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Statement of the Shadow Financial Regulatory Committee on

Improving Capital Adequacy Disclosure

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In the past several weeks three events have emphasized the need for a simple and reliable measure of capital adequacy at large banks that does not rely on risk-weighting assets and is less susceptible to manipulation:

1. The earnings reports of large banks revealed a decline in the size of risk-based assets that appears to be largely a result of modeling revisions;
2. The Basel Committee on Banking Supervision published a study revealing large differences in the internal models estimates of capital requirements for the same trading portfolio at several large banks; and
3. The EU is seeking to delay the reporting of the Basel III comprehensive leverage measure beyond the January 2015 target date.

The intent of Basel III is to strengthen banks' ability to absorb losses. In the absence of a strong leverage ratio requirement, the large banks may use their own models to whittle down their minimum capital requirements, defeating this goal. The Shadow Committee urges that U.S. regulators move promptly to implement an improved leverage requirement, while demanding a ratio substantially above the 3 percent agreed to by the Basel Committee. Many experts including current and former banking regulators have suggested a figure of 8 or 10 percent or higher.

The Federal Reserve has two upcoming opportunities to employ an improved leverage standard. First, the Federal Reserve can revise and finalize its pending rule to require large banks to comply with the Basel III leverage requirement at a level substantially higher than the proposed 3% and also include the Basel III leverage requirement in its proposed rule that sets higher prudential standards for large bank holding companies. The Fed should integrate the leverage ratio into the process for early remediation actions and create a supervisory enforcement mechanism if a large bank fails to meet its Basel III leverage requirement.

Second, the Federal Reserve is about to disclose the results of the Comprehensive Capital Analysis and Review (CCAR), which is becoming the Federal Reserve Board's central tool of capital supervision. Unfortunately, the Fed's template for reporting the CCAR results continues to emphasize risk-weighted capital ratios as the primary measure of a bank's capital strength despite the well-documented inaccuracy of risk weights. Using risk-based ratios can create a highly misleading impression. For example the Tier 1 risk-based ratio for Citigroup is 14.46% and for Morgan Stanley it is 17.2%, both of which are considerably higher than their leverage ratios, as discussed below. Using risk-based ratios also makes it virtually impossible to compare capital adequacy across banks given the large amount of discretion that Basel II gives bank managers to use internal models to determine the risk weights for their exposures.

The Fed will also report a leverage standard that is far from ideal. Choosing an appropriate standard is complicated by a number of factors involving both the numerator and the denominator of the leverage ratio. The objective is to show what percentage of an institution's total risk exposure is funded by equity that can absorb losses on a going concern basis. For bank holding companies, this involves a choice of rules for consolidating affiliated entities as well as many decisions about accounting standards and how to apply them. Particularly worrisome is the issue of how to incorporate off-balance sheet activities into the measure of total exposure.

How the numerator and the denominator are defined can make a substantial difference in the apparent strength of a bank's capital position. For example, with regard to the numerator, the Fed has chosen Tier 1 capital as the numerator. This is broader than the amount of capital that can be relied upon to sustain the institution as a going concern. Tangible common equity is a better reflection of a bank's ability to withstand a period of stress. To illustrate the significance of this choice, Citigroup shows Tier 1 capital of $141 billion, but tangible equity of only $98 billion. The Tier 1 numerator overstates Citigroup's ability to absorb loss and remain a going concern.[1]

The Fed's leverage standard also tends to understate the denominator because it neglects off-balance sheet exposures. The Basel Committee has worked through these issues carefully and published a definition that is superior to the standard that the Fed plans to use in

[1] "Capital Ratios of Global, Systemically Important Banks (G-SIBs) found at www.fdic.gov. All data reflects reporting as of the second quarter of 2012.

its upcoming CCAR disclosures. In particular, the Basel approach carefully integrates off-balance sheet positions into the measure of total exposure. This can increase exposure substantially. For example, Morgan Stanley reports total assets of $749 billion, but its total exposure is $1.82 trillion as reported according to International Financial Reporting Standards (IFRS)[2].

Taking into account the appropriate definition of capital and more inclusive IFRS measure of off-balance-sheet risks, the leverage ratios for Citigroup and Morgan Stanley become much smaller. Using Tier 1 as the numerator and only on balance sheet assets in the denominator Citigroup's ratio is 7.42% and Morgan Stanley's is 6.22% But replacing Tier 1 Capital with tangible equity in the numerator and using the more inclusive measure of exposure in the denominator, Citigroup's ratio falls to 5.37% and Morgan Stanley's falls to 2.52%.

The Shadow Committee believes that the Basel leverage ratio is a more accurate indicator of the capital strength of banks and should supplant the opaque, difficult to verify risk-weighted denominator that proved so unreliable during the crisis. We encourage the Basel Committee to adopt tangible common equity in the numerator rather than Tier 1 capital, a possibility that the Basel Committee is currently examining.

The Fed could advance the cause of transparency in reporting capital adequacy and improve market discipline by requiring that banks report their CCAR results using a leverage ratio that employs tangible common equity in the numerator and also incorporates off-balance sheet exposures through use of the internationally- agreed Basel III approach in defining the denominator.

[2] IFRS may be overly inclusive with respect to bringing off-balance sheet risks onto the balance sheet, but it illustrates how deceptive comparisons between US and European banks can be. The Shadow Committee advocates the use of the Basel III accounting procedures as an appropriate middle course between the overly-inclusive IFRS standard and the much weaker GAAP standard.