases, assets require no capital support at all, such as those


\textsuperscript{131} See id.

\textsuperscript{132} 12 U.S.C § 1813(m) (1988).

\textsuperscript{133} Treasury Modernization Study, supra note 31, at 97,359.


\textsuperscript{135} Generally all corporate managers, who are not themselves heavily invested in the companies they run, have a moral hazard problem because the money they gamble with is not their own. Bank managers are more susceptible to moral hazard because most of the funds they gamble with are insured by the federal government.

\textsuperscript{136} See Treasury Modernization Study, supra note 31, at 97,361.

\textsuperscript{137} See Kane, supra note 1, at 39. When banks fail either the Bank Insurance Fund will pay for the losses or the government will have to bail out the fund. In either case, the costs are eventually passed on to the taxpayer or the bank customer through higher fees and interest rates.
that fall into the zero percent risk weight category. When more liquid funds are available, an unexpected surge in withdrawals or payments will less likely cause a bank to fail to meet its current obligations. CAGs, thus, guard against liquidity risk.

6. The Level Playing Field

A primary objective of the Basle Agreement was to "diminish[ ] an existing source of competitive inequality among international banks." For example, if two countries have different capital requirements for their banks, and those banks are competing against each other, the cost of doing business for the bank with the higher capital requirement is greater because that bank will have to raise more capital to control the same amount of assets. Theoretically, leveling the playing field removes other considerations allowing investors to choose the highest rate of return for a given level of risk. Banks, in turn, must respond to the needs of investors by creating a more efficient system for maximizing value without adding cost. Nationally, CAGs prohibit the establishment of a level playing field. This problem and others will be addressed in Part II.

The previously enumerated reasons for imposing CAGs on banks are substantial and sound. They were imposed to improve the banking system by changing the behavior of banks. Congress has noted that CAGs have required a major readjustment by the banking industry. The change in banks' behavior, however, was supposed to strengthen and stabilize the banking system, but in many ways CAGs have, and will continue to, hurt the banking industry and the economy. Part II explores both the good and bad that CAGs have wrought.

138. Treasury bills, for example, are highly liquid instruments that yield a relatively low rate of interest. A bank need hold no capital to support such an asset. For a detailed discussion of the risk weight categories see discussion infra part I.B.1.


140. Liquidity risk is the risk that a party will not settle a payment when it is due. It differs from credit risk in that liquidity risk does not necessarily mean a loss but merely a delay that could be costly. See Jeffrey C. Marquardt, Payment System Policy Issues and Analysis, in The Payment System: Design, Management, and Supervision 136-37 (Bruce J. Summers ed., International Monetary Fund 1994).

141. See Basle Agreement, supra note 29, at 3309.


143. See id.

144. See discussion infra part II.B.2.


146. Congress has shown concern for the long range effects CAGs have on lending, especially to small businesses. See id.
CAGs have affected not only banks, but bank customers, taxpayers, and the economy. A brief overview of bank asset management is necessary in order to demonstrate the CAGs’ effect upon individual bank profitability. Then, the impact on the banking industry can be discussed, and finally, the manner in which changes in banking affects everyone associated with banks.

CAGs prevent banks from putting capital to its highest value use, at least the highest value from the bank’s perspective. Banks must allocate capital in quantities that regulators regard as sufficiently safe to ensure the stability of individual banks and the banking system. Regulators, while concerned with ensuring bank solvency, do not primarily concern themselves with individual bank profit. Maintaining the credit function of individual banks, and thereby protecting the banking system, is of greater importance to regulators. The stability of individual banks poses a concern for regulators because the failure of one bank may lead to a lack of confidence in other banks prompting withdrawals, increased incidents of bank failure, and weakening the banking system. The resulting disintermediation would harm the economy.

One effect of across-the-board capital requirements is that they harm individual banks in an effort to make the banking system more stable. Surprisingly, CAGs may actually increase bank failure in the process of strengthening the banking system. Under FDICIA, regulators have broad authority to compel recapitalization of undercapitalized banks. If a bank has less than two percent capital, regulators may close the bank even though it is still solvent. When capital dips below acceptable levels, regulators can restrict asset growth, prevent banks from paying dividends, and prohibit banks from solicitation.

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147. From the regulators’ perspective, capital is put to a better use if it is used to protect the banking system rather than the individual bank.

148. Most banking law and regulation is concerned with protecting and encouraging this essential function. See, e.g., Helen A. Garten, A Political Analysis of Bank Failure Resolution, 74 B.U. L. Rev. 429, 429-30 (1994) (analyzing the failure of government intervention that took the form of deregulation in the 1980s in light of the successful government response to the banking crisis of the 1930s) [hereinafter Garten, Bank Failure Resolution].


150. Id.; see supra note 48 and accompanying text.


153. See 12 U.S.C. § 1831o(h)(3)(A) (Supp. V 1993); 12 C.F.R. § 303.9 (1994). The institution must be seized and placed in receivership if, on average, it remains critically undercapitalized during the calendar quarter beginning 270 days after the institution first falls into that condition.” Baxter, supra note 18, at 521.


155. Id. at 520-21.
ing deposits from brokers. These measures can have damaging effects. Such effects are especially evident when the reason for low capital is not poor management, but a narrower profit margin. In most cases, banks experiencing financial difficulty need lower, not higher, capital requirements.

Equity capital may decline because of lower profits, weaker assets or too rapid growth. For the banking industry as a whole, equity capital ratios are now higher than they have been for two decades. But the industry does not seem any stronger, or more willing to lend freely. If undercapitalized banks are effectively barred from competitive funding markets, they will either shrink or fail.

Troubled banks usually need improved management not more capital. Even a large capital cushion will not maintain a distressed bank for long. CAGs, thus, fail to address a fundamental problem with the banking industry. Capital standards are designed to maintain the safe operation of banks, but when the regulatory environment burdens banks with a competitive disadvantage, fewer banks will be able to compete with nonbank competitors or money center banks.

A. Bank Operations and Capital Management

Banks use capital differently than most companies. Rather than as a source of funds available to finance buildings and equipment, banks use capital as protection against unforeseeable losses. The eight percent figure that banks must maintain, however, is arbitrary and can be harmful to an institution that needs to manage its capital structure differently. Each individual bank's ideal capital structure var-

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158. Money center banks or money market banks are the largest banks in the United States. They are important players in major markets including the Fed funds market, the repo market, the government and agency securities market, and other securities markets as well as the derivatives market. These banks engage in a various businesses in addition to traditional banking such as dealing in domestic securities, foreign capital markets and clearing securities for other dealers. Stigum, supra note 90, at 118-21.
160. "That figure was seat-of-the-pants stuff," admits Peter Cooke, the former Bank of England official who chaired the BIS Committee on Banking Supervision that hammered out the Basel Agreement." David Fairlamb, Beyond Capital, Institutional Investor, Aug. 1994, at 42.
161. Notwithstanding the theoretical appeal of increased capital requirements, there are significant problems with relying exclusively or even principally on this approach. First of all, there are considerable difficulties in determining exactly how far capital reserves should be raised. As was true in the case of risk-regulation through activity restrictions, optimal capital reserve requirements are likely to vary greatly from institution to institution, even within a single segment of the financial services industry. Recent events suggest that political pressures and theoretical dissension have combined at different
ies depending on many factors\textsuperscript{162} that CAGs do not take into account.\textsuperscript{163} Moreover, overcapitalized banks harm society by diverting capital from more productive uses.\textsuperscript{164}

1. Measuring the Maturity Gap

CAGs intrude upon the primary function of bank management—to maximize profits while maintaining an acceptable level of perceived risk.\textsuperscript{165} Banks must manage risk in an environment where capital regulations, deposits, and the current economic climate are outside a bank’s control.\textsuperscript{166} Within a bank’s control is its asset portfolio. Banks normally fund their asset portfolios with relatively short term liabilities: deposits, Federal funds,\textsuperscript{167} repos,\textsuperscript{168} and other money market instruments. Banks must attempt to measure the average maturity of assets and liabilities to divine the inevitable mismatch in the bank’s position.\textsuperscript{169} Management constantly monitors the time gap between liability and asset maturity so that the gap does not grow so large as to interrupt cash flow or expose the bank to too great a rate risk.\textsuperscript{170} If cash flow is interrupted and withdrawals are not met, the bank is in-

\begin{itemize}
  \item \textsuperscript{162} See Finnerty, supra note 99, at 175-95.
  \item \textsuperscript{163} Minimum capital requirements in themselves do not demarcate safe versus unsafe or sound versus unsound banking activity. Rather, the FDIC requirement that a bank maintain capital at a specified level is nothing more than an alarm triggering full evaluation of the bank’s condition—nothing more than a signal that a particular bank has reached or is approaching an unsafe or unsound capital position. Metzger, supra note 25, at 254-55.
  \item \textsuperscript{164} Butler & Dugan, supra note 1, at 872.
  \item \textsuperscript{165} Stigum, supra note 90, at 122.
  \item \textsuperscript{166} See id.
  \item \textsuperscript{167} Federal funds are the reserves, required by law, to be kept on account at a bank’s local Federal Reserve Branch. A bank with a funds deficit can borrow from other banks with surplus funds. This usually occurs on an overnight basis because of the volatility in the amount of funds a bank may have on any given day. Id. at 42-44, 177.
  \item \textsuperscript{168} Government securities dealers use repurchase agreements, repos for short, to finance overnight borrowing of funds to finance their positions. Id. at 44. Banks use repos instead of deposits because repo funds require no FDIC premiums and no reserve requirement. Id. at 179.
  \item \textsuperscript{169} Id. at 126-27.
  \item \textsuperscript{170} Id. at 127. Rate risk or interest rate exposure is a traditional risk in banking. Banks lend funds for long periods of time while their deposits base and borrowing avenues are usually short term. If interest rates rise, banks will be paying more money for short term funds while receiving less money from their long term loans. Of course, banks can profit when interest rates fall and money is inexpensive. Banks cannot perfectly match maturities because many of their assets and liabilities do not have definite maturities. Id. at 126. Instead, banks pool their assets and liabilities and determine the average of both and match the overall position of the portfolio. Id.
\end{itemize}
The more liquid a bank's assets the less capital it needs to hold and vice versa. Even with CAG requirements, capital is only a small percentage of assets and can only protect against short term loss that results from such temporary volatility. It cannot protect a bank that is not profitable. With actual bank capital ratios at above ten percent, CAGs force bankers to focus on higher profits margins rather than asset growth. Because of this shift in perspective, banks can cover unforeseeable losses with incoming revenue rather than with the capital cushion. The increased concentration on maximizing profit is a positive effect of CAGs, but regulators have failed to address banks' abilities to compete profitably with higher capital levels.

2. Asset Management

Commercial banks are the largest discrete group of financial intermediaries and the largest suppliers of credit to business firms, consumers, the federal government, and state and local governments. They hold assets in the form of debt, mostly in the form of business loans and mortgages. Government securities make up the second largest pool of bank assets. Banks have incentive to hold government securities because they are in the zero percent risk category. Investment in government securities, however, does not ensure stability and safety. The relatively low rate of return Treasury Bills offer can be inappropriate when interest rates are rising. The growth and stability of banks depend more on the type of services they can offer and the cost of funds (transaction and time deposits) in relation to the return they produce than the amount of liquid funds a bank may have on hand at any given time. Banks often hold large quantities of government securities for liquidity purposes and for profit, especially when interest rates are falling. Rising interest rates force banks to maintain their governments by raising more capital or shedding higher

171. Technically, insolvency is the inability to pay debts on maturity, or having a negative net worth. The two are distinguishable but may have the same effect. The first may be due to illiquidity. See supra part I.C.5 (offering improved liquidity as a rationale for CAGs); see also supra text accompanying notes 54, 254-63 (describing lack of liquidity as leading to insolvency).
173. Taylor, supra note 2, at 43.
174. Id.
175. See Fairlamb, supra note 160, at 44. Indeed, the top 20 banks now have between 13% and 26% total capital ratios. Id. at 40. Eight percent is a minimum capital requirement. Id.
176. Id.
177. See Taylor, supra note 2, at 97.
179. See id.
180. See supra part I.B.1.a.i.
181. Stigum, supra note 90, at 125.
182. See id.; see also supra note 170 (discussing interest rate risk).
risk assets. Both are difficult to do. In some years "the case for a bank to hold any governments was weak at best."183

CAGs induce banks to counsel customers to collateralize loans with government or agency securities. This creates an unfair economic advantage to government organizations that often do the same business as private organizations. For example, mortgage-backed securities from Fannie Mae or Freddie Mac are more attractive collateral than the same class of securities issued by a private company. Government organizations often get preferential treatment, but just as often it is at the expense of the economy because the funds are not being allocated to a use that maximizes their value.184 The effect is a reduction in economic productivity.185 CAGs thus affect the allocation of resources and impose social costs186 in the purest sense.

It is not uncommon for federal law and regulations to limit the investment choices banks may make. Examples of such limitations include prohibiting investment in corporate stocks,187 limiting the percentage of assets that may be invested in one borrower,188 limiting investments in real estate,189 and limiting the interest rate banks may charge.190 These prohibitions reduce risk in a bank's portfolio, thereby making the institution more stable.191

While CAGs affect a bank's portfolio substantially, they do not take into account portfolio investment theory. Portfolio risk management seeks to establish a negative covariation between assets, that is, to establish a group of assets that will respond differently to the same external economic event so that the return on assets remains stable.192 Measuring risk among investments depends on the interrelationship between the investments; for example, the same occurrence outside

183. Stigum, supra note 90, at 125.
184. There is nothing level about a playing field in which the United States Government is a competitor. [I]t seems clear ... that Fannie Mae and Freddie Mac will retain their favored position in the marketplace. While Fannie and Freddie were required to increase capital somewhat, they will continue to escape many of the regulatory constraints.
Marilyn R. Seymann, Banking's Role in Emerging Secondary Markets, 47 Consumer Fin. L.Q. Rep. 253, 260 (1993); see also William Pesek Jr. & Allison Penn, Bond Prices Edge Higher as Participants Await Meeting of the Fed's Policy-Making Committee, Wall St. J., Mar. 28, 1995, at C21 (indicating that banks show a preference for Ginnie Mae securities because they have to hold less capital against them).
185. See Posner, supra note 111, at 10.
186. Social costs as opposed to private costs can be substantial and diminish the wealth of a society. Id. at 7, 544-45.
191. See Clark, supra note 139, at 55.
192. Id. at 51-52.
the bank's control may decrease profits for a supplier while increasing profits for a retailer. The system has shown some traditional regulation to be arbitrary: "The principal defense against volatility is diversification, which, if done correctly, will also reduce overall losses for the portfolio. By diversifying appropriately, a portfolio manager creates a portfolio with less overall risk than the risk of any single loan or a narrowly defined group of loans."193

3. Addressing Management's Moral Hazard

Shifting risk from the FDIC and taxpayers back to depositors and stockholders mitigates the moral hazard problem. Stockholders (primarily Tier 1) or debt holders (primarily Tier 2) could lower bank risk taking by monitoring management's decisions to invest in riskier assets for greater profit if they had the proper motivation.194 This argument makes more sense for bondholders who are guaranteed their income at a constant rate absent severe financial difficulty,195 than for stockholders who would reap the benefits of the high reward of risky investments in the form of dividends and higher value stock. CAGs put this burden back on the stockholders by forcing them to risk more funds as management increases risk in the bank's portfolio.

This position, however, is ultimately flawed. Given the nature of the banking industry, the proposition that stockholders could control bank investment strategy is unconvincing: Because of all the filings and approvals required, it is unfeasible for bank investors to oust bad managers. Bad managers are the primary cause of failed banks.196 Moreover, most shareholders own only a small fraction of outstanding stock,197 and are usually widely dispersed making the cost of organiz-

194. See Jackson, supra note 1, at 586.
195. If a bank becomes critically undercapitalized it will be prohibited from making payments of principal or interest on subordinated debt. There are five categories of capitalization under prompt corrective action system. A bank is (1) well capitalized if it has a total risk-weighted capital of 10% or greater, Tier 1 capital of 6% or greater and a leverage ratio of 5% or greater, (2) adequately capitalized if it has a total risk-weighted capital of 8% or greater, Tier 1 capital of 4% or greater and a leverage ratio of 4% or greater (or 3% or greater if the bank is rated 1 in its most recent examination), (3) undercapitalized if it has a total risk-weighted capital of lower than 8%, Tier 1 capital lower than 4% and a leverage ratio lower than 4% (unless the bank had a rating of 1 in its most recent examination). Then it will have to have a ratio of less than 3%, (4) significantly undercapitalized if it has a total risk-weighted capital less than 6%, a Tier 1 capital lower than 3% and a leverage ratio lower than 3%, and (5) critically undercapitalized if the bank has a ratio of tangible equity to total assets that is equal to 2% or less. 12 C.F.R. § 6.4 (1994).
ing prohibitively expensive.\textsuperscript{198} Therefore, it is more efficient for shareholders to devote themselves to investment strategies than to corporate governance.\textsuperscript{199} Management takes advantage of their position because stockholders have neither the voting power, the expertise, nor the time to effectively monitor banks. Management, therefore, does not have to be responsive to stockholders. Empirical studies suggest that banks encounter agency problems in that managers can pursue their own interests instead of acting in the best interest of the bank.\textsuperscript{200} In addition, because bank management is large and complex, it is difficult to assign blame to any one person or group of persons.\textsuperscript{201}

B. The Practical Effects of the CAGs

The CAGs have affected the banking industry significantly. Some expected and quantifiable effects are the consolidation and stratification of banks and a shift in bank assets. The CAGs, however, also have added to the problems facing banks by undermining their ability to compete with nonbank financial companies, reducing the supply of available credit for businesses and consumers, and compounding the already burdensome and costly reporting requirements, all the while failing to account adequately for the risk in bank portfolios.

Eight percent of risk-weighted assets may not appear to be a burdensome amount of capital to maintain when considering historical levels of capital. In the 1840s, bank capital-to-total assets ratios approached sixty percent.\textsuperscript{202} Today, in a poor economic environment, an eight percent capital minimum can have a profound effect on banks.

The fact that capital is important to the regulators makes it important to us, but it is important to us for another reason. Because of the way regulation is done in this country, and because of the regulators' risk-based capital guidelines... the primary constraint to an institution's being a predator, a survivor, and a winner, is capital.\textsuperscript{203}

There are a number of ways CAGs make it more difficult for banks to survive.

\begin{thebibliography}{9}
\bibitem{198} Id. at 46.
\bibitem{199} Id.
\bibitem{201} See id.
\bibitem{202} See Kaufman, supra note 134, at 189.
\bibitem{203} Bollenbacher, supra note 120, at 87.
\end{thebibliography}
1. Tiering and Consolidation

CAGs have split banks down the middle. Those banks with smaller profit margins cannot afford to keep as great a capital cushion, because their profits are lower. Lower earnings result in smaller additions to contingent reserves, so banks will not be able to bear loan default as easily. They also prevent banks from growing. To obtain higher profits banks must make riskier loans. The divergence can only grow wider as well capitalized banks expand and under capitalized banks struggle to maintain their capital requirements and earnings by making more profitable and riskier one hundred percent category loans. Reliable data support this contention. Since 1989, the number of national banks has dropped from 4397 to 3262. Most of these losses came from smaller banks, those with assets under $100 million. Moreover, data from the Comptroller of Currency indicate that the assets of smaller national banks are shrinking, while those of larger banks are growing.

Consolidation and shrinkage of the banking industry below an optimal level will cause a loss in efficiency. It can also harm customers and suppliers who rely on the current industry structure such as the low and middle income borrowers who rely primarily on community banks and thrifts. Consolidation and shrinkage mainly eradicate this sector of the industry causing a disproportionate impact on those customers. Moreover, consolidation of the banking sys-

204. "[A] tiering has occurred among banks according to their respective capital levels. Banks with adequate or excess capital are able to raise additional capital at advantageous rates and are able to take advantage of the resulting wider margins between loans and bank capital." Alford, supra note 159, at 210-11 (citations omitted).

205. Fairlamb, supra note 160, at 43.

206. See Gowland, supra note 2, at 14.

207. Alford, supra note 159, at 216-17.


209. See id. at 5.

210. See id. at 6.

211. Because of the poor capital positions of many banks, CAGs force consolidation. "In New York, we have repeatedly urged our banks to think about consolidation to strengthen their capital positions and secure greater economies of scale." Jill M. Considine, A State's Response to the United States Treasury Department Proposals to Modernize the Nation's Banking System, 59 Fordham L. Rev. S243, S256 (1991).

212. Defining the socially optimal level of capital is extraordinarily difficult. The task does not just involve replicating the level that various claimants on financial institutions (such as depositors, equity holders, employees, and suppliers) would bargain for under conditions of perfect competition and costless information. Rather, third party interests—particularly public interests in avoiding the externalities of failures—would also have to be factored in. For purposes of analysis, the optimal level is a hypothetical capital requirement that factors in all relevant welfare effects.

213. Id. at 588.

214. Id.
tem leads to homogenization and nationalization of banks, which is exactly what the dual banking system of the United States was supposed to prevent.215

2. Increased Competition

By removing many of the obstacles to free competition in financial services, deregulation made banks more efficient. The failure of deregulation, however, has exposed a fundamental incongruity in the goals of legislators and regulators. They want competitive and efficient banks without bank failure. To accomplish this, regulators have removed market restrictions to make banks compete more fiercely while tightening prudential restrictions to ensure banks will not fail under the increased competition. Market discipline as well as regulatory discipline thus encumber banks. In addition, factors such as the globalization of financial markets, improvements in communication technology, development of new products, and securitization have made the financial intermediary market much more competitive.216 At a time when banks need less regulation so they can compete more effectively, regulators are fine tuning CAGs to a point that approaches micromanagement.217 In contrast to the spirit of deregulation, CAGs constitute a reregulation response to the perceived failures of deregulation in the 1980s.218 CAGs, however, are not likely to make banks safer because they curb profit making abilities219 in a competitive deregulated market by forcing banks to hold more capital than is efficient.220 In a system where banks are no longer the sole performers of the essential function of efficiently making payments,221 they are at risk not from other banks, but from nonbank financial institutions that compete with banks for deposits, securities brokering, and loans.

An important goal of the CAGs was to level the playing field.222 Commentators have noted that considering the number of variables

215. See Michael P. Malloy, The Regulation of Banking 11-15 (1992) (excerpting the debate between Alexander Hamilton and Thomas Jefferson on the establishment of a national banking system); Considine, supra note 211, at S244.
216. See Stigum, supra note 90, at 131-33.
219. "What difference does it make if a bank has no capital or has some capital if it is now operating profitably?" Root, supra note 1, at 152 (quoting The Impact of Bank/Thrift Closures on Local Economies: Hearings Before House Small Business Commission, 102d Cong., 1st Sess. 50 (1991) (testimony of Dr. Paul S. Nadler, Professor of Banking, Rutgers University)).
220. "Instead of using a static measure like bank capital adequacy, the regulators should determine the bank's prospects for earning profits now and in the future—profits that can build up capital over time."
221. Pierce, supra note 27, at 17.
222. See discussion supra part I.C.6.
and differences between international financial institutions, achieving equality is virtually impossible.\(^{223}\) This brings into question the importance of equalizing capital regulations (on a national level) without equalizing other regulations that govern competing institutions. CAGs alone certainly do not create a level playing field. To achieve a level playing field, two prerequisites must be met: (1) regulations must be reformed to remove competitive inequalities among competing institutions without any burdensome regulations, and (2) equal access to information must be allowed to all participants so they may evaluate their economic position.\(^{224}\)

As to the first requirement, competitive equality, CAGs apply consistently to depository institutions with few differences\(^{225}\) so financial institutions gain no advantage or disadvantage in the market.\(^{226}\) But, Congress has not applied CAGs to nonbank competitors. By implementing CAGs in a deregulated market, lawmakers and regulators have removed restrictions on market forces, yet have increased restrictions on certain market participants. The complexity and definitional problems associated with CAGs, as well as the confidentiality afforded banks, make it difficult for market participants to evaluate the capital base of banks.\(^{227}\) Moreover, until tax and accounting standards are also made uniform across the financial industry, the treatment of capital cannot be uniform.\(^{228}\)

Regulatory policy precludes the second requirement, that equal access be given to all market participants. Regulators have broad discretion not to release information about banks.\(^{229}\) Regulators' examinations of banks are always confidential.\(^{230}\) These rules on disclosure of a bank's financial position give regulators an opportunity to remedy troubled or problem banks before a bank failure can undermine public confidence. Regulatory implementation of CAGs, therefore, does not meet the goal of leveling the playing field. In fact, such regulations make competition more difficult. Without removing restrictive regulatory constraints on banking activity, banks and their nonbank competitors will continue to compete under different conditions. Increasing market discipline, under such circumstances, exposes banks to risks that controvert a sound macroeconomic policy of ensur-

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\(^{223}\) See Gowland, supra note 2, at 42.

\(^{224}\) See Norton, supra note 1, at 1355-56.

\(^{225}\) See Capital Standards, supra note 36, at 36,833-37.

\(^{226}\) See Norton, supra note 1, at 1355.

\(^{227}\) See id. at 1357.

\(^{228}\) See id. at 1361.

\(^{229}\) See, e.g., Rules, Policies, and Procedures for Corporate Activities, 12 C.F.R. § 5.13(a) (1994) (giving regulators ability to withhold information regarding notifications and decisions if they believe withholding is in the public interest).

\(^{230}\) See Books and Records on National Banks, 12 C.F.R. § 7.6025(c) (1994).
ing the availability of credit and maintaining the safety and soundness of banks.\textsuperscript{231}

3. Asset Conversion

To maximize asset value, banks must convert, dispose of, or securitize their “high risk” assets. These one hundred percent category assets are prohibitively expensive because they require a bank to hold at least eight percent of the value of the assets as regulatory capital.

a. Monetization

Banks may choose to monetize their fixed assets by, for example, selling the bank premises (which fall within the one hundred percent risk weight category) and arranging for a lease.\textsuperscript{232} Funds from the sale would generate, as well as free up, regulatory capital enabling the bank to hold more profitable assets. Banks also may shed assets by cutting out discrete bank operations such as data processing units and by hiring outside contractors to do the work, thus reducing the fixed one hundred percent risk weight assets.\textsuperscript{233}

b. Risk Category Adjustment

CAGs also encourage banks either to convert high risk assets into lower risk assets or dispose of them entirely. In the personal loan market this may mean converting consumer debt to home equity debt,\textsuperscript{234} consequently reducing a bank’s capital requirement by half.\textsuperscript{235} Conversions of this sort will also lower gross profits, because banks can charge higher interest rates on personal loans than on home equity loans. The costs imposed by these regulations will eventually be passed on to the consumer in the form of higher interest rates. This, in turn, poses two problems: (1) as a public policy matter, less credit will be available, especially to that segment of the population unable to secure home equity loans, and (2) banks will be less able to compete with nonbank financial institutions which are not burdened by regulatory costs. CAGs encourage banks to shed off-balance sheet commitments such as swaps and exchange contracts, especially in light of the proposed interest rate regulations that one banker called “imprecise and inflexible,” continuing, “Since we all have different port-

\begin{itemize}
  \item \textsuperscript{231} See Garten, \textit{Market Discipline}, supra note 151 at 749, 776-77.
  \item \textsuperscript{232} Bollenbacher, \textit{supra} note 120, at 95.
  \item \textsuperscript{233} \textit{Id.}
  \item \textsuperscript{234} See, e.g., 58 Fed. Reg. 68,735 (1994) (to be codified at 12 C.F.R. pts. 208 & 225) (announcing final rule permitting state member banks and bank holding companies to lower certain multi-family homes loans from 100\% to 50\%).
  \item \textsuperscript{235} \textit{Id.; see supra} parts I.B.1.a.iii & iv for a discussion of the 50\% and 100\% risk weight categories.
\end{itemize}
folios, we vary in our ability to adjust our positions . . . . It therefore is ridiculous to have set rules for the industry as a whole." 236

c. Securitization

Traditionally, banks would reduce the risk of a pool of assets through diversification, but these are assets that remain on the balance sheet and are subject to capital requirements and as previously noted, CAGs do not take diversification into account. Through securitization, 237 banks sell shares of these asset pools, often with recourse, 238 so that the assets no longer have to be secured by a high capital ratio. 239 However, securitization has not necessarily made banks safer because higher quality assets are more easily securitized. 240 Many of the loans being securitized are credit card receivables, car loans, and home equity loans that tend to be lower risk than business loans. 241

The growth of securitization has helped banks transfer risk and avoid holding excess capital, but it also has changed the financial environment so dramatically that it poses a threat to the bank's function as intermediary. The narrowed profit spread has made traditional banking less profitable and has given banks more reason to want to enter investment banking. 242 Eventually securitization may remove the bank between the borrower and the lender. Businesses will be able to transfer their assets to individuals with a surplus of funds through marketable financial assets at the speed made available by electronic transfer. 243 Mutual funds 244 allow borrowers to tap directly into the

236. Fairlamb, supra note 160, at 46.
237. Commercial banks and thrifts, their subsidiaries or their holding company affiliates either originate or buy the loans, mortgages or other assets to be securitized and then segregate these assets into pools that are relatively homogenous with respect to credit, maturity and interest rate risk. These pools of assets are then transferred to a trust or other entity . . . that will issue securities backed by the pool of assets.
Puleo, supra note 92, at 352.
238. Id. at 348.
Asset sales with recourse must be treated on the commercial bank Call Reports as financings, with the result that the assets remain on the balance sheet and require capital maintenance against the assets. It is thus in the banks' interest to structure asset sales to avoid recourse or other retention of risk.

Id.
240. Fairlamb, supra note 160, at 40.
242. See Stigum, supra note 90, at 59.
243. Greenspan, supra note 239, at 44.
capital markets without using banks as intermediaries.\textsuperscript{245} Major manufacturers can issue asset backed securities directly, based on contracts for orders they have signed.\textsuperscript{246} Small and less credit worthy businesses will, for the immediate future, still have to go to banks because they cannot tap the capital markets directly to obtain financing.\textsuperscript{247} Nevertheless, the incentive CAGs provide banks to securitize their assets portends the demise of banks' tradition role in the economy.

By adopting the Riegle Community Development and Regulatory Improvement Act of 1994,\textsuperscript{248} Congress continued to support securitization by banks while transforming another traditional bank market. The Act facilitates the securitization of commercial real estate by allowing banks to buy and hold securities of pooled commercial real estate loans.\textsuperscript{249} It also lowers capital requirements by putting them in the same risk category as government securities.\textsuperscript{250} Regulators have already proposed rules that more accurately measure levels of risk in pools of loans.\textsuperscript{251} These are based on the level at which the bank is contractually liable for losses.\textsuperscript{252}

4. Ensuring Liquidity

Regulators have not imposed formal liquidity ratios for banks.\textsuperscript{253} Illiquidity, however, can damage the credibility of a bank severely. It is technical insolvency brought about by a bank's inability to meet current commitments.\textsuperscript{254} It has been suggested that liquidity is more important than a high capital ratio\textsuperscript{255} and that a bank can operate safely with no capital as long as it remains profitable.\textsuperscript{256} Liquidity is also a primary concern in determining systemic risk. One theory postulates the cause of the Great Depression was a liquidity crisis brought about by the Federal Reserve Board's reducing the money supply.\textsuperscript{257}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{245} See id.
\item \textsuperscript{246} See Donald Simonson, \textit{Vendor Financing Business Bypasses Banks}, U.S. Banker, May 1994, at 86.
\item \textsuperscript{247} Id.
\item \textsuperscript{250} See id.
\item \textsuperscript{252} See id.
\item \textsuperscript{253} While regulations often mention liquidity as a factor taken into account in the overall assessment of a bank, there are no quantitative measures similar to those for capital.
\item \textsuperscript{254} See Finnerty, supra note 99, at 172.
\item \textsuperscript{255} See Clark, supra note 139, at 56.
\item \textsuperscript{256} See Taylor supra note 2, at 90.
\end{enumerate}
\end{footnotesize}
Federal regulators have acknowledged that liquidity risk is difficult to measure and that CAGs are not an adequate means of ensuring liquidity.\textsuperscript{258} CAGs encourage liquidity by allowing banks to hold extremely liquid assets free of capital requirements.\textsuperscript{259} Nonetheless, capital requirements are generally not employed to maintain liquidity, but to "prevent[] . . . bottom line insolvency."\textsuperscript{260}

The indeterminacy of liquidity arises from the difficulty in determining depositors' withdrawal rate. Commercial banks have a legal obligation to pay depositors who request withdrawals, and withdrawals are typically not uniform. Banks must accurately predict the impact of deposit shocks if depositors request an extraordinarily large number of withdrawals on a given day.\textsuperscript{261} The amount of funds the banks dedicate to withdrawals are only a small portion of total assets they hold. A lack of liquidity harms not just the individual bank, but the entire banking system as lack of confidence in one institution breeds lack of confidence in others.

CAGs do not make it easier for banks to remain liquid. Banks must find the correct liquidity ratio to maintain both liquidity and profitability. The more liquid an asset, the less profitable the asset, and when profitability decreases, the liquidity of a bank must increase in order to compensate.\textsuperscript{262} Thus, preventing illiquidity and bottom line insolvency, the two ways a bank can fail,\textsuperscript{263} are at odds with each other.

5. Enforcement and Compliance Costs

There is no doubt that regulation, and in particular CAGs, have costs and dangers, and the costs can be high.\textsuperscript{264} The price for regulation is paid, initially on both sides of the regulatory fence. Enforcement costs include the budgets of federal regulators. Compliance costs include the routine and elaborate reporting demanded by regulators that must be carried out by bank personnel. The cost of regulators is paid directly by taxpayers, the cost to the banks is ultimately passed on to bank customers, bank employees, and shareholders.\textsuperscript{265} The larger potential cost is in decreased lending capacity. This means


\textsuperscript{259} See Finnerty, supra note 99, at 172.

\textsuperscript{260} See Clarke, supra note 139, at 68.

\textsuperscript{261} Id. at 55.

\textsuperscript{262} See Finnerty, supra note 99, at 260.

\textsuperscript{263} Gowland, supra note 2, at 77-78 n.11.

\textsuperscript{264} See id. at 24.

\textsuperscript{265} "A 1992 study by the American Bankers Association estimated compliance costs at $10.7 billion or 59% of the industry's profits." Danforth, supra note 45, at 2.
lower profits and a higher percentage of bank failures.\textsuperscript{266} FDICIA has been singled out as increasing compliance costs substantially, in particular the cost of incorporating interest rate risk and concentration risk into the CAGs.\textsuperscript{267}

Costs are not limited merely to the funds needed to create, supervise, and examine banks. The effect of the CAGs on bank activities also imposes costs on market participants whose loans fall within the higher risk categories requiring the most capital. There has been a marked shift in the balance sheet of banks. Between the first quarter of 1989 when risk-based capital standards were formally adopted and the fourth quarter of 1992, mortgage loans have increased by twenty seven percent and United States government securities have increased by seventy percent.\textsuperscript{268} Meanwhile, nonmortgage loans of United States commercial banks have fallen by three percent.\textsuperscript{269}

High costs may be justified if they are necessary to maintain a healthy system of financial intermediaries. The current CAGs, however, do not merit this justification. Risk weighting in certain instances does not adequately reflect the interests of a safe and sound banking systems. It reflects other public policy goals. The fifty percent risk weighting of first mortgages for one to four family houses is an example of regulators giving banks incentives to loan money for first time home buyers. Depending on many factors such as market conditions, the buyer's credit, and interests rates, this policy may undermine bank stability. Most regulation produces a safer banking system; however it reduces the efficiency of the market enormously. Because of the constraints placed on banks, fewer transactions are completed, except perhaps in the arenas that the regulators favor, such as housing.\textsuperscript{270} Government credit rationing violates the free market principle of allowing assets to flow to their highest valued use.\textsuperscript{271}

5. Credit Crunch

CAGs have forced banks to shift the assets they hold in their portfolios. In the early 1990s banks reduced their commercial loans and raised their treasury holdings.\textsuperscript{272} This resulted in a corresponding decrease in the number of borrowers who were able to obtain loans.\textsuperscript{273} Large companies are not seriously harmed from this decline in credit

\begin{itemize}
\item \textsuperscript{266} Id.
\item \textsuperscript{267} Id.
\item \textsuperscript{268} Id.
\item \textsuperscript{269} Id.
\item \textsuperscript{270} See Gowland, \textit{supra} note 2, at 24, 39.
\item \textsuperscript{271} Butler & Dugan, \textit{supra} note 1, at 873.
\item \textsuperscript{272} Allen N. Berger & Gregory F. Udell, \textit{Did Risk-based Capital Allocate Bank Credit and Cause a "Credit Crunch" in the United States}, 26 J. of Money, Credit & Banking 585, 586 (1994).
\item \textsuperscript{273} Id.
\end{itemize}
because they have the option of issuing commercial paper.\textsuperscript{274} Rather, consumers and small businesses, that portion of the economy that represents half the gross domestic product and constitutes the principal source of job creation, suffer.\textsuperscript{275} Congress recognized the reliance of small businesses on bank lending and the importance of small businesses to the economy.\textsuperscript{276} Congress has also acknowledged that the regulatory environment has caused banks to reduce significantly lending to commercial and industrial enterprises.\textsuperscript{277} Congress recommended, however, that the regulators encourage banks to hold even more capital so that banks would be able to make commercial loans and would be protected from downturns in the economy.\textsuperscript{278} Requiring banks to hold more capital regardless of the assets they hold defeats the purpose of the risk weight categories. It is a retreat to simple capital-to-assets ratio. Furthermore, the credit crunch indicates that holding excess capital is too costly for banks. Forcing banks to hold a larger percentage of less profitable loans will increase the negative effects of the CAGs already discussed. The imposition of excess capital will only prolong a situation where banks are not willing to lend because the penalties imposed by the CAGs outweigh the benefits of higher yields.\textsuperscript{279}

6. The Imprecision of the Risk Weight Categories

The risk weight categories define four levels of risk.\textsuperscript{280} The difficulty with these categories is that they are very complex, yet not precise enough to reflect substantial variance in the risk of the most important assets banks hold, those in the one hundred percent category. These “high risk” loans provide financing to the private sector, to large corporations and small businesses.\textsuperscript{281} The CAGs make no attempt to differentiate between a loan to a blue chip company and a loan to a company in extreme financial difficulty.\textsuperscript{282} At the same time, the regulations subsidize municipalities with poor credit ratings, which regardless of their financial condition, still fall into a twenty percent risk weight category.\textsuperscript{283} Furthermore, CAGs make no attempt to take collateral into account in business loans. Because there are no incentives for banks to hold less capital for safer loans, the CAGs give

\textsuperscript{275} Id.
\textsuperscript{277} Id.
\textsuperscript{278} Id. at 38.
\textsuperscript{280} See discussion supra part I.B.
\textsuperscript{282} See Alford, supra note 159, at 216.
\textsuperscript{283} Gordon, supra note 2, at 509-10.
banks an unfortunate incentive. To maintain earnings, banks must securitize or shed expensive, high risk assets. Yet, those high risk assets that are held must be profitable, and therefore risky enough to make them worth holding.\(^{284}\)

CAGs do not take into account the tremendous effect management can have on the assets within each category.\(^{285}\) Risk may vary depending on "underwriting standards, documentation, and review and collection procedures."\(^{286}\) CAGs neither take account of poor management, nor account for management fraud, a cause of many bank failures.

Two other inadequacies of CAGs should be mentioned. The first is that CAGs do not measure the market value of assets or capital, but rely on the book value or the cost of the assets.\(^{287}\) Depending on the economic environment, or a host of other variables, bank assets can change drastically in value, leading to insolvency. CAGs would not respond to such a change in value. The second is that they measure the risk of individual assets risk rather than the portfolio risk of all the assets a bank may hold.\(^{288}\) Basic portfolio theory dictates that regulators should look at the overall return and variance of a bank's portfolio rather than the individual assets a bank selects.\(^{289}\) CAGs, therefore, do not encourage banks to diversify their portfolios to reduce the risk of the most commonly held assets: commercial and personal loans. If CAGs took account of portfolio diversification, banks

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284. Statistical studies on this point conflict, but an article published by the Comptroller of Currency concludes that the CAGs had no impact on the portfolio risk of capital constrained banks. Jacques & Nigro, supra note 20, at 3.
286. Id. "Thus, some real estate loans may entail substantially more risk than many business or consumer loans that require more capital." Id.
287. Id. Regulators proposed rules that would make banks value certain securities at market value when calculating their inclusion in capital. See 59 Fed. Reg. 18,328 (1994). Regulators have decided to drop this rule, known as F.A.S. 115 (for Statement of Financial Accounting Standards No. 115) because, according to Eugene A. Ludwig, the Comptroller of Currency, "'Requiring banks to use FAS 115 to calculate risk-based capital would have subjected some banks to wide swings in their risk-based capital ratios with no real public benefit.'" Robyn Meredith, Regulators Decide to Scrap Controversial Capital Plan, Am. Banker, Nov. 9, 1994, at 1, 2 (citation omitted).
288. Many reasons have been presented for the lack of rigor in the bank portfolio management process, especially when compared to the sophistication of capital market investors.
A major reason has been the lack of readily available tools for estimating and projecting credit losses and the related volatility for loan cohorts that have common characteristics or dependencies.

Banks that can demonstrate that their credit loss volatility is both understandable and controllable should be able to justify for lower capital requirements which, in turn, may set the stage for the survival and growth of the institution.
Abraham, supra note 193, at 26.
289. See supra notes 192-93 and accompanying text.
would be able to reduce their capital requirements by offsetting the risks associated with classes of loans that respond in opposite ways to the same external event. By failing to take account of this type of risk management, CAGs do not help banks perform their core function of making loans. Instead, they hinder it.

Regulators have fashioned guidelines sophisticated enough to reduce systemic risk and protect the Bank Insurance Fund. For banks, the CAGs are complex enough to be costly, yet they are not sufficiently precise to measure risk accurately. The result is that CAGs encumber banks without providing proper incentives, such as the incentive to diversify their portfolios and manage risk more carefully.

CAGs do not encompass many of the risks to which banks are subject. These risks include interest rate risk, foreign currency risk, liquidity risk, inflation risk, market risk, position risk, legal risk, fraud risk, and poor management risk. The formulators of the current CAGs concentrated almost exclusively on credit risk when determining the risk weight categories for bank assets. Under FDICIA, however, regulators have been instructed to incorporate interest rate risk, concentration of credit risk and the risk of nontraditional activities into the CAGs. These proposed rules will be discussed further in part III.

III. THE FUTURE ROLE OF REGULATORY CAPITAL

Banks have responded well to the current economic climate in spite of the difficult, though improving, market environment they face. Proposed amendments to the CAGs, however, still threaten increased regulatory control over bank assets. While Congress and the regulators consider allowing banks to participate in investment banking ac-

290. A primary purpose of FDICIA was to recapitalize the Bank Insurance Fund. FDICIA, supra note 38, § 101. However a common complaint regarding FDICIA is that it did not include the broad reforms of the banking system sought by the Treasury Department and the banking industry. See Sarah J. Hughes, Banking and Deposit Insurance: An Unfinished Agenda for the 1990s, 68 Ind. L.J. 835, 835 (1993).

291. Despite their superficial complexity, none of the existing risk-based capital regimes goes much beyond the most simplistic systems of risk classification. Given the great expense that such a regime would impose on institutions to comply with these risk-based rules and on regulators to monitor compliance, it is not obvious that the end result would be better than traditional capital rules. Jackson, supra note 1, at 593.

292. See Bollenbacher, supra note 120, at 96.

293. See Basle Agreement, supra note 29, at 3312-14.

tivities, a modified role for the CAGs has not yet been formally discussed; however it is likely that CAGs will continue to play an important role in bank regulatory policy. Indeed, if Congress continues to reduce product and market restrictions, capital regulation will inevitably increase.

A. The Current Market Environment

The trend of securitization continues to portend the disintermediation of banks as Wall Street issues more and more securities backed by traditional bank products. While Congress and the regulators have taken a step forward in breaking down branching restrictions, they have not responded to entreaties by the banking industry to allow banks to underwrite securities, insurance, and mutual funds. Non-bank financial institutions can engage in bank restricted activities and enjoy most of the privileges traditionally reserved for banks. Non-banks are consequently much more efficient intermediaries than banks. For example, mutual funds can run on one percent of their managed assets, and Fannie Mae runs on twenty basis points while banks must operate between three and five percent. Banks have appeared to overcome this disadvantage somewhat during the past two years, but the recent prosperity of the banking industry is more likely attributable to the concurrent growth of the economy.

In the second quarter of 1994, national banks earned their highest profits ever. Much to the delight of regulators and bank owners, this trend of earning record profits has continued for the second year in a row. These record profits may indicate that banks are thriving because of the regulatory environment. It certainly demonstrates that, at the very least, they can thrive in spite of it. The Comptroller's figures also indicate a rapid consolidation among national banks. It also appears that the largest national banks are thriving while smaller banks are disappearing. This continues the trend begun by deregulation over a decade ago; the performance of banks, however, has di-

295. Seymann, supra note 184, at 253.
296. There are 100 basis points in one percent, so one basis point is one one-hundredth of a percent.
297. Seymann, supra note 184, at 253.
300. See Arthur E. Wilmarth Jr., Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks, 77 Iowa L. Rev. 957, 1081 (1992) (concluding that consolidation is likely to continue toward nationwide banking leading to a riskier, less efficient and less profitable banking system) [hereinafter Wilmarth, Too Big to Fail]; Arthur E. Wilmarth Jr., The Potential Risks of Nationwide Consolidation in the Banking Industry: A Reply to Professor Miller, 77 Iowa L. Rev. 1133, 1133 (1992).
301. See Wilmarth, Too Big to Fail, supra note 300, at 1040.
Access to information continues to improve and interest rates are on the rise. Increased competition and the lower margins caused by higher interest rates are causing banks to lend more freely and at reduced rates to maintain their earnings. In the event of a recession, this freer lending could bring trouble to banks when more borrowers will have difficulty paying the money back. Regulators have taken note of the easing of credit and are showing concern. In addition, banks are continuing to lose market share to nonbanks. These same conditions in the 1970s and early 1980s prompted Congress to reduce regulation so banks could keep up with nonbank competitors who had access to information and the ability to emulate banking functions without a banking charter at prices below those banks could offer. Because of the recent good times enjoyed by banks, however, regulatory policy, reactionary by nature, maintains its course.

B. Recent Proposed Rules

Recently, regulators announced significant additions to the CAGs. For example, regulators implemented final rules that take account of bilateral netting requirements, concentration risk, and nontradi-

302. See supra notes 204-10 and accompanying text.
306. Id.
308. “Commercial banks have ceded market share to nonbanks in credit cards, mortgages, and commercial paper. The industry also stands to lose a big chunk of the small-business lending market if legislation pending in Congress passes.” Barbara A. Rehm, Business Loans are Rising Again, and Banks Hear Rivals' Footsteps; Washington Wrestles with New Entrants, Am. Banker, June 23, 1994, at 5.
309. See Barth et al., supra note 1, at 61-62.
tional activity risk. Derivatives pose the newest challenge. Congress and the regulators have just begun a dialogue on how best to account for the risk imposed and prevented by these instruments. The proposed rules that account for interest rate risk present the most imminent and menacing addition to CAG regulations.

Interest rate risk ("IRR") is a serious problem for banks. Regulators plan to raise CAGs to account for a high interest rate exposure. Banks are exposed to interest risk because they normally hold long term debt at low interest rates against shorter term deposits. Because banks often loan at fixed interest rates and hold long term securities, fluctuations in interest rates can affect a bank's position substantially. Banks must carefully estimate factors such as the rate of inflation to maintain profitability. Risks are often interdependent. Fluctuation in the rate of inflation affects both IRR and credit risk. If money devalues faster than expected this devalues the assets of banks. It also means wages are not keeping up with the cost of living which, in turn, reduces the credit worthiness of borrowers leading to an increase in loan defaults. When inflation is slower than a bank estimates, the market value of that bank's loans will decrease because the value of cash flow will not equal the bank's projections. Because CAGs induce banks to hold long term, fixed rate government securities, CAGs contribute to the interest rate exposure of banks.

The regulators have attempted to address IRR under their mandate from Congress to do so. Currently, CAG calculations only account for the credit exposure of IRR contracts, not the interest rate exposure.

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312. Id.
314. See 12 C.F.R. § 3.10(d) (1994).
315. See Taylor, supra note 2, at 90.
317. Id.
318. Id.
319. See Breeden, supra note 274, at A14.
321. FDICIA, supra note 38, § 305.
Interest rate contracts are treated as off-balance exposures that must be converted to on-balance sheet items. The risk weight category to which an asset is assigned is limited to a fifty percent capital requirement. Currently, the conversion factor for IRR contracts depends on whether the asset has a maturity of one year or less or greater than one year. If the maturity is less than one year, the conversion factor is zero percent, and therefore capital must be held only against the replacement cost of the contract. If the exposure is greater than one year, the conversion factor is 0.5%. Though long overdue, the regulators have not yet promulgated a final rule on IRR.

The regulators responded to FDICIA’s mandate to incorporate IRR with proposed rules in the summer of 1992. In the summer of 1993, the banking regulators responded to criticisms and comments by banks by issuing the most recently proposed rules on IRR with “major changes.” The formulation of these rules has been protracted; an acceptable model has proven elusive. Even four years after the statutory mandate, there is evidence the proposed regulations will be offered once again for public comment.

The current proposed rules measure IRR by placing a bank’s assets, liabilities, and off-balance sheet items into “time bands” based on their maturities. They are then multiplied by an appropriate risk.

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323. See supra note 90 and accompanying text for a description of the conversion factors.
330. 58 Fed. Reg. 48,206, 48,207 (1993) (codified at 12 C.F.R. pts. 3, 208 & 325). Critics noted that the proposed rules were not flexible enough, that they were imprecise, and that they were too complex and burdensome. Id. Many banks thought their in house risk measurement was superior to that of the agencies and that forcing banks to make decisions based on a less accurate model would prove deleterious. Id.
331. Id. These changes include exempting low-risk banks from IRR reporting requirements and allowing banks to rely on their internal risk measurement systems when approved by regulators. Id.
333. 58 Fed. Reg. 48,206, 48,214 (1993) (to be codified at 12 C.F.R. pts. 3, 208 & 325). The proposed time bands are (1) up to 3 months, (2) 3 to 12 months, (3) 1 to 3 years, (4) 3 to 5 years, (5) 5 to 10 years, (6) 10 to 20 years, and (7) greater than 20 years. Id.
334. Id. at 48,208.
weight and those risk-weighted positions\textsuperscript{335} are added to produce a net risk weight position.\textsuperscript{336} The IRR formula has many of the qualities of CAGs—it is not precise enough to be useful to banks and too complex not to be burdensome. For example, to simplify the calculation risk, weights are based on hypothetical instruments.\textsuperscript{337} With the numerous and varied instruments available to manage rate risk, these hypotheticals cannot be sufficiently precise.\textsuperscript{338} If the regulators determine that the bank’s own risk measurement model is more accurate, the bank may avoid risk weights based on hypothetical instruments.\textsuperscript{339}

Working so closely with banks in developing an IRR measurement tool, regulators come very close to managing the banks themselves.\textsuperscript{340} Regulators continually disavow a policy that would lead to micro managing banks, however, the methodology used to implement interest rate risk is ongoing and intrusive.

In addition to accounting for risk inherent in a cyclical economy, regulators must respond to the innovative ways that banks can risk assets without having to provide a capital cushion. Derivatives\textsuperscript{341} have posed new problems and forced regulators to account for the wide variety of risk to which they are subject.\textsuperscript{342} Regulators have responded with regulations that account for the credit risk of derivatives,\textsuperscript{343} but have acknowledged that the wide variety of risks

\begin{itemize}
\item \textsuperscript{335} There would be four main categories of risk weights, each divided into seven parts. The four categories refer to the types of assets that would be included. They are (1) Adjustable rate mortgages and securities, (2) Fixed rate mortgages, asset-backed securities, fixed rate mortgages, consumer loans, etc. (3) zero or low coupon securities, and (4) high-risk mortgage securities. \textit{Id.} at 48,214.
\item \textsuperscript{336} \textit{See id.}
\item \textsuperscript{337} \textit{See id.}
\item \textsuperscript{338} The regulators are aware of this imprecision. \textit{See id.} Their answer is to allow banks to use their own measurement model. \textit{Id.}
\item \textsuperscript{339} “To make this determination, examiners would consider the types of instruments held or offered by the bank, the integrity of the data, and whether the assumptions and relationships underlying the model are reasonable.” \textit{Id.} at 48,208.
\item \textsuperscript{340} At a minimum, examiners would identify the components of an internal model that incorporate assumptions or calculations that differ significantly from those used in the supervisory model, assess the importance of these differences, and then determine whether a bank has a sufficient basis for its treatment. Examiners would also monitor changes to an institution’s assumptions or calculation procedures over time in order to assure the ongoing integrity of the measure.
\item \textit{Id.}
\item \textsuperscript{341} Derivatives are financial contracts whose value depends on underlying assets. \textit{See supra} note 313 and accompanying text.
\item \textsuperscript{342} These risks include “counterparty credit risk, market risk, settlement risk, operating risk, market liquidity risk, legal risk, and aggregate or interconnection risk.” Daniel M. Trieff, \textit{Developments in Banking Law: 1993}, 13 \textit{Ann. Rev. Banking L.} 90, 98 (1994).
\item \textsuperscript{343} \textit{See, e.g.,} 12 C.F.R. pt. 3 app. A, tbl. 3 (1994) (summarizing the method of calculating the credit equivalents of interest rate and exchange rate contracts).
\end{itemize}
associated with derivatives cannot be quantifiably measured and accounted for in the CAGs.\textsuperscript{344}

C. The Future of Regulation and Deregulation

Regulators maintain that deregulation will continue to make banks more competitive\textsuperscript{345} and that regulation will continue to evolve and change as banking evolves and changes.\textsuperscript{346} This implies that prudential regulation will increase as deregulation enhances banks’ powers to compete.\textsuperscript{347} Thus, despite the difficulties with CAGs, they will remain a strong part of effectuating regulatory policy. While there are indications that regulators consider the emphasis on the role of CAGs to be too great,\textsuperscript{348} the presumption that they are responsible for the recapitalization of the Bank Insurance Fund and improved bank earnings indicates that CAGs will continue to play a primary role in ensuring bank safety.\textsuperscript{349} Moreover, the recent efforts of the Basle Committee and Federal regulators to take account of more types of risk\textsuperscript{350} demonstrate their strong commitment to CAGs as the regula-
tory policy of the future. The lofty goals regulators have for capital requirements also reveals their commitment to them: "[B]anks must hold sufficient capital to make the deposit insurance guaranty moot."351

D. Shifting to Risk Management as an Alternative to CAGs

Leading financial companies have overhauled their risk management programs and have adopted a new attitude toward managing risk that expands the responsibility of risk from internal auditors to everyone from the "CEO on down."352 "Control is effective... only when managers become convinced that it is part of doing business, not separate from it. ... 'The guys making the money can’t relegate control to someone else. They’ve got to take responsibility for it themselves.'"353 Alan Greenspan, Chairman of the Federal Reserve Board, praised the creation of chief risk management officers in financial firms.354 He noted that banks are behind the private sector in risk management. "[L]oss covariances across the bankwide portfolio of all risk position are still in their infancy."355 The Chairman called for a shift in individual bank evaluations toward the bank’s overall risk position.356 Together with his position that it is not efficient to refine CAGs further,357 this acknowledges that CAGs, while a useful tool to recapitalize banks reeling from problems acquired in the 1980s, should be de-emphasized as a policy to ensure safety and soundness in a changing financial environment.

[T]he temptation seems great to make regulatory capital rules ever more complex and as complicated as the ever increasing array of credit and credit-substitute products. But if we start down the road of varying capital requirements by fine risk gradations, where will it end? Greatly increasing the complexity of capital regulations can only lead to inefficiency. No matter how complex capital requirements might become, we can be confident that new products would be developed that would seek to exploit the remaining inevitable distortions in the capital regulations.358

This is not just a problem with CAGs, it is a problem inherent in regulation: it is reactive and does not anticipate the problems even that regulation itself causes.

FDIC’s decision not to include unrealized gains or losses in Tier 1 capital after much outcry from the banking industry).
351. Greenspan, supra note 239, at 47.
353. Id. (quoting William C. Jennings, internal control consulting partner at Coopers & Lybrand).
355. Id. at 47.
356. Id.
357. Id.
358. Id. at 48.
When regulators interfere with the market by creating adequacy guidelines, they do not necessarily ensure the stability of individual banks. Market conditions and management are the principal factors other than credit risk that determine bank stability. These factors are much more likely to interfere with a bank's ability to thrive. Regulators do provide systemic stability by giving banks time to merge with other, more skillfully run banks, thereby mitigating loss of public confidence in the banking system. The increased overhead of the CAGs, however, will make it more difficult for individual banks to survive as the economy recedes. CAGs will only work efficiently if they are taken to their logical extent—having the regulators run the banks. The benefits that free enterprise produces, in efficiency and innovation, advise against such a drastic measure. The need for strong public confidence, however, precludes reliance solely on market forces to discipline banks.

The debate over how much regulation is good for private enterprise is especially germane in today's economic and political environment, but this debate, in various forms, has continued since the founding. In 1791, Hamilton and Jefferson argued over whether the federal government had the power to create a central bank and the harms and benefits such power might engender. In the case of CAGs, it is time again for the regulatory current to ebb. The current entrenchment of CAGs in regulatory policy reveals the inadequacies of banking regulation. Regulators will continue to enforce and refine capital standards as the principal method of maintaining a safe and stable banking system. In light of the regulators' predilection for capital standards and Congress' reluctance to address the competitive inequality banks face, the future of banking does not look bright. CAGs are certainly not the answer to the regulatory and market challenges United States banks face. The traditional role of banking is changing rapidly, and the banking system needs major regulatory reform to ensure the continuing role of banks as intermediaries in the economy. Congress has introduced legislation that would modernize the banking regulation. As for CAGs, there are

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360. The Financial Services Competitiveness Act of 1995, H.R. 18, 104th Cong., 1st Sess. (1995), a bill to enhance bank competition, is currently being considered by Congress. This bill proposes to reform the Glass-Steagall Act of 1933 by allowing bank holding companies to engage in investment banking activities. Not surprisingly, the securities activities would only be allowed if the depository institution is well capitalized as defined by section 38(b) of the Federal Deposit Insurance Act. Id. at §§ 103(b)(2)(a) & (k)(1). Regulators have urged Congress not only to expand bank activities, but also to remove the regulatory burdens that put banks at a competitive disadvantage: "If we dismantle the Glass-Steagall wall, we must not leave so much regulatory barbed wire in its place that we defeat our objectives." Testimony of Eugene A. Ludwig, Comptroller of the Currency, before the Committee on Banking and
alternatives to increasing their scope. Leveling the playing field between banks and nonbank intermediaries would remove much of the burden of CAGs. Examining such broad scale regulatory reform, however, is beyond the scope of this Note. Instead, within the current regulatory environment, Congress and the regulators must emphasize finding an optimal, rather than an adequate, level of capital for banks. Supervised private sector risk management would provide a more efficient means of maintaining bank safety than imposing imprecise blanket capital requirements.