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Statement of the Shadow Financial Regulatory Committee  
**Group of Governors and Heads of Supervision Statement on  
Capital Standards**

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The Group of Governors and Heads of Supervision (GGHS) of the G-20 met this past weekend and announced agreement on new capital and liquidity requirements for banking organizations. Their recommendations center on raising equity capital requirements from 2% to 4.5%, requiring higher quality capital (namely equity and omitting various hybrid securities), imposing a capital conservation buffer of 2.5%, creating a 0-2% countercyclical capital buffer that is intended to increase during economic upturns and be drawn down during times of economic contractions, and retaining a 3% non-risk-based leverage constraint as a backstop to the risk-based capital requirement. The Shadow Financial Regulatory Committee (SFRC) applauds the efforts to increase bank capital requirements and to improve the quality of capital that meets the standards.

However, there are several reasons to be concerned about the new standards. First, the recommendations continue to rely heavily upon a flawed risk-based capital model that employs arbitrary risk weights, banks' own risk models and book value concepts that proved to be inadequate as indicators of financial strength during the recent crisis.

Second, the Committee believes that the 4.5% new minimum book value capital requirement is still too low, given that most of the financial institutions that required government assistance during the crisis had currently reported ratios in excess of that amount. Furthermore, the new standard is really not that new, because a 4%

common equity standard had long been in place but was eroded over time as other forms of capital were permitted to count as equity.

Third, the SFRC believes that both the capital conservation buffer and countercyclical buffer are insufficient to protect against sudden shocks. The proposal also suggests that enforcement of the capital conservation buffer may be unduly lenient. Rather than prohibiting distributions of earnings as the buffer is approached, the GGHS announcement indicates that there will only be some restriction on the size of such payouts. Permitting a payout of capital when a firm's capital cushion is declining toward a critical threshold makes little economic sense.

Fourth, the agreement also leaves the determination of the actual restrictions to regulatory discretion rather than tying the restrictions to triggers based on capital as in prompt corrective action standards in the U.S. The SFRC believes that the supervisory objectives would be better served by imposing a simple, significant and consolidated leverage constraint. A leverage constraint should be the linchpin of any change in capital standards rather than serving as the backstop to the risk-based standards as is the case in the GGHS agreement.

Fifth, the regime is unduly complex and lacks uniformity when it comes to enforcement of the countercyclical buffer. Individual countries will be given substantial latitude in implementing and deciding when to evoke the capital cushion buffer, despite the fact that many of the systemically important institutions operate across national borders. Furthermore, the buffer is geared at this point only towards cushioning against undue credit growth. While important, this should be only one of many screens to decide when more or less capital is needed. For example, credit growth, when fueled by non-domestic suppliers, might be difficult to measure or trace. Other signs of imbalances or stress, such as sudden changes in asset prices, should also enter into the GGHS's agreement.

Finally, the GGHS agreement provides for a prolonged and complex phase-in period that lasts nearly 10 years. Given the current capital position of EU institutions and those in many other countries, the recent success of these institutions in raising capital, the announced plans of many banks to add more capital, and the lack of convincing evidence accelerating the phase-in period would result in either higher interest rates or slow the rate of real economic growth, the SFRC believes that the higher requirements should be imposed promptly with no more than a 1- or 2-year phase-in period.