Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?

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I. Introduction

An overarching concern of modern bank regulation and supervision is how to accommodate a "deregulating,"1 "internationalizing,"2 and "innovating"3 banking and related financial services environment within a "safe and sound" domestic and international banking system.4 The key to an understanding (and, perhaps, to an eventual resolution) of this quandary may prove to be the development of appropriate

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1. "Deregulation" refers to the process occurring over the past decade in many industrialized countries whereby market place distinctions between banks and nonbank financial intermediaries and between money and capital markets are breaking down, and whereby bank regulations over such matters as sources of funds, powers, and geographic expansion are being reduced or eliminated. This process is occurring within these industrialized countries and internationally. On the process in United States, see, inter alia, HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 97TH CONG., 1ST SESS., FINANCIAL INSTITUTIONS IN A REVOLUTIONARY ERA 1 (Comm. Print 1981) [hereinafter FIRE REPORT]; General Accounting Office, Report: Federal Examination of Institutions: Issues that Need to beResolved G.C. D-81-12, at 1 (1981); U.S. Dep't ofthe Treasury, Geographic Restrictions on Commercial Banking in the United States (1981); Report of the President's Commission on Financial Structure & Regulation (1971) ("Hunt Commission Report"); HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG., 2D SESS., FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY (Comm. Print 1976) [hereinafter FINEL STUDY]. See also THE DeregULATION OF THE BANCING AND SECURITIES INDUSTRIES (L. Goldberg & L. White eds. 1979); FINANCIAL DeregULATION: THE PROCEEDINGS OF CONFERENCE HELD BY THE DAVID HUME INSTITUTE IN MAY, 1986 (R. Dale ed. 1986).

2. "Internationalization" refers to the process over the past two decades whereby the intermediation of financing and the movement of money and capital are being effected on a cross-frontier basis (as opposed to home-based transactions) largely by multinational banking and other multinational financial institutions. See, e.g., R. DAK, THE REGULATION OF INTERNATIONAL BANKING (1984); A. MIELEKAIN, INTERNATIONAL MONEY AND BANKING: THE CREATION OF A NEW ORDER (1987); R. PECCHIOLI, THE INTERNATIONALIZATION OF BANKING: THE POLICY ISSUES (1983).

3. "Innovation" in the financial services area refers to the dramatic increase of new products and services brought about by banking and other financial institutions during the past decade as a result of customer demands for hedging financial risks (e.g., interest rate swaps and standby commitments), of the growing convergence of the money and capital markets (e.g., the rise in asset securitization), and of the desire of institutions to circumvent costly regulations (e.g., capital requirements). While generating revenues for banking institutions and often entailing some degree of institutional and system risks, many of these innovations are never fully reflected in an institution's financial statements or regulatory reports. These "off-balance sheet" risks are of increasing concern for the bank regulators. See generally BANK FOR INTERNATIONAL SETTLEMENTS, RECENT INNOVATIONS IN INTERNATIONAL BANKING (1986) (report prepared by Study Group established by the Central Banks of the Group of Ten Countries (Sam Y. Cross, Chair.) [hereinafter CROSS REPORT].

4. See generally R. PECCHIOLI, PRUDENTIAL SUPERVISION IN BANKING (1987). As used in the Article, the following terms (unless otherwise indicated or the context otherwise requires) mean:

Prudential supervision or prudential regulation refers to the practices and measures undertaken by banking authorities with respect to trying to maintain the "safety and soundness" of the banking institutions under their administrative supervision. Prudential regulation is sometimes distinguished from structural regulation which is designed to affect the organization, opening, and geographic structure of such institutions; although, there is frequently an overlap between such types of bank regulations. Safety and soundness, in turn, is an all-encompassing byword of the bank regulators (often, but not always, derived from express legislative or administrative authority) used to reflect either the acceptable liquidity and stability for the banking system as a whole, or an acceptable financial condition for a particular banking institution (so that these institutions are not in foreseeable danger of insolvency, as viewed from the perspective of the government and bank regulators).

Banking institutions are financial intermediaries regulated by domestic bank regulatory authorities. The traditional functions of these financial intermediaries have often been thought to be the taking of deposits and the making of loans, whereby these institutions serve as depositories for mobilizing the public savings and redirecting these funds to more productive and profitable combined uses. However, the scope of activities, as well as the type of institutions, that are regulated by banking authorities may vary considerably from domestic jurisdiction to jurisdiction. Regulation and supervision are sometimes used interchangeably to cover all forms of direct and indirect, formal and informal, interventions and practices of a bank regulator. In a stricter sense "regulation" connotes a specific exercise of a legislatively or administratively delegated authorization by an appropriate governmental authority; while "supervision" implies more of oversight practices and functions of such authority over the subjects and subject matter of this authority (in our instant case, over banking institutions and banking activities). Legally significant rules is used sometimes to connote not only formally enacted or derived legal rules, but also acts (though not formally enacted or derived) that may have the capacity to generate legal rules, effect formal institutional or administrative changes, affect private or public transactions, or
standards on "capital adequacy" for domestic and international banking activities. This Article dissects the concept of bank capital adequacy to ascertain whether it is a legitimate (i.e., functionally and legally appropriate) regulatory concern for the prudential supervision of domestic and international banking activities.

First, Part II considers the numerous dilemmas inherent in the bank capital adequacy notion. Then, Part III reviews the historical role of bank capital adequacy to link practically the subject to bank regulatory objectives and practices. Next, the recent international dynamics helping to shape and accelerate regulatory treatment of bank capital adequacy will be explored in Part IV. Particular emphasis will be placed upon the initiatives of the Basle Committee on Banking Regulations and Supervisory Practices ("Basle Committee"), which is comprised of representatives of the central banks and bank supervisory authorities of the Group of

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5. See infra Part IV.

6. The Basle Committee was established at the end of 1974 by the central bank governors of the Group of Ten Countries and Switzerland for the primary purpose of providing its members a regular forum for cooperative discussion and efforts in the prudential supervision area. On formation of the Committee, see Press Communiqué of the Bank for International Settlements (Feb. 12, 1975). For further discussion of the Committee and its work, particularly regarding internationally acceptable capital adequacy standards, see Part IV, infra.

7. The institutions represented on the Basle Committee are:

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<th>Country</th>
<th>Institution</th>
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<td>Belgium</td>
<td>National Bank of Belgium</td>
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<td></td>
<td>Banking Commission</td>
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<tr>
<td>Canada</td>
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<td>Office of the Inspector General of Banks</td>
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<td>France</td>
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<td>Banking Commission</td>
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<td>Federal Banking Supervisory Office</td>
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<td>Japan</td>
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<td>Ministry of Finance</td>
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<td>Sweden</td>
<td>Sveriges Riksbank</td>
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<td>Royal Swedish Banking Inspectorate</td>
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<td>Switzerland</td>
<td>Swiss National Bank</td>
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<td></td>
<td>Swiss Federal Banking Commission</td>
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<td>United Kingdom</td>
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<td>Office of the Comptroller of the Currency</td>
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<td>Federal Deposit Insurance Corporation</td>
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<td>Secretariat</td>
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In the United States, the bank regulatory structure is fragmented and complex, with most banking institutions having multiple regulators for different purposes. In terms of primary regulators, the Comptroller of the Currency charters and supervises national banks; the Federal Deposit Insurance Corporation is the federal regulator of state-chartered and state-supervised banks that are not members of the Federal Reserve System; and the Federal Board of Governors of the Federal Reserve System is the primary federal regulator of state-chartered and state-supervised banks that are members of the Federal Reserve System, of foreign banks engaging in banking activities in the United States, and of bank holding companies and their nonbank subsidiaries. In addition, in the United States, because of the federal structure and the existence of a dual banking system, various state banking authorities may have jurisdiction over certain banking
Ten ("G-10")\(^8\) countries of the Organization for Economic Cooperation and Development ("OECD")\(^9\) and of Luxembourg. In Part V, critical examination is undertaken into the domestic and international policy underpinnings supporting the proposition that capital adequacy is a sustainable subject for bank regulatory (albeit not necessarily legal) concern. The Conclusion analyzes lessons for the future concerning the legitimate regulatory role for bank capital adequacy standards.

II. Dilemmas Within a Definition

Capital adequacy of banking institutions refers to the minimal level of capital for such an institution, viewed as necessary or desirable by the bank regulator for the "safe and sound" operation of the institution.\(^10\) However, within this superficially straightforward working definition, a number of substantial problem areas emerge.

A. The Concept Itself

"Capital" is not a unitary concept; it is susceptible to differing meanings to different persons under divergent circumstances. This disparity, as will be discussed, may impair or distort desired regulatory objectives (e.g., transparency and competitive equality) and can bring into question (or at least can challenge) certain regulatory predispositions toward the capital adequacy issue.\(^11\)

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\(^8\) The G-10 Group was organized in 1974 as a consequence of the establishment in 1962 of the General Agreement to Borrow (GAB) pursuant to decision of the Executive Board of the International Monetary Fund (IMF). The Group was informally established with the support of the IMF, OECD, and the Bank for International Settlement (BIS), by the finance ministers of Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, and United States for the primary purpose of intergovernmental consultation regarding implementation of calls upon the lines of credit extended to the IMF under the GAB but the scope of such consultation was broadened over the years. Subsequently, Switzerland has become an active member of the Group, rendering the "G-10" designation a misnomer.

\(^9\) The OECD was formed in 1961 by 24 of the leading industrialized and market-oriented nations for the primary purposes of serving as a consultative body, research centre, and forum on high-level economic issues. For further discussion of OECD, see R. Edwards, INTERNATIONAL MONETARY COUABORATION ch. 2 (1985).

\(^10\) The following is a statement by P. Jaans, then the Commissioner of Banks, Luxembourg: "The specific concern of the supervisor with regard to capital is that it should be at any time sufficient to ensure the ultimate solvency of a bank, that is its ability to meet all its obligations arising from borrowed funds and guarantees granted and other contingent liabilities." See Jaans, Measuring Capital and Liquidity Adequacy for International Banking Business, 24 INT'L CONF. OF BANKING SUPERVISORS, LONDON JULY 5--6, 1979 REC. PROCS. 24.

\(^11\) On the nonunitary nature of the capital concept, see J. A. Dewing, THE FINANCIAL POLICY OF CORPORATIONS ch. 2 (5th ed. 1953). On the underlying policy goals and objectives, see infra Part V. The notion of "transparency" is used in this Article in its economic sense that reflects conditions and elements of an economic transaction or system that permit the transaction and system to be visible and susceptible to external analysis. Transparency is important as it places all affected parties on an equal footing within their respective group in the evaluative process.
1. Economic Meaning

To the economist, capital, natural resources, and human labor refer to the triune of productive factors in the economy. The "capital" factor is the productive, nonconsumable physical resources (i.e., assets) of an enterprise. These assets may comprise "fixed assets" such as land, building, fixtures and equipment, or "circulating assets" such as inventory. These physical assets are derived from the economy and are dedicated to the further production of goods and services. The sale or rental of these goods and services is designed to produce a profit for the enterprise, with a substantial portion of the profit normally representing the implicit return on invested capital and being capable of reinvestment in capital goods. The economist focuses on the current market value or "present net value" of these capital goods. Present net value measures the value of capital goods in their "highest and best" use. This "true" value of assets normally is determined by calculating the present value of a stream of future returns, in the form of receipts or rentals, on such assets.12

2. Financial Accounting Meaning

To the financial accountant, capital is the net worth (i.e., residual value) of an enterprise, calculated on the assumption that assets of the enterprise can be liquidated on a going-concern basis, and liabilities and obligations of the enterprise can be paid and satisfied in full. Capital, to the extent it can be translated into monetary value, becomes an integral part of the right-hand side (i.e., the liability and equity side) of an enterprise's balance sheet. The balance sheet is intended to be a historical summary of the financial condition of an enterprise as of a specified date. Regardless of the profitability or solvency of the enterprise, the balance sheet always balances because the left-hand side (the asset side) indicates the value of the assets, or resources of the enterprise, which must be derived from an equivalent value of liability and capital sources.

Assets, liabilities, net worth, and their respective values are determined by the financial accountant based upon the "generally accepted accounting principles and standards" of the accounting profession. Assets, however, are not synonymous with the economist's notion of capital goods, which also includes various other tangible (e.g. cash) and intangible (e.g., patent rights and goodwill) assets that can be given a monetary value. Unlike the "net present value" approach of the economist, the accountant's valuation of these assets is often the actual historical costs of the items. However, special accounting rules may require the use of replacement costs or other formulae, as in the case of inventory valuation. The valuation of assets may also be affected by special financial accounting rules regarding depreciation of fixed assets and various reserves for such matters as taxes and losses on asset values. The final net worth or capital calculation is the sum of the value of nonliability contributions

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(in money or property) made to the enterprise by its owners plus retained (undistributed) earnings.\(^{13}\)

3. Investment Banking Meaning

For the investment or merchant banker, capital is most often synonymous with the amount of saved funds available for investment in an enterprise. Such funds may be solicited individually from private parties, collectively through formal offering processes, or institutionally through negotiations with financial institutions. When invested in an enterprise, these funds give rise to a contractual interest in the enterprise for the contributor. This interest may be in the form of a proprietary interest in the "net worth" of the enterprise (e.g., common or preferred stock) or of a creditor interest (e.g., bonds and debentures). In investment (i.e., noncommercial) transactions, the investment banker makes no functional distinction in how these saved funds are placed at the disposal of an enterprise.\(^{14}\)

4. Business Management Meaning

The business manager often uses the term "capital" imprecisely, combining both economic and financial accounting notions. The manager often thinks in terms of liquid and illiquid capital. The latter term refers to the economic notion of fixed assets, while liquid assets are assets that can be readily converted into revenues or utilized for other business purposes. The perspective of the manager is that of the accountant, looking at the enterprise on a going-concern basis.\(^{15}\)

5. Legal Meaning

The lawyer uses the term "capital" to mean the legal amount of money, property, or permitted services the owners of an enterprise invest as "equity" (and not as loans) in the enterprise or in the lawful amount (determined by specific corporate statute or case law) that may be required before a distribution to the owners can be effected by way of dividends or share repurchase. The legal scheme for corporate capital is based primarily on the historical concern that creditors dealing with a corporate entity should be able to look to an unimpaired level of value in the entity at all times as a form of protection for repayment and a guard against corporate distributions of money, shares, or assets in a manner unfair to creditors and non-participating shareholders or in a manner that might render the entity insolvent. In another sense, the legal capital structure parallels the contractual and legal rights and order of priority of distribution for different classes of shareholders upon


\(^{15}\) See A. DEWING, supra note 11, at 50–53.
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while the continuing value of legal capital schemes is subject to considerable question, and the vitality of such schemes has been continuously eroded by law and practice in jurisdictions such as the United States, legal capital requirements continue to exist in most states of the United States. These requirements are of varying significance in many Western European countries and under European Community company law directives. Thus, capital continues to have a particularized importance for the corporate attorney in advising or in rendering opinions respecting incorporation validity, shareholder contributions, dividend distributions, share repurchases, and recapitalization. In addition, this legal concept, when forming the basis of a legal dispute, may involve assessing the legal notion of capital and of related matters such as valuation.

6. Rating Agency Significance

Capital analysis is also important to rating agencies and parties relying on such ratings. These agencies (e.g., Standard & Poors, Moody’s, and Fitches) are particularly influential in U.S. debt securities markets. Their ratings are a key factor in the pricing and marketability of debt security instruments. Thus, when a banking institution attempts to issue commercial paper or debt instruments through the securities markets, one or more of the rating agencies may be called upon to evaluate the overall financial soundness of the institution, including the viability of its capital base. These ratings are qualitative ratings expressed in alphabetical letter grades. The grades vary from the highest investment quality through successively lower grades of investment quality, down to speculative and default grades. These grades serve as yardsticks representing business and financial risks present in such debt instruments. The ratings, however, represent value judgments of the rating agency as to the possibility of default based on a comprehensive analysis of the issuer’s earning power and financial condition (including capital position).

7. Bank Regulatory Meaning

To the bank regulator, capital represents the amount and type of financial resources of a banking institution evaluated by the regulator in assessing the level of

financial solvency of the enterprise. Historically, the bank regulatory view of capital has been roughly akin to the financial accounting approach; regulators normally took their figures and valuations from a bank's published balance sheet, focusing on the net worth segment of the balance sheet as it related to either total deposit liabilities or total asset value (i.e., a "gearing ratio"). But, in recent times; this evaluation has become far more complex. Regulators have deviated from a strict financial accounting approach in pursuit of one that will better serve regulatory policies on prudential supervision by indicating, at all times in the life of the banking institution, a prudent level or "cushion" of capital available to absorb unexpected bank losses that cannot be absorbed by current bank earnings.

B. Composition

The bank regulator's search is to identify financial items that realistically can serve as components of this desired protective financial "cushion." Nonredeemable common stock that makes no contractual demand on bank earnings would certainly qualify. But, what types of other equity items, equity equivalents, and equity hybrids should be permitted to comprise part of the regulatory acceptable base and to what degree? For example, how are preferred stock instruments, subordinated debt and other types of shareholder debt instruments, and reserves to be treated?

1. Preferred Stock

Preferred stock refers to equity (non-debt) contributions of shareholders that have a contractual preference over other equity interests in terms of voting rights, dividend rights, or liquidation. This type of stock possesses many of the attributes of traditional common stock: permanence, subordination upon liquidation to depositors and other debt claimants, and depending on applicable corporate law, a capability to have dividends deferred. However, while dividend payments on common stock are at the discretion of the board of directors, such payments on preferred stock are determined according to complex contractual provisions normally providing for fixed (but sometimes floating) regular payments and specifically circumscribing conditions for deferment of payment by the share contract. Even if dividends are deferred, payments may (by contract or law) be cumulative, and deferment may result in a remaining contingent claim of arrearages against assets and possibly even in enhanced, disproportionate voting rights for the class of preferred shareholders. Preferred stock also may be issued for limited periods (limited life) or in perpetuity (perpetual life), may be redeemable or nonredeemable at the issuer's or holder's option, and may be


25. See infra Part III for a specific discussion of many of these issues in the context of U.S. regulatory practice.
convertible or nonconvertible into common stock under prescribed conditions.\textsuperscript{26} Thus, depending on its particular contractual or legal structure, preferred stock may not provide bank management with the organizational flexibility common stock provides in circumstances where a bank encounters a weakening in earnings and financial condition.

2. Debt Instruments

Subordinated debt instruments are forms of contractual loan capital that are inferior to deposit liabilities and other forms of bank debt in a liquidation. Where recognized as regulatory capital, such instruments have enjoyed recent popularity for the following reasons: banking institutions can raise "capital" without diluting the equity holders; internationally, such institutions can use these instruments for matching currency risks; and in various jurisdictions, these institutions may enjoy favorable tax advantages (e.g., deductibility of interest for tax purposes).\textsuperscript{27} To the extent debt contracts provide for long-term or even perpetual life, are subordinate and unsecured, and permit deferment of interest or principal in specified situations, the more such instruments functionally resemble equity instruments. But, to the extent such loan capital has a specified maturity and payment schedule or has a contractual "trigger" (i.e., acceleration) clause in the event of default, the value of such instruments as equity equivalents is substantially diminished and impaired. Similar analyses can be made of hybrid debt/equity instruments that share mixed attributes of debt (e.g., prescribed interest payments) and of equity (e.g., ability to suspend such payments or to convert into equity in times of financial crisis).\textsuperscript{28}

The closer a bank financial instrument resembles equity, or more importantly serves the function of equity, the stronger the argument is that the instrument should rank as a legitimate capital component. However, this analysis requires a case-by-case scrutiny of the legal, contractual, and functional nature of the instruments. Moreover, the reality may often be that even if resembling equity, a debt or hybrid instrument may serve only one of the functions of capital—such as the financing of a bank’s infrastructure (e.g., buildings or computer systems). Finally, these instruments may not necessarily be suitable, on a going-concern basis, for offsetting sudden and significant losses except in a possible liquidation situation.

3. Financial Reserves

A further complicating factor in defining bank regulatory capital is the treatment of financial reserves or provisions as capital equivalents. These reserves may be loan loss reserves, "hidden" reserves, or property revaluation reserves. Such reserves

\textsuperscript{26} For general discussion of nature of preferred stock, see A. DEWING, supra note 11, at ch. 6; Buxbaum, 

\textsuperscript{27} For general discussion of nature of subordinated debt, see Everett, Subordinated Debt—Nature and 
Enforcement, 20 BUS. LAW. 953 (1965).

\textsuperscript{28} For a general discussion of nature of hybrid securities, see H. HEDN & J. ALEXANDER, LAWS OF CORPORATIONS 
may connote differing financial, accounting, tax, and regulatory treatment and may have varying functional abilities as buffers against losses.29

Loan loss reserves anticipate either a latent deterioration in loan portfolio quality based upon historical average loss experiences (i.e., a general reserve) or an identifiable and likely value reduction of a specific asset (i.e., a specific reserve). The calculation of either reserve is based largely on bank management assessment of its overall loan portfolio and of specific asset quality and value, as agreed upon by the bank’s auditors and reflected on a bank’s financial statements—with the role of the bank supervisor being primarily to oversee the consistency and prudence of such determinations. A general loan loss reserve reflects certain characteristics of capital as it is available to absorb unidentified (albeit anticipated) credit losses. But, a specific loan loss reserve would not do so as the immediacy and probable extent of the specific loss has already been identified.30

"Hidden" reserve is a generic term used to embrace unreported additional value resulting either from an undervaluation of a bank asset or overvaluation of a bank liability. In effect, the residual value of a bank is more than what the bank’s published financial accounts indicate and is a situation known only to bank management and the bank regulators. The main justifications for the existence of such reserves are that they provide an "extra cover" for absorbing risks and losses, and they help level out published profit figures.31 For example, Japanese banks, which generally have low published capital figures, have significant hidden reserves resulting largely from the difference between the at-cost book values and market value of debt and equity securities.32 Should such reserves count for regulatory capital? Some countries such as Japan believe they should count, but at a discounted value to take account of market fluctuations and the attendant uncertainty of future realizable value.33

Another type of reserve is an asset revaluation reserve resulting from a bank’s periodic financial statement re-evaluation of certain assets such as real estate at current market values. This is a practice sanctioned by some bank regulators (e.g., the Bank of England).34 However, the same problem exists with revaluation reserves as with hidden reserves in that current market values are not necessarily a good indicator of future reliable values.

The manner in which reserves are to be treated for capital adequacy purposes can influence the readiness of bank management to make adequate loan loss provisions.

30. See American Institute of Certified Public Accountants, Auditing the Allowance for Credit Losses of Banks (1986) (Auditing Procedure Study).
31. See Revell, supra note 29, at 221.
Such provisions are chargeable against current earnings, and as such can have a
cognizable impact on dividend distributions and market perception of the stock and
banking institution. Thus, management needs to balance the need for adequate
provisions against desirable levels of retained earnings and dividend payments. The
latter two factors are often key market perception aspects that can influence a bank’s
access to capital markets. In addition, domestic tax laws can affect and blur
classifications between general and specific reserves because specific reserves are tax
deductible, while general reserves may not be or may be only partially deductible.35

C. Measurement

Yet, even when a bank’s regulatory permissible base is determined, capital is a
meaningless concept except as it relates to such other factors as institutional size or
type, or to elements of the bank balance sheet susceptible to causing sudden or
sustained losses. In this sense, for bank capital adequacy purposes, the notion of
capital is relational.

Regulatory judgments are required for deciding whether one capital measure-
ment should be applicable to all types and sizes of banking institutions. Should the
small community bank be treated the same as the larger multinational bank: is the
larger institution inherently safer (i.e., requiring less capital) than the smaller
institution or vice versa? Should a nonbank parent of a bank and its nonbank affiliates
have to maintain, on a consolidated basis, the same capital level as the bank?

Perhaps the thornier question is to what financial items the capital base should
relate. A number of possibilities exist. One is a formula derived from a financial
statement, whereunder the capital base is used as a numerator over a denominator
comprising deposit liabilities or asset values. The use of deposit liabilities as the
reference for the “gearing ratio” is more appropriate for reflecting desired levels of
capital for liquidity purposes: the deposit side of the balance sheet is highlighted as
the more potentially volatile aspect of a bank’s financial condition. Alternatively, the
use of a fixed capital-to-assets ratio directs attention to the asset side as a possible
source of financial deterioration. Each approach has the advantages of simplicity,
transparency, and flexibility. Such formulae are readily ascertainable and are
analyzed from a bank’s published financial statement. In addition, they pose minimal
constraints on bank operations and avoid regulatory judgment as to the relative degree
of risk in a bank’s operations.36 However, such approaches are poor reflectors of
inherent risks in the banking business and are incapable of dealing with bank
innovations such as the rise in off-balance sheet activities.37

35. See, e.g., PECCHOLI, supra note 4, at 111–12, 241–56.
36. For comparative discussion of various approaches used internationally, see id. at 229–40.
37. For off-balance sheet risks, see COMM. ON BANKING REG. AND SUPERVISING PRAC., THE MANAGEMENT OF BANK’S
OFF-BALANCE SHEET EXPOSURES: A SUPERVISING PERSPECTIVE, at 1 (Mar. 1986) (copy on file with the Ohio State Law
Journal); CROSS REPORT, supra note 3, at 17–126; OFF-BALANCE SHEET BUSINESS OF BANKS (Bank of Eng. Consultative
Another possible solvency formula is to focus on the concentrations of large loan exposures (in terms of individual credits, credits of affiliate groups, aggregate industry exposure, or country risk) vis-à-vis a bank's capital base. While this formula appears to have the element of simplicity, it often will entail numerous difficult analytical and prudential judgments, as in determining aggregation of credits or the comparative risks of different industry or country lending. Moreover, these tests are more borrower-oriented in a generic sense and do not reflect risks of assets or of operations.

A third approach, and one of current appeal to many bank regulators, is the risk-asset ratio. In this approach, different weights are given to different classes of bank assets and off-balance sheet activities giving rise to risk, and then are aggregated as the denominator for a capital adequacy formulation. The primary goals of such an approach are to present a meaningful risk profile of bank operations in light of a bank's capital base, to incorporate off-balance sheet risks into the profile, and to provide a disincentive for banks to shift resources from more liquid, less risky assets to less liquid, riskier assets and activities.

The main problems with a risk-based formula are the complexities of devising the formula, the increased possibility for divergence among bank regulators, and the diminishment of transparency for bank depositors, other creditors, and the marketplace. For instance, decisions need to be made regarding the relevant groupings of bank assets and activities, the attachment of a perceived risk factor to such categories, and the selection of a minimum aggregate capital ratio. Such decisions call upon the regulators to make numerous subjective judgments that should be based on perceived historical experiences.

The assignment of a particular item to a risk group and the weight given may well influence bank management behavior. For example, if real estate mortgages are placed in a high risk category, a bank may make fewer of these loans and may move toward securitizing such loans in order to remove them from its balance sheet. Moreover, present risk formulae only incorporate credit risk assessment and not other possible risks such as interest rate risk, market risk on securities, country or transfer risk, funding risks, currency and exchange risk, fraud risks, tax risks, and transparency risks.

Notwithstanding the adoption of a preferable measurement, most regulators and bank management concur that it is impossible for one ratio to encapsulate all the factors bearing upon a bank's exposure to risks and the corresponding potential calls on capital. Strength of bank management, quality of assets, reserve policies, earnings structure and potential, institutional history and reputation, and liquidity are all

relevant and related factors touching upon the ultimate soundness of a banking institution.\textsuperscript{41}

Also pertinent in a final determination of the capital base is what deductions or adjustments should be made from capital. For example, the value of goodwill and the value of stock in affiliates or other banks may create a corresponding inflation in the capital level. Goodwill is an intangible asset representing the excess of purchase price over the fair market value of net acquired assets. It is a going-concern concept that evaporates in a liquidation situation. Notwithstanding this observation, deduction of goodwill from bank capital estimations is contrary to generally accepted accounting principles. These principles recognize goodwill as a legitimate intangible asset (if supported by appropriate valuations or appraisal) that should be capitalized on the balance sheet and amortized over the anticipated life of the earning stream.\textsuperscript{42} Moreover, negative treatment of goodwill for capital adequacy purposes could adversely affect a banking institution's acquisition possibilities and government-assisted bank bailouts.\textsuperscript{43}

The value of bank investments in unconsolidated subsidiaries is not fully reflected on the bank's consolidated financial statements. In addition, these investments are really supporting the subsidiary assets and are not generally available to support bank risks.\textsuperscript{44} As to holdings of another bank's capital instruments on a reciprocal basis, this is tantamount to a capital swap and is not actually adding to the capital base.\textsuperscript{45}

\textbf{D. Institutional Applicability}

A further dilemma intrinsic to the capital adequacy issue regards the most advantageous institutional applicability of the bank capital rules. Focusing first on the banking industry itself, should the same regulatory capital standards apply equally to banking institutions engaged in international operations and those solely engaged in domestic activities? Arguably, the primary regulatory objectives of transparency and competitive equality behind international supervisory rules are not equivalent objectives in domestic bank regulation. If this is the case, then uniform standards would have to be justified solely on a parallel objective of "safety and soundness." Further, why should international rules regarding international subject matter and concerns be translated automatically into domestic standards?\textsuperscript{46}

A second bank industry concern is whether these rules should apply to all types of banking institutions. For example, due to the deregulation process over the past decade, what formerly were financial institutions (\textit{e.g.}, thrift institutions and credit

\textsuperscript{41} See infra notes 81–86 and accompanying text.
\textsuperscript{42} See \textit{ACCOUNTING FOR INTANGIBLE ASSETS}, Accounting Principles Board Opinion No. 17, as amended in the case of banking institutions by \textit{ACCOUNTING FOR CERTAIN ACQUISITIONS OF BANKING OR THRIFT INSTITUTIONS}, Statement of Financial Accounting Standards No. 72 (Fin. Accounting Standards Bd. 1983).
\textsuperscript{44} See, \textit{e.g.}, 53 Fed. Reg. 8550, 8556 (1988) (a discussion of the issue by U.S. federal bank regulators).
\textsuperscript{45} See, \textit{e.g.}, \textit{id.} at 8557 (a discussion of this issue by U.S. federal bank regulators).
\textsuperscript{46} See \textit{infra} Part IV.
unions in the United States) distinct from commercial banks are now direct competitors with banks in many financial services. Should such other banking institutions be under the same capital requirements?

Bank affiliates are a third bank industry concern. Should a nonbank parent company of a regulated bank and the parent’s permitted nonbank subsidiaries and affiliates be drawn within the same capital ambit? Such nonbank, but bank-related entities, are outside a formal definition of a “bank” and are often competing with nonregulated (or more leniently regulated) nonbank financial entities. But if one looks at such entities and the related bank as one financially independent economic unit, then logic and prudence would appear to dictate a broader coverage of the capital standard.

But the concerns are not simply intra-banking industry; they go cross-industry into the realm of competing nonbank financial intermediaries such as investment bankers and finance companies. If such other entities are either to escape capital regulation or to be subject to less rigorous and less costly requirements, then the bank requirements may in fact lead to a disintermediation of bank business, which, in turn, will strain the financial health of a bank and the banking industry. For instance, in the United States, commercial banks and investment banks traditionally have not been directly competing financial intermediaries, primarily due to the federal Glass-Steagall Act. Accordingly, respective rules on institutional capital developed separately under separate regulators and for differing purposes. But with the increasing linkages between money and capital markets and hybrid market products, securities firms are finding themselves often assuming forms of credit risk and banks are finding themselves assuming market and other noncredit risks.

Yet substantially different capital rules distort competitive pricing. For example, in the United States, the capital (i.e., net worth) rules for securities firms are set by the Securities and Exchange Commission (SEC). The SEC rules are based on notions of net worth to total indebtedness (as distinguished from the present bank regulatory notion of capital-to-assets). Moreover, what comprises net worth and what is to be deducted therefrom for SEC regulatory calculations differ from corresponding U.S. federal bank regulatory calculations: subordinated debt of more than one year’s duration and certain prescribed credits are counted, and deductions include intangible,

47. See FIRE REPORT, supra note 1.
52. See (SEC Rule 15c-3-1) Net Capital Requirements for Brokers or Dealers, 17 C.F.R. § 240.15c3-1 (1988).
fixed and other illiquid assets, nonmarketable securities, unsecured receivables, and "haircuts" reflecting estimated trading risks. As reflected by one commentator:

The regulatory capital requirements imposed on commercial and investment banks are designed to address the traditional business activities of each industry. Direct competition between these industries within the capital markets, however, is not traditional. It involves products which introduce risk elements from both arenas. Securities firms are assuming more term, nonmarketable credit exposure, particularly for performance on complex new instruments. In addition, investment banks have begun to provide merchant banking services, investing directly in their own deals either temporarily (bridge loans) or permanently. Concomitantly, banks have begun to deal in options and other difference contracts in addition to their established trading presence in the foreign exchange and public securities markets. The turnover of bank assets has also been increased by securitization of previously unmarketable assets. These activities generate significant noncredit risk.

Although supervisors of both banking and securities firms attempt to assess the credit and price risk of new activities, they differ in the capital burden they now require. It is not clear how the common risks could be best included within both industries' quantitative capital calculations so as to place similar requirements on banks and securities houses. . . .

E. Significance of the Dilemmas

The various dilemmas indigenous to the notion of bank capital (in terms of concept, composition, measurement, and institution applicability) have broad implications for a banking institution, its management, shareholders and depositors, and for domestic and international bank regulators and regulators of other financial intermediaries.

For a banking institution, regulatory bank capital requirements impose an inescapable strain and tension between the need for prudent risk management and the need to be competitive and to produce an acceptable level of return for investors. Most well-managed business enterprises will secure (from owner investments or retained earnings) an adequate level of capital to support infrastructure operations and expansion and to cover foreseeable growth and contingencies; management judgments on capital are normally reflected on a going-concern and foreseeable basis. But, bank regulatory capital is based on absorption of unexpected losses and, if not on a worst case, liquidation scenario, then on a sustained bad times projection. Larger-than-normal business amounts of required capital for banking institutions, in turn, amount to a regulatory tax that increases overall operational costs, cost of funds, and regulatory reporting and compliance burdens. That levy may restrain dividend payments, competitive positions, and growth capabilities, and may lead to an institution taking greater portfolio risks or "untaxed" risks (e.g., "off-balance sheet" activities) in pursuit of greater profits or divesting quality assets (i.e., "asset stripping" and "asset securitization") to reduce the capital adequacy formula.

53. For further discussion see Haberman, supra note 49.
54. See supra note 15 and accompanying text.
55. See supra notes 23–24 and accompanying text.
denominator as to satisfy the required capital-to-assets percentages and to avoid having to raise additional capital funds.  

Obviously, a capital-to-asset risk-based formula is intended, in part, to address the off-balance sheet risk problem and trends toward selling off an institution's more liquid and less risky assets; but, even this formula still leaves a banking institution in a likely uncompetitive position with competing nonbank financial intermediaries, which can lead to underpricing of competing products and, thus, to greater risks and lower profit possibilities for the banking institution.

Mandatory regulatory capital schemes, therefore, can leave banking institutions on the horns of a dilemma. To meet new and higher capital standards, the institution will have to do one or more of the following: go to the securities markets (which is probably only available to the very top creditworthy banks and which may still be adversely affected by the type of financial instruments includable in the permitted capital base); revise its profit goals and attendant management policies for attempting to generate the needed earnings to be retained as capital; or reduce its asset base and shift to more nonloan, fee-generating activities. Regulatory capital requirements not only place constraints on an institution’s portfolio growth (as more assets mean more capital and not simply more sources of available funds), but also place constraints on an institution’s growth through acquisition policies, particularly if goodwill is to be deducted from acceptable capital.

For bank depositors, interbank lenders, and bank investors (existing and potential), a high capital ratio is often proffered as a badge for public confidence in the institution—an intangible factor or perception deemed necessary to promote fund deposits, equity and long-term debt placements, and investments, and to avoid liquidity runs. But a serious question exists whether the higher ratio can ever be fully adequate in a forced liquidation or insolvency situation. Moreover, bank

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58. See supra notes 42–43 and accompanying text.

59. See, e.g., H. Crosse & G. Hempel: It is probably more meaningful, therefore, to look on the primary function of bank capital funds not as a cushion of excess assets that enables a bank to absorb losses and still remain solvent but rather as a factor, perhaps the most important factor, in maintaining the confidence a bank must enjoy to continue business and prosper. The primary function of bank capital is to keep the bank open and operating so that time and earnings can absorb losses—in other words, to inspire sufficient confidence in the bank on the part of depositors and the supervisor so that it will not be forced into costly liquidation. In this sense, capital serves to protect the stockholder as much as, if not more than, the depositor.

The fact that confidence is the vital ingredient of a bank’s success should be self-evident. Depositors must be confident that their money is safe, and borrowers must be confident that the bank will be in a position to give genuine consideration to their credit needs in bad times as well as good. Above all, under the closely supervised private banking system of the United States, the continuing confidence of the bank supervisor is essential to a bank’s continued existence.


60. See, e.g., Young, Bank Capital Adequacy in the United States, Issues in Bank Reg., Spring 1986, at 3, 4: "In a sense 'capital adequacy' is misleading. No amount is adequate if its bank's credit culture goes wrong. No amount is sufficient to weather a liquidity crisis."
depositors often will look to a deposit protection scheme for primary protection against loss; interbank lenders will rely on the short-term nature of their loans and on their interbank management skills; and market investors will desire a reasonable return on investment for some inevitable investment risk-taking. Further, as the capital formula becomes more complicated and as more subjective regulatory judgments are required on such matters of risk assessment and capital adequacy, such parties will be in need of greater transparency for making sound deposit, lending, or investment decisions.

For the bank regulator, reformulation of regulatory capital notions forces a rethinking and resorting of the policy justifications for prudential supervision regulations. Such reformulation considers the following: if the large institutional and system costs of a mandatory capital scheme outweigh the benefits; what functional purposes capital formulae serve for the regulators; and if such tests are only for solvency evaluation purposes, or for broader purposes as institutional evaluation, bank management assessment and constraint, or enhancement of transparency for the regulators.61

In more mundane terms, use of a more sophisticated capital adequacy test imposes new and greater burdens on the regulators in implementing the test in a fair and meaningful manner. Better information gathering, analytical assessment tools, trained staff, and surveillance procedures will be needed. Also, the increased complexities of an asset-risk test exacerbate the potential for divergent treatment and use of the test. Because this divergence may give rise to competitive inequalities for banking institutions from different jurisdictions, the need arises for better cooperation, exchange of information, and convergence of capital and related prudential supervision policies with respect to the various national bank regulators.62 Accordingly, mandatory regulatory capital requirements have significant external manifestations respecting numerous (and conceivably individualized and nonaligned) interests—including those of the banking institution, its management, its investors, its depositors, its lenders, and regulators from other jurisdictions. Furthermore, these requirements have significant internal implications for a particular bank regulator.

The legal dimension of capital adequacy comes to be whether legal (or legally significant) rules (as opposed to informal approaches) can better deal with these definitional dilemmas of bank capital in terms of fulfillment of legitimate policy objectives and in terms of provision of certainty, predictability, fairness, stability, competitive equality, and transparency in the practical application of such definition to banking institutions.

61. For discussion of these and other policy issues, see infra Part V., subpart B.
62. See infra Part IV.
III. HISTORICAL PERSPECTIVES ON THE REGULATORY ROLE OF BANK CAPITAL ADEQUACY

The twentieth century has been a historical period of declining capital ratios for banking institutions. Regulatory concern for bank capital adequacy in the United States arose as a result of the collapse of the U.S. banking system in the 1930s, although the "consensus of scholarly research is that the level of bank capital has not been causally related to the incidence of bank failure." Moreover, until recently, this regulatory interest was largely internalized in nonrule-oriented examination and supervisory practices of the U.S. bank regulators. In fact, in a country such as the United Kingdom, this regulatory topic did not become an issue of supervisory concern until the 1970s. However, capital adequacy now is emerging as the cornerstone for regulatory approaches to prudential supervision of domestic and international banking activities by bank regulators in the United States, United Kingdom, and other industrialized countries, and is a subject lending itself increasingly to more formal rulemaking characterization.

A. The Pre-1980 Era United States Experience

At the end of the nineteenth century, the average ratio of bank capital to assets among U.S. banks approximated twenty percent. With a surge in bank portfolios as a result of the First World War and rapid economic expansion during the 1920s, this figure was reduced to thirteen percent. Then, through the Great Depression to the end of the Second World War, six percent became the norm. In the 1950s there was an upward movement to around ten percent. This figure has since dipped to around six to seven percent.

This decline in bank capital levels and the bank collapses endemic to the Depression (and for that matter, to bank failures since then) give no indication that capital levels were critical; mismanagement, fraud, and loss of public confidence leading to illiquidity have been and remain the primary culprits. Moreover, prior to the end of the Second World War, when the retail nature of banking transformed the

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63. See, e.g., M. LEWIS & K. DAVIES, DOMESTIC AND INTERNATIONAL BANKING 148-50 (1987) (indicating that with respect to U.S. banks, equity capital to total assets went from 18.3% in 1914 to 6.9% in 1985; in the United Kingdom the ratio was 12% in 1900 and down to 4.6% in 1985).
64. G. VILLA, BANK CAPITAL ADEQUACY 8 (1973) (copy on file with the Ohio State Law Journal).
65. See generally infra Part III.
67. See generally infra Parts III & IV.
68. See G. VILLA, supra note 64, at 212–13.
69. Statistics furnished by FDIC depict the ratio of equity capital to total assets in the total U.S. commercial banking system as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Equity Capital/Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>8.1</td>
</tr>
<tr>
<td>1970</td>
<td>6.6</td>
</tr>
<tr>
<td>1980</td>
<td>5.8</td>
</tr>
<tr>
<td>1983</td>
<td>6.0</td>
</tr>
</tbody>
</table>

70. See G. VILLA, supra note 64, at 8–9.
bank balance sheet from large portfolios of low risk government securities to ones of higher risk commercial and retail loans, use of capital ratios were of little worth. In fact, it was not until 1981 that any formal bank capital adequacy regulation existed. Prior statutory and regulatory references to capital were only to minimal and static levels for bank formation. Under the public surface, however, a bureaucratic culture predisposed to capital ratios was forming. At the beginning of the twentieth century, the unsupported regulatory wisdom was that a ten percent capitalization ratio of assets to deposit liabilities should be the norm. In the late 1930s the Federal Deposit Insurance Corporation (FDIC) shifted emphasis to a capital-to-total asset approach. Then in the 1950s, the Federal Reserve Board began to employ, for internal purposes, a simplistic capital-to-adjusted-risk analysis that loosely identified a broad category of "risk assets" by deducting groups of assets viewed as relatively without risk (e.g., government securities) from total assets: the norm was one dollar of capital funds for each six dollars of risk assets reflected on the balance sheet.

In 1952 the Federal Reserve District Bank of New York embarked on a more elaborate risk asset-based examination reporting form ("ABC") by breaking risk assets into various categories and by assigning different (and arbitrary) risk weights to these asset classes. In 1956 the Federal Reserve Board adopted the New York District Bank's capital analysis and added a further degree of sophistication by linking a separate but related capital-liquidity analysis. In 1972 the Federal Reserve Board further refined (and complicated) this adjusted risk asset capital adequacy analysis.

But the Federal Reserve's examination procedures relating to capital did not become a predominant view until the economic and regulatory significance of the Federal Reserve's supervisory responsibility for bank holding companies (derived from the Bank Holding Company Act of 1956) came into ascendancy in the 1970s with the emergence of holding companies as a leading form of banking institutions. As to total assets, the Federal Reserve did not previously have a major supervisory and examination function, but was responsible for state-chartered banks that were

71. See id.
72. See infra Part III., subpart B.
74. See G. Freeman, THE PROBLEMS OF ADEQUATE BANK CAPITAL (1952).
75. Id. at 11.
76. See Federal Reserve Board Form FR 363 (1956), Form for Analyzing Bank Capital, in G. Voita, supra note 64, at app. I.
77. See Federal Reserve Board Form FR 363 (Form ABC) (1972), Form for Analyzing Bank Capital, in G. Voita, supra note 64, at app. II.
79. According to George Bush, "the number of registered holding companies rose from only 53 in 1956, when the Bank Holding Company Act . . . was enacted, to almost 5,400 at year-end of 1983. In fact, over the last 15 years the holding company form of organization has grown from relatively limited use to become the dominant organizational form of U.S. banking companies, with well over half of all U.S. banks now owned by holding companies." G. Bush (Chairman), Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services (1984), reprinted in Special Supplement No. 1030, Fed. Banking L. Rep. (CCH), at 20 (Nov. 16, 1984) [hereinafter Bush Task Force Report].
members of the Federal Reserve System and for the limited number of holding companies under its jurisdiction.\textsuperscript{80}

Until the recent dominant economic presence of bank holding companies, the primary banking institution supervisor was the Comptroller of the Currency, who had charge of national banks. In the 1960s the Comptroller set off on a completely different tack regarding capital adequacy. The Comptroller discarded the risk-asset approach as arbitrary and incomplete. Although using a formula based on a seven-to-one gross loans-to-capital ratio as a guidepost to capital adequacy, the Comptroller would examine each national bank on a case-by-case basis, making its analysis of capital adequacy in an overall evaluation of management quality, asset quality, liquidity, earnings history, ownership strength, and cash flow abilities. The Comptroller's emphasis was neither on static equations nor on "worst case" estimations, but was on total management performance of the bank as a going-concern under normal conditions. This individualized assessment became translated into an internal bank rating system for the Comptroller.\textsuperscript{81}

The Comptroller of the Currency's approach to capital adequacy in the early 1970s was summarized by Charles Van Horn, the Regional Administrator of National Banks for the Second Region:

The traditional capital-to-risk assets and capital-to-total deposit ratios are no longer relied upon, because such arbitrary formulas do not always take into account important factors.

In evaluating capital adequacy, the Comptroller's Office considers the following factors: the quality of management; liquidity of assets; the history of earnings and of the retention thereof; the quality and character of ownership; the burden of meeting occupancy expenses; potential volatility of the banks' deposit structure; the quality of operating procedures; and the bank's capacity to meet present and future financial needs of its trade area, considering the competition it faces.

In addition, we use a formula which relates capital to the volume of loans and discounts. In making the calculation, the numerator is gross loans and discounts. Total capital accounts, including reserves, are the denominator. This loans-times-capital ratio is a first quick test of capital adequacy. Where gross loans exceed seven times the total capital accounts, the bank is scrutinized more closely.

Application of any rule-of-thumb obviously requires judgment. The Comptroller's Office analyzes the loan portfolio for quality and liquidity. Such loans as commercial paper, brokers' loans, municipal loans, and loans guaranteed or insured by the United States Government are taken into consideration. By carefully evaluating all relevant factors, we avoid penalizing well-managed, profit-conscious banks.

Earnings are extremely important from a supervisory standpoint. Generally, a bank with a good earnings record is in a position to do better in five vital areas: (1) pay adequate salaries and thus attract and retain executive talent; (2) withstand a shrinkage in asset values;

\textsuperscript{80} As of June 1970, approximately the following number of banking institutions were under the direct supervision and examination of the Federal Reserve Bank: 1166 state-chartered bank members of the Federal Reserve System having assets of $117,209 million (as compared to a total of 13,478 FDIC-insured banks having total assets of $526.484 billion); and 121 bank holding companies controlling 895 banks. But in 1987 there were approximately 6600 bank holding companies controlling approximately 9400 banks and having total assets in excess of $1800 billion. These figures were derived from the June 1970 and June 1987 Fed. Reserve Bull. and from Ass'n of Bank Holding Companies, Bank Holding Company Facts (Spring 1988).

\textsuperscript{81} See H. CROSSE & G. HEMPEL, supra note 59, at 78–80.
(3) raise new capital because of greater investor appeal; (4) permit the payment of competitive interest rates on deposits; and (5) support investment in modern and efficient premises, fixtures and equipment. A good-earning bank is a more viable competitor and normally a more progressive institution overall.

A bank's asset quality is measured initially by relating the aggregate volume of assets classified Substandard, Doubtful or Loss, to gross capital funds, including reserves. Each bank is assigned to one of four categories.

Generally speaking, banks with total classified assets of less than twenty percent of gross capital funds receive an "A" rating. Banking, after all, is a risk business and the evaluation of credit involves judgment. It is certainly no reflection upon management or the directors if an examiner criticizes a moderate volume of the bank's assets.

When classified assets amount to more than twenty percent but less than forty percent of gross capital funds, banks earn a "B" rating. At this point, the board of directors usually receives a letter from the Regional Administrator directing attention to the volume of criticized assets and requesting to be advised as to actions taken or contemplated to rectify the weaknesses cited in the report.

A "C" rating goes to banks with classified assets aggregating more than forty percent but less than eighty percent of gross capital funds; and a "D" rating to banks with classified assets in excess of eighty percent of gross capital funds. With few exceptions, a bank in the "C" or "D" category, with classified assets equal to forty percent or more of the capital structure, constitutes a so-called "Problem Bank."

In connection with the examination of "C" and "D" banks, a national bank examiner usually convenes the board of directors to appraise them of the situation and to obtain assurances that corrective measures will be instituted. Incidentally, examiner's meetings with directors are not limited to "Problem Bank" situations. National bank examiners are always pleased to meet with directors at the conclusion of an examination. Such meetings give the directors and the officers of national banks the benefit of seeing their banks through the examiner's eyes.

Only after weighing capital adequacy and asset quality is management assigned a rating. It would clearly be difficult to assign the highest management rating, "Strong," in a bank which had a heavy volume of classified assets, inadequate controls and safeguards, violations of law, or inadequate capital protection. Conversely, it would not be consistent to give management a rating of "Poor," the lowest rating in a bank free of asset, operating or capital problems.

In judging the quality of management, we take into consideration the overall condition of the bank, its liquidity position, its earnings compared with banks of similar size, the adequacy of its credit files, the effectiveness of collection efforts, the quality and distribution of the investment account, the adequacy of internal controls, the efficiency of operations, provision for management succession, and the bank's service to the community.

Based largely upon the combination which results from the earlier evaluation of capital, asset quality and management, a group or composite rating is assigned to each examination report.

Group #1 banks are sound in every respect. Fortunately for supervisors, most banks fall into this category.

Group #2 banks have one or more unfavorable factors, such as asset weaknesses ranging from moderate to moderately heavy, inadequate capital, or less-than-satisfactory management. This rating might also apply when certain special factors prevail such as lack of adequate supervision by the directors, detrimental domination by one or more persons, significant deficiencies in auditing or internal controls, or unfavorable effects resulting from local economic conditions.

Group #3 banks are characterized by an excessive volume of asset problems in relation to capital, serious management deficiencies, exposure to extremely adverse local economic
conditions, or a combination of these or other problems which could reasonably develop into a situation urgently requiring emergency aid from shareholders.

Group #4 banks are confronted with asset problems of an extremely serious nature and with gross inadequacy of management and directorate so that shareholder aid is urgently required. If such aid is not forthcoming drastic supervisory measures appear to be warranted.82

During the 1970s the Comptroller's rating system was further developed and became generally accepted as an interagency examination tool by the Comptroller, Federal Reserve Board, and the FDIC. For example, by the late 1970s these agencies were using trends and peer group comparisons respecting selected ratios to determine capital adequacy, including:

- Equity Capital/Total Assets
- Total Capital/Total Assets
- Loans/Total Capital
- Classified Assets/Total Capital
- Fixed Assets/Total Capital
- Net Rate Sensitive Assets/Total Assets
- Reserve for Chargeoffs/Net Chargeoffs
- Net Chargeoffs/Loans
- Asset Growth Rate/Capital Growth Rate.83

These regulatory practices unfolded in 1978 into a Uniform Interagency Bank Rating System (CAMEL system)84 and the related Federal Reserve Board rating system for bank holding companies (BOPEC system).85 These uniform systems utilized capital adequacy as one of a number of factors that are evaluated individually and then collectively by the bank regulators in applying (for their internal examination purposes) a soundness rating for a particular banking institution. Other factors considered by the regulators in determining institutional soundness include asset quality, management, earnings, and liquidity.86

The uniform system, however, did not detract from the Federal Reserve's own capital-to-risk assets reviews when examining the capital adequacy portion of the rating.

The notion of capital adequacy also found its way into a number of evaluative decisions made in certain application processes before the regulators. For example, capital adequacy is an important consideration in the bank acquisition process,87 for

82. Speech by C. Van Horn, reprinted in G. VorTa, supra note 64, at 11–12 n.16.
83. See H. Cross & G. Hennig, supra note 59, at 79.
86. The CAMEL System has two basic aspects: (1) an assessment by bank examiners of five key aspects of a bank's operations and conditions (capital adequacy ("C"), asset quality ("A"), management ("M"), earnings ("E"), and liquidity ("L")); and (2) a component evaluation of these factors to arrive at a composite, overall rating of the bank's condition and soundness into one of five categories. Rating components and composites are based on a one to five scale. The Federal Reserve also utilizes a component and a composite rating system for bank holding company units, evaluating the following elements: bank subsidiaries ("B"), other (nonbank) subsidiaries ("O"), parent company ("P"), earnings ("E"), and capital adequacy ("consolidated").
FDIC insurance applications, and in the formation of banks. Also, capital is of regulatory importance in calculating compliance with single borrower lending limits.

What is of significance about these earlier regulatory flirtations with capital adequacy in the United States is not simply that capital adequacy was a matter of regulatory concern and scrutiny, but that none of the approaches (aside from the application processes referred to above) were rooted in any specific regulatory or statutory capital requirements, except for an innocuous statutory minimum capital requirement for forming a national bank. Nor did these approaches ever gel into a broad uniform supervisory principle or policy of the bank regulators: substantial differences existed among the regulators. The various regulatory positions were largely separate internal examination tools for helping to assess overall bank soundness and to coax informally management (where needed) to do better. No specific legal enforcement procedures existed for what might be viewed as inadequate capital in a banking institution. It was not until 1983 that the regulators were granted specific powers to issue capital directives. Prior thereto, any perceived regulatory enforcement power in this area rested with the agency’s authority to ensure a “safe and sound” banking system.

B. The Post-1980 Era

1. The 1981 Statements

The first formal regulatory pronouncement on bank capital adequacy standards came in 1981 with the public issuance of a Joint Policy Statement proposing “Capital Adequacy Guidelines” by the Federal Reserve Board of Governors respecting state, Federal Reserve System member banks and bank holding companies, and by the Office of the Comptroller of the Currency respecting national banks. The main motivation for this regulatory action appears to center around the efforts of the Federal Financial Institutions Examination Council’s efforts to achieve uniformity and consistency among the bank regulators concerning their examination and supervisory usages of bank capital standards: “[T]he agencies developed the guidelines in the hope of achieving greater consistency in their supervisory


activities.\textsuperscript{95} The Federal Reserve Board and the Comptroller also mentioned two other regulatory objectives: the facilitation of banking institutions in their financial planning, which is a euphemistic way of disguising a regulatory objective to place prudential restraints on institutional growth; and the eventual levelling out of sizable existing disparities in capital ratios among banking institutions of different size.\textsuperscript{96} These regulators also expressed their growing concern over long-term decline in capital ratios, particularly among the larger multinational institutions.\textsuperscript{97}

From the start, however, the regulators clarified that they were not abandoning their historical practices of evaluating capital adequacy on an institution-by-institution basis and that capital adequacy was more a qualitative than quantitative determination derived from analyses of a number of institutional characteristics such as management and ownership quality, earnings quality, expertise, quality of assets, risk diversification, audit controls, credit and operational policies and controls, economies of scale, marketplace and regulatory discipline exposure, reputation, and market presence.\textsuperscript{98} Also mentioned as a qualitative factor was the control of off-balance sheet risk,\textsuperscript{99} which was one of the earlier regulatory expressions of prudential concerns for the budding off-balance sheet activities of commercial banks in the late 1970s.\textsuperscript{100}

Although the Federal Reserve Board and the Comptroller proposed minimum fixed percentage ratios of capital to assets, the approach taken in implementing these ratios was highly complex. Distinctions were made between sizes of institutions (i.e., multinational banks, regional banks, and community banks),\textsuperscript{101} various capital zones were used as screening mechanisms triggering levels of predetermined supervisory action,\textsuperscript{102} and two capital adequacy tests ("primary capital" to total assets and "total capital" to total assets) were employed.\textsuperscript{103}

In hindsight, what was perhaps of greater long-term significance to the evolution


\textsuperscript{96} See Joint News Release, supra note 93, at 3406.

\textsuperscript{97} Id.


\textsuperscript{99} Id. at 3404.

\textsuperscript{100} For off-balance sheet banking activities, see generally \textit{Cross Report}, supra note 3.

\textsuperscript{101} The regulators had specifically identified 17 banking institutions as multinational institutions; regional banks were all other banking institutions with consolidated assets of one billion dollars or more; and community banking institutions were all others not included as multinational or regional institutions.

\textsuperscript{102} Three zones reflecting levels of total capital to total assets were established for regional and community institutions:

\begin{tabular}{|c|c|}
\hline
Zone 1 & Regional above 6.5% \hline
Zone 2 & 5.5–6.5% \hline
Zone 3 & below 5.5% \hline
Community & \begin{tabular}{c}
above 7.8% \hline
6.0–7.8% \hline
below 6.0% \hline
\end{tabular}
\hline
\end{tabular}

The zones affected the nature and intensity of supervisory actions. Institutions in Zone 1 were presumed to have adequate capital if, in addition, their primary capital ratio was acceptable. Institutions in Zone 2 were presumed to be possibly under-capitalized and the regulators would engage in extensive contact with management and would require submission of an acceptable comprehensive capital plan. Institutions in Zone 3 were strongly presumed to be under-capitalized, would be required to submit a capital plan, and would be subject to continuous analysis, monitoring, and supervision.

\textsuperscript{103} A minimum requirement for primary capital to total assets was 5% for regional institutions and 6% for community institutions. The total capital-to-total assets test is the zone concept. See supra note 102.
of capital adequacy regulations in the United States was the separate path taken by the FDIC as to capital standards for insured state, non-Federal Reserve System member banks. In 1981 the bank regulators joined a regulatory dialectic of sorts regarding the formulation of capital adequacy standards, which was to unfold the myriad complexities of the matter. Yet as more substantive or procedural differences in regulatory approaches surfaced, the argument for achieving uniformity as to definition and to application of capital adequacy standards became more compelling.

The FDIC proposed a uniform threshold level of adjusted equity capital at six percent of total assets for initiating regulatory contact with bank management for submission of a comprehensive capital plan, and at five percent of total assets for requiring a specific program for prompt remedy of the capital deficiency. While the practical reason for such a simple approach may be that the institutions under the FDIC's supervisory control were more homogeneous in size and capital bases, the articulated regulatory reason was to "foster objectivity in the analytical process and provide a benchmark for evaluating capital adequacy." Another substantive difference existed between the views of the FDIC and those of the Federal Reserve Board and the Comptroller that addressed the definition to be given to regulatory capital. For the FDIC, the sole emphasis should be on "equity capital" to be defined as common stock, perpetual preferred stock, capital surplus, undivided or retained profits, contingency and other capital reserves, mandatory convertible debt instruments, and reserves for loan losses. Instruments such as limited-life preferred stock or subordinated notes and debentures were not to be included as they lacked the permanence of true equity, were not available to absorb losses except in an actual liquidation, and imposed mandatory servicing requirements.

However, for the Federal Reserve Board and the Comptroller, the definition of regulatory capital was to be bifurcated between "primary" capital components and "secondary" capital components, with the primary and secondary components combining to form "total" capital. Primary components approximated the FDIC's notion of equity capital; secondary capital was to include, subject to various qualifications, limited-life preferred stock and subordinated notes and debentures. The minimum ratio of primary capital to total assets was five percent for regional banking institutions and six percent for community institutions, with all such institutions generally being expected to operate above these levels.

In addition, the interim regulatory debate was to generate considerable innovation in the financing of banking institutions. For example, the inclusion of "preferred stock" and "mandatory convertible instruments" into primary capital and "limited-
life preferred stock,” and “subordinated notes and debentures” into secondary capital inspired banking institutions and their financial advisers to explore numerous innovative variations of these capital species. In fact, so much originality was being exercised by the banking institutions that the Federal Reserve Board and the Comptroller found it desirable in 1982 to issue a joint statement providing more specific criteria to determine whether a particular type of bank security qualified as primary capital.

2. Major 1983 Events

In 1983 two intervening events—one a domestic court decision and the other an internationally directed domestic statute—were to sharpen and to intensify regulatory focus regarding capital adequacy standards. While the stages of formal rulemaking in the capital adequacy area appeared to have been launched without challenge in 1981, the limitations on the efficacy of this rulemaking became apparent with the federal Fifth Circuit Court of Appeals decision of First National Bank of Bellaire v. Comptroller of the Currency in February 1983. In this case, the Court of Appeals set aside the portion of the Comptroller’s “cease and desist” order requiring the capital levels of a particular national bank to be increased and maintained at a level not less than seven percent of its total assets. Prior thereto, the bank regulators had assumed they would enjoy broad administrative discretion in enforcing their capital adequacy rules pursuant to their powers to issue cease and desist orders under statutory authority granted by the Federal Deposit Insurance Act. The court recognized that the Comptroller had power to issue such orders, after formal hearing and subject to judicial review, when a banking institution subject to its regulation is “engaging or has engaged . . . in an unsafe and unsound practice in conducting the business of such bank,” with the term “unsafe and unsound” encompassing “conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder.” In reviewing the basis of the Comptroller’s order, the court applied a two-prong test: first, whether there was “substantial evidence” to support the order, which means whether the Comptroller made a “reasonable” (and not necessarily correct) finding, that is, whether the evidence as a whole bears a “rational connection” to the order; and second, whether the Comptroller acted arbitrarily or capriciously.

The Bellaire decision had a stunning effect upon the bank regulators. Although the decision did not question the authority of the regulators to supervise bank capital,

110. See Kelly, Preferred Stock Comes of Age, AM. BANKER 11, 20 (Mar. 31, 1983).
112. 697 F.2d 674 (5th Cir. 1983).
114. Bellaire, 697 F.2d at 685 (quoting First Nat'l Bank of Eden, S.D. v. Department of the Treasury, Office of the Comptroller of the Currency, 568 F.2d 610, 611 n.2 (8th Cir. 1978)).
115. Bellaire, 697 F.2d at 686.
it did cast severe doubts upon the ready enforcement of such regulatory actions.\textsuperscript{116} The case gives the impression that the Comptroller was using the capital order in an overreaction to a running battle between this banking agency and the bank management on unrelated matters;\textsuperscript{117} however, the holding of the case is wide enough to have made the Comptroller re-evaluate its whole approach to promulgating its capital adequacy standard. As noted by the court, "even if the Comptroller had proved capital inadequacy it would not necessarily indicate the Bank was in any danger."\textsuperscript{118} Prior thereto, the Comptroller had been content to abide by the flexible "guidelines" approach of the Federal Reserve Board; thereafter, the Comptroller would encourage a form of more legalistic and specific regulations so that their enforcement could be more certain if challenged before the courts.\textsuperscript{119}

The second intervening event occurred in November 1983 when the United States Congress provided a definite statutory legitimacy to the promulgation and enforcement of federal capital adequacy standards by enacting the International Lending Supervision Act (ILSA).\textsuperscript{120} In reacting to the unfolding international debt crisis and its impact on the U.S. banking system, Congress had begun, through its committee hearing procedures, to take the federal bank regulators to task as being unresponsive to identifying, and to protecting against, the enormous sovereign credit risks assumed by the U.S. banks in the 1970s and early 1980s.\textsuperscript{121} The ILSA was intended to address the anomaly that U.S. multinational and other major U.S. banking institutions had been engaging in substantial international lending without the benefit of a statutorily based, comprehensive supervisory scheme; to assure that the U.S. economy (and those of other nations) would not be adversely affected or threatened by imprudent lending practices or inadequate supervision; and to achieve the adoption of effective and consistent supervisory policies and practices respecting international lending by U.S. banking institutions.\textsuperscript{122}

Relevant for present purposes is that the ILSA mandated the federal banking authorities\textsuperscript{123} to "cause banking institutions to achieve and to maintain adequate capital by establishing minimum levels of capital for such banking institutions and by such other methods as the appropriate federal banking agency deems appropriate," and conferred express enforcement powers on these agencies through the issuance of capital directives.\textsuperscript{124} In addition, the Act provided (and, in effect, largely overruled the Bellaire decision) that failure to establish required minimum capital levels would,

\textsuperscript{116} See 2 MATTHEW BENDER, BANKING LAW § 23.08, at 23-17 to-18.3 (1987) (a discussion of Bellaire).
\textsuperscript{117} Apparently, the Comptroller had engaged in ongoing controversy concerning real property owned by the bank and its repeated disregard for informal directions of the regulator concerning such property.
\textsuperscript{118} Bellaire, 697 F.2d at 687.
\textsuperscript{119} See infra Part III, subpart B(3)(i).
\textsuperscript{120} See Lending Act of 1983, supra note 91.
\textsuperscript{121} For legislative history of the Act, see 1983 U.S. CODE CONG. & ADMIN. NEWS 1768, 1913.
\textsuperscript{123} The ILSA applies to members of the Federal Financial Institutions Examination Council, which includes the Federal Reserve Board, the Comptroller, the FDIC, and other U.S. regulators. See 12 U.S.C. § 3902 (Supp. IV 1986).
\textsuperscript{124} Id. § 3907(a).
\textsuperscript{125} Id. § 3907(b)(2)(B)(ii).
in the discretion of the federal banking authorities, constitute “an unsafe and unsound practice” under the general statutory enforcement powers of the authorities.126 Further, the ILSA gave the first congressional “imprimatur” to the need for convergence of international bank capital standards by calling on the federal bank regulators to consult with bank regulators from other nations.127 Thus a piece of federal legislation, motivated by the specifics of the international debt crisis, provided the statutory legitimacy in the United States for the express formulation and enforcement of domestic and international capital adequacy standards for banking institutions.128 It was the ILSA which proved to be a key catalyst for the convergence of domestic capital adequacy standards by the three U.S. bank regulators and for the multilateral efforts of bank regulators within the forum of the Basle Committee.129

3. The ILSA Regulatory Implementation and the 1985 Regulations

Prior to the enactment of the ILSA, the Federal Reserve Board and the Comptroller had been continuing their review of their capital adequacy guidelines. In June 1983 the agencies issued a series of amendments to the 1981 Guidelines, which they applied immediately, while they also solicited comments on the changes.130 The thrust of the amendments was to bring the multinational banks treated specially under the 1981 Guidelines under a uniform five percent minimum ratio of primary capital to total assets and to broaden the definition of secondary capital components for bank holding company analyses. Of particular (but perhaps unnoticed) significance were the following comments of the agencies: “[T]hose banking organizations that have a higher than average percentage of their assets exposed to risk, or have a higher than average amount of off-balance sheet risk, may be expected to hold additional primary capital to compensate for this risk.”131 The heightening preoccupation of the regulators with risk assets and off-balance sheet risks was coming to public light.

With the enactment of the ILSA, the three bank regulators began a total re-evaluation of their prior capital adequacy standards, with the common goal of arriving at a common definition of regulatory capital and common minimum standards.132 By the end of the summer of 1984, the regulators had published separately their proposed uniform minimum capital standards for public comment.133 The three proposals, in substance, roughly approximated each other and were largely

126. Id. § 3907(b)(1).
128. See infra Part III, subpart B(3).
129. See infra Part IV.
132. For historical overview of federal practices relating to capital adequacy, see Carroll, Kalombkis & Kise, Deposit Insurance, Capital Regulation, and Bank Risk, in PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 298 (Fed. Reserve Bank of Chicago 1986).
derived from and built upon the 1981 Comptroller and Federal Reserve Guidelines.\(^{134}\) The regulators were now in full agreement that there should be uniformity of rules for banking institutions of all sizes and that there should be effective enforcement procedures to ensure compliance with the rules.

The reasons given by the regulators for this need for uniform capital adequacy rules were multiple. For example, the issue of adequate capital had become a major practical issue in prudent bank management and regulation. Since the 1960s there had been a demonstrable declining trend in equity capital to total assets ratios for the total U.S. commercial banking system. This erosion of bank capital bases was seen to be aggravated further by the deregulation of interest rates on bank deposit liabilities; by the weakening of loan portfolios resulting from the shocks in the domestic and world economies with the attendant declines in levels of bank profitability (but with increase in levels of risk within the banking system); by the increased and intensified marketplace competition for financial services on an interbank industry and inter-financial institutions basis (with additional pressures on bank profits); by the dramatic rise in off-balance sheet activities and risks undertaken by banking institutions; and by a perceived growth of interdependence within the banking system whereby financial problems of one institution would have severe repercussions throughout the system.\(^{135}\) These systemic problems were also seen as endangering the public confidence required for a safe and sound banking system. Congress called for the need for uniformity through the enactment of the ILSA.\(^{136}\)

In April 1985 the Federal Reserve formally promulgated, pursuant to the ILSA, its final revised "Guidelines,"\(^{137}\) which were coordinated with the regulations adopted the prior month jointly by the Comptroller and the FDIC.\(^{138}\) These regulations reflected uniform definitions for capital composition, uniform minimum capital levels for all federally supervised banking institutions, and revamped enforcement procedures.\(^{139}\) The Comptroller and the FDIC, however, rejected the more flexible "guideline" format of the Federal Reserve Board in favor of the more legalistic, easily enforceable, traditional regulation format;\(^{140}\) and the Federal Reserve (but not the Comptroller and the FDIC) retained the ancillary use of capital "zones."\(^{141}\)

The following key issues raised by the 1985 uniform capital rules are clear in retrospect:

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\(^{134}\) For discussion of 1984 proposals see Banking Agencies Focus on Capital Adequacy, 3 BANKING EXPANSION REP., Aug. 6, 1984, at 6.


\(^{136}\) See id.


\(^{139}\) See infra text accompanying notes 142–59.

\(^{140}\) See supra note 138.

a. The Need for Transparency

The public regulatory focus on capital adequacy proved to be a "Pandora's Box," opening up an ongoing and "vigorous debate" among the regulators, bankers, industry analysts, and others over the definition of capital and the measurement tests to be used.142 While all this may be viewed as an evolutionary process of rulemaking, the numerous changes in regulations, the sundry capital subissues left unresolved in such regulations, and the substantive and procedural differences among the regulators regarding the capital adequacy issue were creating considerable uncertainty and confusion for the regulators and for the banking industry. This uncertainty and confusion posed numerous concerns for the regulators in achieving consistency and fairness in their use of capital adequacy standards in the examination, application, and enforcement processes. Numerous concerns also were raised for the banking industry because the capital standards had a direct impact upon a bank's planning processes for growth, financing, profitability, and its relationship to its primary regulatory supervisor.143 Absent uniform, comprehensive, and clear regulations, these concerns would only continue and, perhaps, become further magnified. Better transparency in the regulatory process appeared to be required for all affected parties.

The 1985 regulations, however, did not achieve full uniformity and transparency. While the regulators had made further and common refinements and clarifications as to the components of regulatory capital and had agreed to use a common approach of primary and secondary capital, the regulators were not in entire agreement. For example, with respect to intangible assets, the FDIC and Comptroller permitted only mortgage servicing rights as part of primary capital inasmuch as these rights historically provided a sufficient predictability of income flow and value, while the Federal Reserve Board would include all intangible assets except goodwill.144 In addition, the FDIC, Comptroller, and Federal Reserve would exclude equity commitment notes (i.e., securities redeemable only from the sales proceeds of common or perpetual preferred stock) from the primary capital of banks, while the Federal Reserve would permit this in the case of bank holding companies.145 Further, with respect to secondary capital, the regulators limited secondary capital components to fifty percent of primary capital, while the Federal Reserve would not apply this limitation for bank holding companies.146 Also, and perhaps more significantly, the new regulations proposed only minimum capital levels of 5.5 percent of primary capital to total assets and six percent of total capital (primary plus secondary components) to total assets. Therefore, the regulators left themselves considerable discretion in requiring greater capital levels for banking institutions on a case-by-case

146. Id. at 16,062.
b. Enforcement Powers

When capital adequacy standards were largely an unpublicized examination tool for the regulators, enforcement was generally achieved on an informal, "jawboning" basis, whereby the state of a banking institution's capital levels was normally left to discussions between the examiners and an institution's management. However, with the expanding importance of these standards to the regulators and the public

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147. Id. at 16,058–59.
148. See supra notes 140–41 and accompanying text.
149. Id.
embarrassment caused the Comptroller in the Bellaire decision,\footnote{See supra notes 112–18 and accompanying text.} the regulators became jointly concerned about their legal abilities to enforce the standards. Enforceability was becoming an integral part of the overall regulatory approach to capital adequacy.

Traditionally, for enforcement purposes, the federal bank regulators had recourse to their authority under the Federal Deposit Insurance Act to issue a "cease and desist" order against a banking institution or its management for engaging in an "unsafe and unsound practice in conducting the business of such bank," or in violating (or being in the process thereof) "a law, rule, or regulation, or [written condition or agreement] between the regulator and the banking institution."\footnote{12 U.S.C. § 1818(b)(1) (1982).} Under the order, the regulator could require affirmative action to correct the result of the detrimental practice or violation of law.\footnote{For general discussion of cease and desist powers, see Comment, Larimore v. Comptroller of the Currency: Agency-Ordered Liability of Bank Directors and Officers Under 12 U.S.C. § 1818(b)(1), 71 MINN. L. REV. 1035 (1987).} As mentioned above, the ILSA made clear that inadequate capital was, in the discretion of the regulators, an "unsafe and unsound" practice for purposes of these cease and desist powers.\footnote{12 U.S.C. § 3907(b)(1) (Supp. IV 1986).}

The ILSA also conferred upon the regulators a new and additional enforcement device, the capital adequacy directive. If a banking institution failed to maintain capital at or above required minimum levels of capital, the regulator may issue a directive requiring the institution to submit and to adhere to "a plan acceptable to the appropriate Federal Banking Agency describing the means and timing by which the banking institution shall achieve its required capital level."\footnote{12 U.S.C. § 3907(b)(2)(B)(i) (Supp. IV 1986).} The directive and any related capital adequacy plan could be enforced before the federal courts in the same manner as could a cease and desist order.\footnote{12 U.S.C. § 3907(b)(2)(B)(ii) (Supp. IV 1986).}


Because of the critical importance of adequate capital to the soundness of a bank's operations, the procedure for issuance of a directive has been designed to reach a resolution in a prompt, but fair manner and the Office intends to actively seek enforcement of directives in the event of noncompliance.\footnote{50 Fed. Reg. 10,207, at 10,211 (1985).}

c. Risk Assessment

The 1985 rules incorporated the notion of risk assessment as an evaluation tool for the regulators. Since the first 1981 rules, the federal bank regulators witnessed domestic changes in the banking industry brought about, in part, by the accelerating
pace of marketplace and statutory deregulation of the banking industry and domestic and economic conditions adversely affecting the banking industry. All these happenings increased the sensitivity of the bank regulators to the differing risks entailed in the various types of assets held, and activities engaged in, by banking institutions.

The 1985 rules explicitly indicate that the regulators, in addition to considering other relevant factors, should factor into their capital analysis an assessment of institutional risks on a case-by-case basis. Institutions "with high or inordinate levels of risk" (a phrase left undefined and unquantified by the regulators) would be required to hold additional primary capital above the 5.5 percent minimum required level. In this sense, the 1985 rules foreshadowed the yet-to-come "risk-based" capital adequacy rules of the federal regulators and of the Basle Committee. Ironically, numerous comments respecting the proposed 1985 rules were received by the regulators from within the banking industry, which lent support to the upcoming regulatory conclusion that a ratio of capital to categories of risk assets would be a more effective regulatory tool than the straight-forward capital-to-total capital ratio.

\section*{d. Off-Balance Sheet Risks}

In recent years, there has been a dramatic increase of banking practices (e.g., commitments, standby letters of credit, hedging instruments, and asset securitization products) that often were not reflected on a banking institution's financial statements, but that nevertheless involved some degree of institutional risk (i.e., "off-balance sheet risk"). Although the 1985 uniform rules did not propose specific treatment of off-balance sheet risks, these rules did give specific focus to this issue. For example, as expressed in the Federal Reserve's 1985 Guidelines, "[The] Federal Reserve will also take into account the sale of loans or other assets with recourse and the volume and nature of all off-balance sheet risk. Particularly close attention will be directed to risks associated with standby letters of credit and participation in joint venture activities." The regulators formally notified the banking industry that they would be conducting an ongoing review of the need for more "explicit procedures" for factoring off-balance sheet risks into the assessment of capital adequacy, and directed the bank examiners to pay careful attention to the nature and degree of off-balance sheet items when determining the capital rating of an institution under the

\begin{footnotes}
160. For further specification of these changes see supra note 135 and accompanying text.
162. Id. at 16,063.
163. For a general discussion on the risk capital issue see Risk and Capital Adequacy in Commercial Banks (S. Maisel ed. 1981); B. Wesson, Bank Capital and Risk chs. 4, 6 (1985). On Basle Committee's risk capital proposals, see infra Part IV.
166. See generally Cross Report, supra note 2, ch. 6.
\end{footnotes}
uniform institutional rating system. The regulation cautioned the banking industry to exercise voluntary restraints and internal monitoring procedures with respect to off-balance sheet activity, if the industry wished to forego formal rules on the matter.168

e. International Convergence

As noted above, the ILSA looked toward the international convergence of capital adequacy standards. Specifically, the ILSA directed the Federal Reserve Board and the U.S. Treasury Department to "encourage governments, central banks, and regulatory authorities of other major banking countries to work toward maintaining, and where appropriate, strengthening the capital bases of banking institutions involved in international lending." Thus, Congress viewed capital adequacy as an integral element for fostering prudent banking practices and preserving safety and soundness in international banking operations. On another level, Congress had been sensitive to the possibilities of foreign discrimination against U.S. banking institutions' overseas activities. While the ensuing government study concluded that a majority of U.S. banks abroad function without undue interference or discrimination and found no evidence that any country singled out U.S. banks for discriminatory treatment, the study did heighten awareness of the federal bank regulators to the competitive inequalities that can arise from divergent bank regulations among nations.171

In addition, with the rapid internationalization of U.S. financial markets in the 1970s and the early 1980s, the Federal Reserve Board (which has primary regulatory authority for foreign bank operations in the U.S. and for U.S. bank overseas operations) was becoming increasingly cognizant of the tensions inherent in applying U.S. capital adequacy standards to foreign bank operations in the United States. On the one hand, the Board had opposed, as a general principle, the extraterritorial extension of its rules to foreign bank operations because it deemed the host country of the parent bank to have the primary regulatory responsibility.172 Yet, with the rash of applications by foreign banking institutions to the Board to establish banking operations in the United States under the Bank Holding Company Act of 1956, as amended,173 the Board, when considering such applications, struggled with how to apply its statutory mandate under the Act to review "the financial and managerial

168. Id.
resources and the future prospects” of the companies and the banks concerned, as these relate to their capital adequacy.174

The Federal Reserve Board’s 1985 Guidelines conspicuously avoided any definitive statement on the treatment of foreign banking operations in the United States. However, in supplemental materials to the Guidelines, the Board observed that it was in the process of discussions with foreign bank supervisors regarding appropriate capital standards, and that, in the interim, the Board would carry on reviewing the financial condition (including the capital adequacy) of foreign banking institutions conducting U.S. operations, with particular attention given to the capital positions of such institutions applying to expand existing U.S. operations or making further acquisitions in the United States.175

f. The ““Level Playing Field” in General

The federal bank regulators were not only concerned about fostering competitive equality among the banking institutions (both large and small) they supervised and regulated and about working toward competitive equality among international banks from the industrialized countries, but also they were concerned about competitive equality respecting other competing U.S. banking institutions (e.g., thrift institutions) and nonbank financial institutions (e.g., investment bankers).176 Competitive equality for the bank regulators, however, does not mean seeking the lowest common denominator for capital adequacy, but seeking a uniform level consistent with safe and sound practices. As the Comptroller observed:

There was extensive support for the notion of a level playing field, i.e., uniform requirements for both large and small banks. This is embodied in the final regulation. Many commentors [sic] pointed out the continuing inequality between banks and savings and loan associations and urged the agencies to work with the Federal Home Loan Bank Board to achieve equal capital requirements for all financial institutions. The Office agrees that capital requirements should be similar for all types of depository institutions. However, concern for competitive equality cannot overrule concern for the soundness of the banking system. The Office will continue to work for increases in the capital required for other types of financial institutions that compete with banks.177

Thus, the regulators were cognizant that uniform capital adequacy standards for commercial banks could not be fully effective in terms of competitive equality goals until the capital levels of other regulated, competing financial institutions could be harmonized.178 Even then there would be gaps, because not all competing financial institutions are regulated.179

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176. For further discussion of this issue, see infra Part V, subparts B–C.
178. The regulatory capital for federal thrift institutions has recently been raised from 3% of liabilities to 6% to be phased in according to industry profitability over a 6 to 12 year period. 12 C.F.R. § 563.13 (1983). For reference to new risk-based capital standards for federal thrift institutions, see infra note 292.
179. Financial institutions such as American Express and General Electric Finance are essentially unregulated entities. See discussion in FIRE REPORT, supra note 1, at 2–3.
Hardly had the ink dried on the 1985 Guidelines when in January 1986 the three federal banking authorities issued a "Joint Press Release" indicating their intention to proceed with the formulation of risk-based capital standards.\(^\text{180}\) In fact, on that same day the Federal Reserve Board floated a "trial balloon" by publishing for public comment its risk-based proposal.\(^\text{181}\) From the Board’s perspective, the higher minimum ratios in its existing guidelines (as compared to its 1981 guidelines), without differentiating assets according to risk, was having the undesired effect of encouraging banking institutions to liquidate their better, low-risk assets, thus retaining a less-liquid, higher-risk overall portfolio of assets. Also, the Board was concerned about the explosion of off-balance sheet activities within the banking industry and about the need to provide bank management and examiners with more objective guidance in relating capital to institutional risk profiles. On an international level, the Board remained firm in its belief that to avoid competitive inequality the U.S. regulators needed to align their capital policies more closely with those of other major industrialized countries (many of which had already adopted some form of risk-based capital assessment mechanism).\(^\text{182}\)

The Board’s January 1986 proposal would supplement, and work in tandem, with its 1985 standards: in fact, the proposal was specifically referred to as "Supplemental Guidelines." Off-balance sheet items would be factored into total assets, with both on- and off-balance sheet assets being grouped into four broad asset categories with the respective risk weight assigned: cash and cash equivalents (zero percent), money market risk (thirty percent), moderate risk (sixty percent), and standard risk (one hundred percent). Off-balance sheet risks, depending on their nature, could fall under any of the latter three asset categories.\(^\text{183}\)

Yet, even while the federal bank regulators were endeavoring to upgrade the quantitative and qualitative levels of their capital adequacy standards, these regulators still had to cope with the economic realities around them, which indicated that the poor financial state of numerous banking institutions was not due to mismanagement but to broader external factors. Of particular concern were otherwise well-managed institutions concentrated in agricultural or energy lending. Under a formal capital forbearance program adopted in 1986 by the bank regulators, banking institutions that qualify and that submit the appropriate application would be permitted to maintain a capital level of four (rather than six) percent.\(^\text{184}\)

In 1986 it became apparent that the debate over what constituted "primary"


\(^{182}\) Id. at 3977.


\(^{184}\) Policy Statement on Capital Forbearance, 51 Fed. Reg. 15,305, at 15,306 (1986) (as codified at 12 C.F.R. § 32.8) (Comptroller). The capital forbearance policy also provides relief through more lenient use of accounting principles, changes to periodic call reports, and relaxation of regulatory single-borrower lending limits (which were based on a loan to capital ratio). Id. at 15,307–08.
capital had not been put to rest. In November 1986 the Federal Reserve Board amended its “Capital Adequacy Guidelines” for bank holding companies to treat perpetual debt securities that met certain criteria as primary capital for bank holding companies (but not for Federal Reserve supervised state banks). In concluding that these instruments served the purposes or performed the functions of primary capital, the Federal Reserve appeared to be influenced by two factors: one, the belief that bank holding companies (as distinguished from the bank subsidiary) should be provided greater flexibility in meeting their consolidated capital requirements; and two, the competitive equality realization that other jurisdictions (e.g., United Kingdom and Canada) were permitting inclusion of such items into primary capital calculations.\(^{185}\)

C. Summary Observations

Capital adequacy has played a historical role in the bank regulatory processes. However, until recently, this role was largely internalized, with the regulations being utilized (in disparate ways by the different regulators) to assist in evaluating the financial soundness of banking institutions for examination purposes. But, beginning in the late 1970s, the external significance of capital adequacy as a more formal concern of prudential supervision was becoming apparent. The first visibility came with the efforts of the Federal Financial Institutions Examination Council (FFIEC) to have the federal bank regulators formulate a common definition of bank capital.\(^{186}\) This move toward uniform examination standards derived from the formal bank deregulation movement embarked upon by the U.S. Congress in the mid-1970s.\(^{187}\)

As the bank regulators became more aware of the general deterioration of capital levels of U.S. banking institutions and as the magnitude of the third world debt crisis and its implications for these U.S. institutions become apparent in 1982, capital adequacy went beyond the examination level and was transformed into a core regulatory banking objective to insure the prudential supervision of banking institutions and the safety and soundness of the banking system itself.\(^{188}\) Further, the ILSA gave statutory credence to capital adequacy as a regulatory objective, not only with respect to the international debt problem, but also with respect to the U.S. domestic banking system as a whole.\(^{189}\) With the ILSA and the intervention of the United States Congress, the capital adequacy issue was legitimized through legislation, and as such, it became politicized (i.e., of concern to the federal political decision-makers). As a result of the new public visibility and concern for the issue, the need for uniformity of and transparency in developing capital adequacy standards became heightened. Moreover, the desire for regulatory competitive equality (domestic and international) among banking institutions became a driving force behind the emerging capital adequacy standards.

186. See supra note 94 and accompanying text.
187. See supra note 1.
188. See supra Part III, subpart B.
189. See supra notes 120–29 and accompanying text.
Also, as the public significance of bank capital adequacy unfolded, so also did the multitude of complexities involved in defining capital and its composition, in selecting a proper measurement test, and in determining institutional coverage. This also lent itself to a greater need for uniformity and transparency, and to a greater degree of formal legalism in the regulators’ approaches to attain these goals.

IV. THE INTERNATIONAL PHASE: NOTE ON THE BASLE COMMITTEE’S EFFORTS

The express direction of the ILSA for the domestic and international convergence of capital adequacy standards evidenced the inseparability between the domestic and international dimensions of this issue. This interconnection had already been recognized by the bank regulators of the major industrialized nations through the Basle Committee, which since the late 1970s had begun to foster multilateral efforts to arrive at a convergence of capital adequacy standards among the leading industrialized nations.  

A. Basle Committee’s Initial Efforts

In 1974 in the wake of significant international banking disruptions such as the failure of Bankhaus Herstatt in West Germany, the Governors of the central banks of the member countries of the “Group of Ten” of the OECD (plus the Governor of the central bank of Switzerland) established the Committee on Banking Regulations and Supervisory Practices under the administrative auspices of the Bank for International Settlements (BIS) in Basle, Switzerland. The membership of this Basle Committee is comprised of the representatives of the central banks and other authorities with formal responsibility for the prudential supervision of banking institutions from these eleven leading industrialized countries and from Luxembourg. The Committee, which operates without any extensive formal mandate or any constitution or bylaws, meets regularly three or four times a year and serves as an informal forum for ongoing cooperation on bank prudential supervision matters.

The Basle Committee’s primary aim is to encourage a gradual convergence of bank supervisory practices of the member regulatory institutions by enhancing the scope and effectiveness of supervisory techniques for international banking activities,

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193. For a list of Committee representatives, see supra note 7.

194. For a reference to its founding mandate from the governors of the central banks of the G-10 countries, see Press Communiqué, supra note 6. Since 1982 the Secretariat of the Committee has endeavored to prepare an annual Report on International Developments in Banking Supervision, which summarizes the work of the Committee.
by studying and making recommendations on specific areas of prudential concern in international banking, and by facilitating the exchange of information among bank supervisors so as to upgrade the quality of international bank supervision. Throughout its existence, the Committee has sought to maintain a low profile (informal, and where possible, nonpublicized). As noted by the second chair of this Committee, Peter Cooke, who was from the Bank of England:

The committee does not undertake a formal supernational supervisory role; its conclusions do not have, and were never intended to have, legal force. Rather it formulates and recommends broad supervisory principles and guidelines of best practices in the hope and expectation that individual authorities will take steps to implement them through detailed arrangements—statutory or otherwise—which are best suited to their own national systems. In this way the committee encourages some gradual convergence towards a common approach and common standards without attempting far reaching harmonization of members countries [sic] supervisory techniques.195

Notwithstanding the disclaimer of Mr. Cooke, the Basle Committee has in fact had a legally significant impact upon international bank supervision in a number of ways.196 For example, in 1975 the Committee prepared a paper (subsequently known as the "Concordat"), which proposed guidelines for the respective responsibilities of different bank supervisory authorities regarding the supervision of banks where those entities were operating in more than one national jurisdiction. The Concordat set forth the principle of consolidated supervision197 in the hope of closing supervisory gaps respecting international banking operations. No foreign banking establishment should escape supervision, so each country needs to ensure that such establishments are supervised. In the case of joint ventures, the host authority is effectively the only authority able to exercise supervision.198

In particular, the 1975 Concordat stated that the primary responsibility for the supervision of the liquidity of foreign banking establishments was that of the authority of the country in which the foreign bank operated (i.e., the host country), although it was a matter of more limited concern for the authority responsible for supervising the parent bank where currency of a parent authority was involved. Although the parent authorities were to take account of the parent bank's moral commitment to those foreign establishments as to matters of solvency, the primary supervisory responsibility for subsidiaries and joint ventures rested with the host authorities. Respecting bank branches overseas, the primary responsibility for supervision was to remain with the parent authorities. The Concordat also suggested a number of areas of practical cooperation among supervisory authorities, such as direct transfers of information (with efforts to remove any national constraints such as bank secrecy laws), direct inspections by parent authorities on territory-of-host
authority, and indirect inspections by host authorities at the request of parent authorities. 199

The Concordat, while circulated worldwide to bank supervisory authorities, never came to public attention until the early 1980s. At that time, the Basle Committee (spurred on by the Ambrosiano bank scandal in Italy) was also preparing a revision of the Concordat, which was completed in June 1983 ("Revised Concordat"). The Committee circulated the Revised Concordat to commercial banks worldwide and otherwise released the document to the public under the title, "Principles for the Supervision of Banks' Foreign Establishments." 200

The Revised Concordat expanded upon the 1975 document, and upon a 1978 proposal of the Committee (endorsed by the Governors of the central banks of the G-10 and Switzerland) that supervision of an international bank's capital adequacy and risk exposure should also be monitored on a consolidated basis. 201 Specifically, the 1983 document expressly incorporated the 1975 proposal; clarified the importance of the roles for both hosts and supervisory authorities respecting the supervision of liquidity of a bank's foreign establishments; reiterated the goal that no international banking operation should escape effective supervision, while suggesting various ways in which a supervisory gap can be prevented (particularly with respect to holding companies and nonbanking companies as part of banking groups); and stressed that the Revised Concordat addresses supervisory responsibilities and not those of a lender-of-last-resort. 202

Through the 1975 Concordat and its 1983 revised version, the Basle Committee had created the basis for reordering the jurisdictional scheme among banking authorities dealing with common international banking problems. While no international banking system exists as a formal or legal entity and the Committee's Concordats were not written as legal documents, the effect has been that the various member countries and others in fact have reformulated their jurisdictional approaches to prudential supervision of international banking activities to align themselves with the principles of the Concordats. In essence, the Concordats have given effect (in some instances, extraterritorial) and legitimacy to what otherwise might have been questionable extensions of legal jurisdiction by either parent or host country banking authorities over a nondomestic subject matter or entity.

A second matter of legal significance respecting the Basle Committee's efforts has been its ability to create a worldwide forum for discussion of bank prudential supervision problems, discussions that have gone beyond the formal membership of the Committee. For example, the Committee was the catalyst for the establishment of the Biannual International Conference of Bank Supervisors, which was first held in

199. Id. at 30–32.
202. For a general discussion of the Revised Concordat, see id. at 153–54.
Moreover, the Committee has generated an offshore group of bank supervisors, a commission of Latin American and Caribbean banking supervisory and inspection organizations, and a SEANZA (Southeast Asia, New Zealand, and Australia) organization of banking supervisors. Further, the Committee has established close links with the Contact Group of the European Community bank supervisory authorities and with the European Community's Banking Advisory Committee. Thus, the Basle Committee, although not a formal international organization in an international law context, has taken on the aura and reality of a substantive and permanent international forum that has been a centrifugal force for creating a worldwide network for the exchange of information and the discussion of issues regarding bank prudential supervision. The Committee has created the conditions for an evolutionary international convergence of prudential supervision practices and standards.

For present purposes, the key legal significance of the Basle Committee has been its pronouncements and activities in the capital adequacy area. This legal significance manifests itself in its potential for law generation within the jurisdictions of its members. The Committee has not only generated significant legal actions within its members' legal and supervisory systems, but also it has helped move forward and shape the content of such national actions through the convergence process.

In 1978 the Committee expressed its view on capital adequacy that the principle of consolidated supervision should be applicable to this area of bank prudential supervision. In 1981 the member institutions of the Committee were increasingly concerned with the continuing erosion of bank capital on a worldwide basis and commenced the preparation of a report to the G-10 central bank Governors respecting bank capital adequacy in relation to the international business of banks. The Committee was of the view that further erosion of bank capital ratios was undesirable and that, in principle, it was desirable to achieve a greater approximation in the levels of capital employed by major international banks. While realizing that it was not its role to attempt any formal legal harmonization of capital adequacy standards internationally, the Committee did view its role as trying to achieve a "greater convergence among its members with regard to national definitions of bank capital for supervisory purposes." In June of 1982 the Basle Committee presented a paper to the central bank Governors, who endorsed the Committee's main conclusions "that in the current and prospective environment further erosion of capital ratios should, on prudential

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203. The second ICBS was held in Washington, D.C. (1981), the third in Rome (1984), the fourth in Amsterdam (1986), and the fifth in Tokyo (1988). The host country of each conference maintains copies of the conference proceedings, and the Secretariat of the Basle Supervisors Committee maintains cumulative copies of these proceedings.

204. The annual Report on International Developments in Banking Supervision by the Basle Supervisors Committee generally contains a summary of cooperative efforts being made by these various groups.


grounds, be resisted; and that, in the absence of common standards of capital adequacy, supervisors should not allow the capital resources of their major banks to deteriorate from their present levels, whatever those levels may be."

The main thrust behind these conclusions was prudential concern for the fundamental safety and soundness of the major international banks and of the international financial system.

The Basle Committee's 1982 report also set out an agenda for further work in the capital adequacy areas. The Committee would continue to work toward achieving a "common view" among its member institutions regarding the main constituent elements of capital, with particular focus on the nature and role of subordinated debt instruments and "hidden reserves." Further, the Committee would explore the viability of different ratios that relate balance sheet items to capital, including risk asset ratios, gearing ratios, and large loan exposure ratios. The Committee hoped eventually to evaluate the usefulness of these different ratios for different purposes and to make specific recommendations for the application of such ratios for prudential supervision purposes by its member institutions.

For two years the Basle Committee continued its work on capital adequacy, but became increasingly conscious of the diversity of national systems' capital measurements and the difficulties of devising meaningful and acceptable common standards. In addition, the Committee began to focus on capital adequacy not only in terms of stability of the international financial system but also in competitive equality terms.

The Basle Committee was also particularly influenced by the enactment of the ILSA in the United States and the subsequent concern of the U.S. Treasury and the Federal Reserve Board to pursue these matters internationally within the Basle Committee structure. In fact, in 1984 the G-10 central bank Governors approved further work toward a framework of "functional equivalence" of capital measurement that might be devised to overcome national differences and to make possible development, in due course, of commonly agreed quantitative measures of capital adequacy.

At the end of the summer of 1984, the Basle Committee, in undertaking this task, linked its efforts closely with those of the European Community's Bank Advisory Committee, which was engaged in similar work in the context of European Community integration initiatives in the banking area. The reason for this linkage was that many of the members of the European Community were also members of the Committee; therefore, divergent approaches by these two groups would only prove to be counterproductive. Thus, by the end of 1984, the Basle Committee was


208. Id. at 4.


210. See supra notes 120–29 and accompanying text.

concentrating its efforts on developing a common definition of capital and common capital adequacy assessment methods.212

By the end of 1986, the Basle Committee had formulated a complex definition of capital based upon a six tier system. The first tier consisted of permanent shareholders equity, retained earnings, and disclosed reserves. The other tiers progressively added additional elements accepted as part of capital by some, but not all, of the member states of the Committee. For example, tier two added undisclosed reserves; tier three, perpetual and certain other hybrid capital instruments; tier four, asset re-evaluation reserves; tier five, general provision; and tier six, subordinated debt. In addition, the Committee attempted to evaluate the value of a simple gearing ratio vis-à-vis a risk asset ratio. Although the Committee had concluded that the risk asset approach represented "a more sensitive and reliable test of capital adequacy than the gearing approach," the framework being developed by the Committee was to include both approaches in separate sets of calculation. With respect to the rating of assets and off-balance sheet items for the risk asset test, the Committee had defined six broad categories of assets with percentage ratios being zero percent, twenty percent, fifty percent, or one hundred percent.213

In addition to its work on consolidated supervision and capital adequacy,214 the Basle Committee has issued consultative papers and conclusions touching upon related matters such as foreign exchange positions,215 bank secrecy,216 country risk analysis,217 and off-balance sheet risks.218 None of these documents purport to be prescriptive, but are intended to serve as recommendations and guidelines to be evaluated by the member institutions and by other bank regulators outside the group. While any subsequent implementation remains within the discretion of the national authorities, these documents have been influential in assisting the national supervisors to address these issues within their respective systems.

B. An Intervening Catalyst: U.S./U.K. Accord

Although substantial progress was being made within the Basle Committee on formulating acceptable international capital adequacy standards, this progress appar-
ently was not sufficient for the U.S. bank regulators, particularly for the Federal Reserve Board.\textsuperscript{219} The Federal Reserve felt strongly that the U.S. Congress had established a firm mandate to work toward the convergence of international capital adequacy standards,\textsuperscript{220} and on a practical level, the Federal Reserve was becoming more perplexed and pressed in dealing with foreign bank acquisition applications in the United States (particularly in trying to cope with evaluating the capital bases of Japanese banking institutions).\textsuperscript{221} Accordingly, sometime during 1986, private bilateral discussions began and became intensified between the Federal Reserve Board and the staffs of the Comptroller and the FDIC on the one hand, and the Bank of England on the other. These discussions were conducted outside the framework of the Basle Committee.\textsuperscript{222} One linkage making possible this collaboration was the fact that in formulating its earlier 1986 risk-based capital proposals, the Federal Reserve Board had considered and was familiar with the risk-based capital approach of the Bank of England.\textsuperscript{223} The Bank of England had developed this nonlegal regulatory approach in 1980 and had been utilizing it as an integral part of its prudential supervision procedures.\textsuperscript{224}

The fruit borne of this informal bilateral collaboration was an "[a]greed proposal of the United States federal banking supervisory authorities and the Bank of England on primary capital and capital adequacy assessment," released on January 8, 1987 ("Accord"). In legal terms, this Accord was a nonbinding document in any international or domestic sense. While the banking authorities clearly had authority to promulgate equivalent domestic regulations, there was no legal basis to create a legally binding agreement among the bank supervisory authorities of these nations. In fact, the Accord does not purport to be a legal document at all: it is presented as a consultative paper "to serve as a basis for consultation with the banking industry and others in the United States and the United Kingdom." The Accord was also designed "to promote the convergence of supervisory policy and capital adequacy assessments among countries with major banking centers."\textsuperscript{225}

Looked at strategically, the Accord appears to have been conceived as a stimulus for prompt agreement on capital adequacy within the Basle Committee (particularly for pressuring the hand of recalcitrant countries such as Japan). The fallback position was that the United States and the United Kingdom would proceed with international convergence on a bilateral basis (or, if Japanese agreement could be reached, on a trilateral basis) in the event the Basle Committee did not reach prompt agreement.

The Accord also had the effect of resolving, at least bilaterally, some of the difficult particulars involved in the convergence process being addressed by the Basle Committee membership such as the definition of capital in light of the specific and

\textsuperscript{219} See id. at 814.
\textsuperscript{220} See id. at 790–91.
\textsuperscript{221} See, e.g., Holland, supra note 174, at 788–89.
variant financial, accounting, and government practices among certain of the industrialized countries involved, and the risk weight formula to be adopted. The bilateral agreement was to take effect in May 1987 after a period of comment in each country.

The Accord proposed a common definition of the primary capital base of a banking institution; the deductions to be made from primary capital in computing the capital base for the risk-asset ratio calculation; the weighing structure of risk assets and off-balance sheet activities; and an agreement in principle on the use, for supervisory purposes, of a ratio of primary capital to weight against risk assets. On this latter point, the Accord did not set any precise figure but contemplated that the U.S. and U.K. bank regulators would arrive at minimum common risk-asset ratios and would make these ratios known publicly.226

Under this bilateral Accord, primary capital, which is viewed as the highest quality bank capital for absorbing current losses, would comprise two classes of capital funds—"base primary capital" and "limited primary capital." The "base primary capital" would receive full treatment as primary capital and would include common stock, capital surplus, retained earnings, minority interests in consolidated subsidiaries, general reserves, charged earnings, and hidden reserves comprising undisclosed retained earnings (which was applicable in the United Kingdom and which would be eventually phased out). "Limited primary capital" could not exceed fifty percent of the primary based capital less intangible assets and was to include perpetual preferred stock (or preferred stock having an original maturity date of at least twenty-five years) and qualified subordinated debt (including perpetual debt). Adjustments to capital would include all intangible assets, deductions of investments in unconsolidated subsidiaries and associated companies (including unconsolidated joint ventures), and deductions of bank holdings of capital instruments of other banking institutions.227

With respect to the rating of risk assets, the Accord would create five weighted categories of zero percent, ten percent, twenty-five percent, fifty percent, and one hundred percent, based on perceived credit risks in such categories. Assets in the zero percent class, reflecting no significant risk, were to include vault cash and claims on the domestic central bank; the ten percent class included short-term claims of international governments or government agencies; the twenty-five percent group included risk assets such as short-term claims on domestic or foreign banking institutions and government guaranteed loans; the fifty percent group included claims on domestic national government-sponsored agencies, claims on multinational development institutions, and all domestic and local domestic government general obligation claims; and the one hundred percent category, involving the greatest degree of long-term risk, included long-term (over one year) claims on domestic depository institutions of foreign banks, most claims on foreign governments.


customer liability on acceptances outstanding involving standard risk obligors, domestic state and local revenue and industrial development bonds, net open positions of foreign exchange, and all other assets. Off-balance sheet items also would be given specific risk rates and thus would be given equivalent treatment with comparable on-balance sheet equivalents. For example, direct credit substitutes would receive a one hundred percent credit conversion factor; trade contingencies, a fifty percent credit conversion factor; and sale and repurchase agreements and asset sales with recourse, a one hundred percent conversion factor. Other commitments such as overdrafts, revolving underwriting facilities, underwriting commitments, and commercial and consumer credit lines would receive a ten percent weight for instruments of one year or less original maturity, twenty-five percent over one to five years original maturity, and fifty percent for those with over five years original maturity. A conversion factor for interest rate swaps and foreign exchange rate contracts was to be determined in the future.  

The Bank of England and the U.S. bank regulators made clear that the newly proposed risk-based capital standards would be applied in tandem with the pre-existing capital requirements. For example, in the United States, the capital-to-total-assets ratio would still be employed.  

The Accord led the Federal Reserve Board to revise its January 1986 risk-based proposal in the form of a new February 1987 capital adequacy proposal that substantially comported with the U.S./U.K. proposal. However, the greatest significance of the bilateral Accord was the pressure it added to the Basle Committee process, which resulted in the issuance of its joint capital adequacy proposal in December 1987. The Accord was never to be given effect.  

It is open to debate whether the bilateral U.S./U.K. efforts were constructive. Some view the process as a catalyst for accelerating the efforts of the Basle Committee, which was viewed as bogged down in the details and complexities of different treatments of capital by the various member countries. Others indicate that the December 1987 Basle Committee proposal would have come about in any event and that the intervening pressures from the U.S./U.K. proposal only aggravated the difficulties of bringing about a common proposal. For example, as indicated by Dr. Markus Lusser, Vice-Chairman of the Governing Board of the Swiss National Bank:

The two countries [i.e., U.S. and U.K.]—the homes of the two largest financial centres in the world—have agreed [to] a joint approach in defining the capital of banks, laying down a system for valuing bank assets including off-balance sheet operations and allocating them to specific categories of risk. As a next step, they are trying to reach agreement with Japan. This would cover the three most important financial centres in the world. Countries not

228. Id. at 5138.
230. Id. at 5119.
232. See, e.g., Bardos, supra note 222, at 28.
prepared to join an agreement among this group of three countries could easily be put under pressure. It would be sufficient to bar their banks from using the three financial centres or to subject them to special treatment there. If they wish to remain competitive internationally, the large banks that operate worldwide can no longer be absent from these centres today. They would quickly try to encourage their government to co-operate internationally.

At least to the representative of a small country the agreement between the United Kingdom and the United States arouses somewhat mixed feelings. My skepticism—and this I would like to emphasize—is not directed at the content of the agreement. It brings about an international harmonisation with respect to banks’ capital adequacy that is very desirable. Moreover, my country is not directly affected. As far as the amount of required own funds is concerned, Swiss supervisory legislation goes further in any case than the new Anglo-American agreement. My skepticism is directly solely at the approach which was adopted.

In light of the urgency of the problem, the pressure originating from the agreement between the two countries to come to an accord in the concrete case of regulations on capital adequacy is acceptable. However, should the example set a precedent and the strategy of the two powers be extended to other fields of harmonising banking supervision—as a substitute, so to speak, for internationally negotiated compromises—then the willingness to co-operate internationally could suffer damage in the long run. In view of the problems that need to be solved, this would be a harmful development.233

C. The Basle Committee’s Recent Efforts

In December of 1987 the Basle Committee issued its consultative paper on Proposals for International Convergence of Capital Measurements and Capital Standards (Basle Proposal).234 This proposal sets forth a common framework of capital adequacy measurement and a common minimum target capital standard to be achieved and maintained by banks operating internationally. In broad terms, there was general similarity between the December 1987 Basle Proposal and the Accord. The Committee’s proposal made distinctions between core capital components and other supplemental capital elements; provided broad categories of weighted risk assets; provided an equivalent risk assessment of off-balance sheet items; and recognized that the proposed risk-based capital standards were only one step in overall evaluations of banking institutions’ capital adequacy and financial soundness.235

However, the December 1987 Basle Proposal differed in a number of significant ways from the prior Accord. For example, although both proposals treat the capital structure on a two-tier level (core and supplemental capital), the Basle Proposal provides that, after a transitional period, the core capital tier would be comprised solely of common stockholders’ equity (including retained earnings and minority interest in the common equity accounts of consolidated subsidiaries). Allowance for loan and lease losses (i.e., general loan loss reserves) would not be included in core capital: the Basle Proposal assigns general loan loss reserves to the tier two supplemental capital elements, and phases in limitations on revaluation reserves.

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234. See supra note 231 and accompanying text.
Further, the Basle Proposal requires only a deduction of goodwill from capital, but other intangible assets such as purchase mortgage servicing rights would not necessarily be deducted in calculating the risk-based capital ratio; the national authorities would be given discretion in the treatment of these other intangible items.\footnote{236} Another significant difference between the two proposals is the role of subordinated debt, which was not included in the U.S./U.K. capital definition. However, under the Basle Proposal, term subordinated debt, along with intermediate-term limited life preferred stock, may be included in the supplemental capital tier up to an amount equal to fifty percent of core capital.\footnote{237}

Also, the risk-rating framework of the December 1987 Basle Proposal varies in a number of ways from the U.S./U.K. structure. Government securities with remaining maturities of ninety-one days or less would be assigned a zero percent risk category rather than being placed in the ten percent category. All other U.S. government and agency obligations would be assigned to the ten percent risk category; the weight of short-term bank claims is reduced from twenty-five percent to twenty percent; the risk weight of securities issued by U.S. government sponsored agencies and general obligations of U.S. local governments is reduced from fifty percent to twenty percent; the risk rate for short-term commitments is reduced to zero percent; the weight for self-liquidating trade-related contingencies such as commercial letters of credit is reduced from fifty percent to twenty percent; and portions of assets backed by the full faith and credit of domestic depository institutions is assigned a twenty percent weight.\footnote{238} Further, the procedures for determining capital requirements for interest rate swaps and foreign exchange rates is simplified and their respective capital requirements are reduced.\footnote{239}

The December 1987 Basle Proposal established an explicit schedule for achieving a minimum level of capital to weighted risk assets by the end of the transition. It strived for a target risk-based ratio of 7.25 percent (of which 3.25 percentage points must be in the form of "core capital," that is, common stockholders equity) by the end of 1990, and required a minimum standard of eight percent (of which at least four percentage points must be in the form of core capital) by the end of 1992.\footnote{240}

After a six month period of comment, the Basle Committee promulgated its final risk-based capital adequacy report in July 1988.\footnote{241} Although there were several major changes, the July 1988 Report substantially paralleled the earlier December 1987 Proposal. For example, noncumulative perpetual preferred stock is to be included in the definition of tier one core capital.\footnote{242} In addition, the Committee indicated that if

\footnote{236. See Basle Proposal, supra note 231, § I & Annex 1.  
237. Id. para. 21.  
238. Id. § II & Annex 2.  
239. Id. para. 42 & Annex 3.  
240. Id. §§ III-IV.  
242. See 1988 Capital Standards, supra note 34, para. 12 & n.2.}
it could establish clear guidelines to distinguish general from specific reserves, then such general reserves would be includable within the supplemental tier two capital category without limits. However, if such agreement is not reached, then the general reserves would be included in tier two on a limited basis as originally proposed.

The July revision also clarifies that term debt instruments must have a minimum original term of maturity of over five years. Further, the July 1988 Report assigns reduced risk rates to a defined group of OECD member nations and those that have concluded special lending arrangements with the International Monetary Fund under its general arrangement to borrow. In addition, the preferential fifty percent risk rate for home mortgages on owner-occupied housing is extended to cover loans secured by mortgages on rental housing.

In sum, the July 1988 Report on bank capital adequacy represents a comprehensive statement of the view of the Committee, which has been subsequently endorsed by the central bank Governors of the G-10 countries.

D. The Spin-Off Factor: Subsequent Law Generation

While the Basle Committee's July 1988 Report is presented as a consultative paper, it has received the endorsement of the respective banks' supervisors of the member countries of the Committee and has been formally endorsed by the G-10 central bank Governors. As such, at least on a political level, the respective government authorities of the member states have agreed that the principles of the July 1988 Report will be followed and implemented, albeit the means of implementation through legal or administrative mechanisms is left to the respective national authorities to choose. The July 1988 Report clearly envisions some form of subsequent adaptation by national authorities. In fact, national authorities have begun to act in reliance upon the other authorities so acting. In this sense, the July 1988 Report can be seen, at least analogously, as a form of "soft law" in that the formulators of the principles embodied in the July 1988 Report intended these principles to be observed and to be implemented within their respective national jurisdictions.

In countries such as the United States, Germany, and those within the European Community, the principles of the Basle Committee's capital adequacy proposal will
be enacted through formal legal means. For example, the U.S. banking agencies have already begun the process, at the time of this writing, for formulating new capital adequacy proposals derived from and consistent with the July 1988 Report.\footnote{See, \textit{e.g.}, \textit{Regulators Negotiate Over Capital Rules, Final Action Not Expected Soon}, [July–Dec.] Banking Rep. (BNA) No. 10, at 422 (Sept. 12, 1988). (Editor's note: \textit{see} Risk Based Capital Adequacy Guidelines, 54 Fed. Reg. 4168 (Jan. 27, 1989) (Comptroller); 54 Fed. Reg. 4186 (Jan. 27, 1989) (federal reserve board.).)} Countries such as the United Kingdom will probably continue not to incorporate these provisions in any formal regulation, but the Bank of England has issued a public notice to the U.K. banking community as to its intent to implement the Basle Committee's proposal.\footnote{See, \textit{e.g.}, Bank of England Banking Supervision Division Explanatory Paper, \textit{Proposals for International Convergence of Capital Measurement and Capital Standards}, paras. 2 and 6, No. 1/88 (1988) (copy on file with the Ohio State Law Journal).}

Thus, the Basle Committee's July 1988 Report is proving itself a major step in achieving the convergence of standards of national bank supervisors respecting capital adequacy. Clearly, the Report will have a direct and pervasive impact upon the uniform capital adequacy regulations to be adopted in the near future by the U.S. federal banking authorities.\footnote{In conjunction with research being conducted at Keble College, Oxford University and at the Centre for Commercial Law Studies, University of London, the author presently is preparing a monograph on the work of the Basle Committee, with particular emphasis on its work in the capital adequacy area. (Editors note: The regulations were enacted. \textit{See supra} note 250. These guidelines substantially follow the July 1988 Report.)}

\section*{V. Policy Underpinnings}

Given the historical context for domestic and international regulatory usages of capital adequacy measures for banking institutions, the next subissue concerning the legitimacy of such measures is the ascertainment of sustainable governmental policies supporting these regulatory measures.

\subsection*{A. The Contextual Framework}

There would be little argument against the proposition that a prudently managed bank should have an adequate capital base to support infrastructure and planned expansion needs and to provide protection against anticipated losses. But, so should any other prudently run enterprise. Moreover, business prudence, by itself, should not dictate a governmental policy that would require the imposition of capital standards on banking institutions by the bank regulators.

Regulatory imposition of bank capital standards also is not justified by traditional policy considerations behind general corporate capital statutes. Historically, the general corporate capital schemes are based upon a policy that a corporate entity should have some minimum and transparent basis of unimpaired capital that will provide some degree of protection for general creditors and that will ensure fair treatment of all shareholders in instances of corporate distributions or share repurchases. These policies were sown at a time when financial accounting was a fledgling discipline and corporate finance had yet to evolve into a discipline. As previously noted, in certain jurisdictions today (\textit{e.g.}, in the United States), the legal
significance of corporate capital has become largely divorced from modern financial practices and attitudes of sophisticated corporate creditors because of countervailing policies favoring the establishment of small businesses in corporate form. However, in other jurisdictions (e.g., those in Western Europe), corporate capital statutes maintain an enduring legal vitality and significance.253

But, regardless of any continuing arguments favoring formal corporate capital schemes, the policies behind the general corporate statutes cannot be imputed as justification for a formal bank capital regime, as it is not the policy or practice of bank regulators to base their special regulation of banking institutions on a concern for general creditors of a bank or for bank shareholders. In terms of third parties, the bank regulators' concerns go to bank depositors. Although depositors are a special type of bank creditor, it is not the creditor status that triggers governmental concern: it is the governmental conclusion that these depositors of the national savings deserve special protection against untoward losses.254

Accordingly, any justification for bank capital regulations should sit squarely within the general governmental policies that support treating banking institutions and their depositors as special subjects for regulation. These institutions are politically perceived as having a "public" character or at least as having "public" attributes. In this sense, banking institutions and the system within which they function are looked upon governmentally as the provider of public services. They are 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. The depositors are special because they fuel the system. In addition, the system and the depositors may be governmentally "subsidized" through government deposit insurance or a government lender-of-last resort facility—another significant reason for direct government concern. Thus, prudential regulation should be designed to protect the integrity of and to support the "safety and soundness" of the banking system, and to shield the government in any of its subsidization facilities.255

While banking inescapably involves risk taking and risk management, regulations regarding the prudential supervision of banking institutions are designed to ensure that the institutions do not take imprudent risks and that they manage their assets and sources of funds in a prudent and honest manner.256 Yet, the regulatory concern for prudential risk taking and management is a systemic concern for "safety and soundness" of the banking system as a whole: this is normally thought to be the sustaining raison d'être for prudential supervision regulation. Prudential supervision is not intended to prevent all bank failures, but to prevent failures or other bank

253. See supra Part II, subpart A(5).
254. See, e.g., BANKREG SUPERVISION, 1986, CAND. No. 9695, at 7. "The primary role of the banking supervisor is to reduce the risk of capital loss to depositors as a result of the banks with which they place their funds being run imprudently." Id.
problems that pose a serious risk of undermining public confidence in the banking system or of creating significant governmental liabilities as deposit insurer or lender of last resort.257

Another broad policy basis for prudential regulations can be the prevalent government policy to encourage deregulation of the banking system. The thought is that deregulations and prudential regulations are not contradictory, but should be complementary.258 As one government committee looking at the functioning and regulation of financial institutions observed:

The dilemma for the regulatory authorities, whether statutory or non-statutory, is to devise effective methods of regulation which do not so stifle competition between the financial institutions as to lose their customers the advantages usually associated with it in terms of price, innovation and quality and variety of service. Ideally, regulation and competition should be complementary, the one providing a framework within which the other can then be allowed to operate safely.259

Thus, as regulatory restrictions on bank powers, operations, sources of funds, and geographic expansion are being eliminated, bank regulation needs to be redesigned to foster a competitive but “safe and sound” banking environment. Accordingly, regulations that are directed to engendering a more competitive banking environment without increasing systemic risks would be sustainable for policy reasons.

B. Domestic Policy Considerations

1. Safety and Soundness

If economists and the regulators are correct in observing that inadequate capital is not a verifiable major cause of bank failure in real world situations (with poor management, fraud, and unanticipated external economic conditions being primary causes),260 why should bank capital adequacy generate regulatory concern for “safety and soundness” purposes? In terms of domestic regulatory concern, there appear to be at least five interrelated ingredients to a possible response: institutional solvency as related to system stability; public confidence in banking institutions and the banking system; backstop for governmental losses; examination tools; and management discipline.

a. Solvency

With respect to solvency, a part of the prudential reasoning is that banking institutions should have the visible ability through an adequate capital base to absorb

259. COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS, 1980 CAND. NO. 7937, at 289 [hereinafter WILSON COMMITTEE].
unexpected losses or sustained losses.\textsuperscript{261} For the reasons alluded to above and below, it is thought not to be in the public interest for banks to fail as this may create systemic problems or may threaten the insurance fund. Yet, while capital may delay the inevitable result of insolvency, this problem is more often a matter of liquidity. Normally in a poorly run institution (particularly if combined with adverse economic conditions) capital is never adequate in a worst case situation.\textsuperscript{262} Further, high capital requirements exacerbate the cost of doing business. These increased costs may place a banking institution in situations leading to greater risk taking or underpricing—all ultimately undermining the financial condition of an institution.\textsuperscript{263}

Serious doubts exist respecting the efficacy of government regulations focusing on the solvency of individual banking institutions, particularly in institutions with some form of deposit insurance. The focus should be on solvency of individual institutions only to the extent it represents a threat to the banking system as a whole. The threat suggested by the regulators is the "domino" effect that one bank failure may have upon depositor confidence in other banks and in the system. However, little substantiated evidence has been put forth by bank regulators that a bank failure by itself (even of a major institution) poses a materially adverse threat to the system.\textsuperscript{264}

b. \textit{Public Confidence}

If the conditions for a public perception of a bank as "safe and sound" do not exist, then the placers of bank funds (\textit{i.e.,} depositors, banks, and other financial institutions) will not retain confidence in the bank; thus, risks of deposit volatility and of a bank deposit run will be increased. As pointed out by one leading commentator on bank prudential supervision:

In view of the fact that the viability of a bank depends to a critical extent upon public confidence, there is a strong public relation aspect to capital adequacy. It is generally recognised that the availability of capital is neither a perfect indicator of the state of health of a bank nor a sufficient condition to ensure the maintenance of confidence by depositors and creditors, but no doubt it represents a major element in shaping their perception of the solidity of an institution. Even though there is no unanimity of views about all the elements that constitute capital and the extent to which its components should be publicly disclosed, capital is in practice the principal yardstick against which the marketplace assesses a bank’s capacity to withstand adverse changes and to manage the risks incurred in the course of business. Moreover, with the growing involvement of banks in the financial markets, the market’s view of a bank’s capital has acquired greater importance in that it has become one basic reference for classifying the bank’s standing vis-\-á-vis its competitors in the markets in which it operates.\textsuperscript{265}

\textsuperscript{261} See, e.g., Speech by Federal Reserve Board Governor H. Robert Heller, U.S. League of Savings Institutions Regulatory Policy Conference (June 29, 1988) (copy on file with the Ohio State Law Journal) (This speech is entitled, "Capital and Diversification: The Pillars of Bank Safety.").

\textsuperscript{262} See Young, supra note 60.

\textsuperscript{263} See, e.g., M. Watson, supra note 57.


\textsuperscript{265} R. Pecchioli, supra note 4, at 106.
In fact, bank analysts and rating agencies pay considerable attention to a banking institution's capital strength, as do institutions participating in the interbank lending markets. As such, the insurance schemes should militate against the possibility of a bank "run"; although, if and when the appearance of a bank "run" surfaces, a "contagion" effect often is produced on a wider basis.

Thus, the pressure of deposit insurance militates against the need for prudential supervision regulation. But, the matter is not that simple:

A major issue is whether regulation becomes redundant in a regime of deposit insurance. Three immediate problems arise with deposit insurance and which may require a continuing role for regulation: (i) the moral hazard associated with insurance in terms of the risk behavior of the institution; (ii) the moral hazard faced by the depositor; and (iii) the reduced efficiency of insurance if, in order to deal with (ii), cover is restricted to less than the total volume of deposits. In brief, deposit insurance saves insured depositors the cost of assessing the risk of each institution and to some extent reduces the pressure on banks to consider their depositors' concerns with risk. This may induce the institution to take more risk than would be the case without insurance because it has less fear of a withdrawal of deposits.

More specifically, under most deposit insurance schemes, coverage is not one hundred percent. Often a ceiling (percentage, quantitative, or both) will be imposed. Further, large portions of corporate and other wholesale deposits remain uninsured. It is usually the withdrawal of these large uninsured deposits that precipitates a bank "run."

Regulators indicate that capital is a key element in public confidence: the external world is traditionally said to look at capital levels of banking institutions as a sign of financial strength. But, as already indicated, capital has different meanings to different parties for differing purposes, and historical capital tests have not been terribly meaningful in depicting a bank's risk profile. Further, newly proposed risk-based capital adequacy schemes may be too complex, and such schemes, when analyzed in light of unrelated financial statements, may not be very visible or transparent for the public. Moreover, the real link to public confidence for depositors and in interbank arrangements is liquidity (i.e., the ability of the institution

266. See, e.g., Young, supra note 60.
271. See generally Deposit Protection Schemes in the Group of Ten Countries (including Luxembourg and Switzerland), Report by the Committee on Banking Regulations and Supervisory Practices, at 1, Doc. BS/86/42 (1986) (copy on file with the Ohio State Law Journal).
273. Cf. Muller, Towards a Stronger Banking Industry in an Era of More Freedom, 4TH INT'L CONF. OF BANK SUPERVISION 51, 52 (1986) (address stating that "market perception is not what it should be").
to meet its obligations on a current basis), to which capital tests are related but not always helpful.\footnote{See BIS Economic Paper No. 8, \textit{supra} note 267.}

c. Examination Tool

Even if concerns for solvency of banking institutions and the need for public confidence in banking institutions provide only incomplete policy answers for having capital adequacy standards, capital adequacy, as a practical matter, remains of critical importance to the bank regulators in their prudential supervision functions—as evidenced by the present flurry of regulatory activity in the area.\footnote{See generally Part IV, \textit{supra}.} Obviously, this observation, by itself, is self-serving reasoning: the fact that regulators think something is so does not create a viable policy underpinning, even if the regulators have the legal wherewithal to implement their views. At its furthest, this line of reasoning leads to support for the use of capital adequacy tests by the regulators as examination or general supervisory tools for internal regulatory purposes.

Obviously, such tests can be useful for various financial soundness analyses and can generate relevant information for the regulators. However, the internal utility of such tests should not provide the controlling rationale for the formal elevation of capital adequacy as a cornerstone of bank prudential regulation.

d. Backstop for Insurance Funds

Perhaps a more compelling policy reason is that capital adequacy standards provide a degree of government insulation for the deposit insurance funds.\footnote{See Flannery, \textit{Deposit Insurance Creates a Need for Bank Regulation}, \textit{Fed. Res. Bank of Philadelphia Bus. Rev.}, Jan.-Feb. 1982, at 17, 21.} In effect, these standards “up the ante” for bank shareholders by requiring a larger capital buffer to be available before demands can be made upon the insurance fund. This may have some importance where the scheme is more a subsidized fund (\textit{e.g.}, flat rate approach), as opposed to a true insurance fund (\textit{i.e.}, risk-based or other actuarially based premiums). In a risk-based insurance fund, the risks (including, conceivably, a low capital base) would be factored into the insurance premium, and as such, the fund should be financially self-sustaining.\footnote{For discussion of a risk-based system, see FDIC, \textit{Risk-related Deposit Insurance: A Discussion Paper} (Sept. 1985); Herring & Van Kungre, \textit{The Moral Hazard Constraint on the Pricing of Deposit Insurance} (Brookings Disc. Paper in Int’l Econ. Nov. 1985); \textit{Working Group of the Cabinet Counsel on Economic Affairs} (U.S.), \textit{Recommendations for Change in the Federal Deposit Insurance System} (Jan. 1985). \textit{See also Munton, A Survey of the Issues and the Literature Concerning Risk-Related Deposit Insurance}, \textit{Banking and Econ. Rev.} (FDIC), Sept./Oct. 1986, at 11; FDIC Office of Research and Strategic Planning, \textit{Mandate for Change: Restructuring the Banking Industry}, app. C at 73 (1988) (copy on file with the Ohio State Law Journal).} Even where a subsidized scheme exists, a straight liquidation of an insolvent bank (even a larger institution deemed by the regulators as capable of setting off a “domino” effect within the banking system) is not always affected, but something short of liquidation (\textit{e.g.}, a
third party rescue or purchase) may be devised without government financial assistance.278

e. Management Discipline

Although cumulatively the above policy considerations may suffice as justifiable reasons for bank capital adequacy regulation, none of these various rationales is conclusive. Perhaps the one closest to being a dominant reasoning is the submerged policy that the regulators need an effective tool for monitoring and instilling bank management discipline. Given that mismanagement is the dominant cause of bank failures and that the bank regulators have a governmentally assigned mission to foster prudent bank management, then it appears legitimate that regulators attempt to devise regulatory approaches for “safe and sound” bank management:

From the standpoint of bank safety, the fundamental raison d’etre of bank capital is to instill discipline on management. This function of capital has a major public policy content to the extent that regulators are empowered to impose standards on the level and composition of capital and its relationships to risk factors. Thus, by acting on the required level of capital adequacy, supervisors are in a position to impose constraints by setting definite boundaries on the potential for expansion of the bank’s business and, according to the modalities of measurement adapted, on the relative cost factors of the various activities in which it can engage. But by introducing constraints on the banks’ asset and liability management, supervisors must take a view of the implications in terms of competitiveness and profitability.279

However, bank management involves people and their judgments. Can prudential regulations address this subjective area of concern? Arguably, the Bank of England through its practice of “moral suasion” has traditionally done this. But the historical practice of banking in London and the U.K. banking community’s relationship with the Bank of England are somewhat unique. In such a closed setting, the Bank could observe bank management on a close and regular basis and apparently a “raised eyebrow” of the regulator most often made a difference with bank management.280

Outside such a controlled environment, a regulator’s control over bank management comprises regulatory requirements for bank management qualifications at the formation state of a bank, in other application processes, or (where utilized) through a formal examination or institutional evaluation process. Yet, such regulatory encounters with management remain largely subjective and nontransparent. For example, results of examinations are not made public, and the quality of examinations depends to a large extent upon the adequacy and qualifications of available bank examiners. But, if a more objective guide could be conjured, then a regulator’s diligence could be better employed in a uniform and more transparent manner.281

278. See, e.g., discussion of possible alternatives for FDIC in a failed bank situation in J. Norton & S. Whitley, supra note 7, ch. 3A.
279. R. Pechiol, supra note 4, at 106.
281. For a general discussion on the bank examination process in the U.S., see Flannery & Guttentag, Problem
In this sense, capital adequacy schemes (particularly if risk-based) are an apparently objective means for providing a check and balance on bank management. As already discussed, a risk-based standard places curbs on bank growth and risk taking and otherwise is designed to constrain aggressive management planning. To comply with this type of capital adequacy standard, bank management is forced to undertake a better risk analysis of its portfolio; to evaluate more carefully its costs, profit, and capital structures and policies; and to make tough choices in its growth policy. Moreover, with the bank shareholders being forced to have a greater equity stake (thus, to have a greater potential for loss), greater management discipline and accountability through the corporate governance structure may develop. Yet, because of the complexities of such a risk-based test, there is little transparency for depositors, other creditors, or investors, and there is the likelihood of divergent application of the standard by and among bank regulators.

2. Competitive Equality and Transparency

In a deregulated banking environment, competitiveness is to be encouraged, but uncontrolled competitiveness can lead to imprudent practices and undesired results. For example, underpricing and greater risk taking can lead to greater bank failures, unwanted monopolies, or oligopolies, and ultimately to higher prices and costs to bank users. Moreover, in a fragmented or diverse domestic regulatory structure such as in the United States or within the European Community, it is possible that differing regulatory treatment can create competitive advantages and disadvantages among differently regulated banking institutions. For example, if the Comptroller of the Currency had a more lenient regulatory treatment of capital for national banks than the Federal Reserve Board or FDIC had for state banks, then the costs of operation for national banks would be reduced, thus giving them a competitive advantage over state banks. Obviously, if there were uniform regulations uniformly applied, no such advantage or corresponding disadvantage would exist.

However, there are several limitations on the competitive equality justification. First, this line of reasoning presupposes that capital adequacy regulation is necessary in the first place: the competitive equality policy simply directs that the existing rules be revamped and be applied so as not to create economic inequalities among institutions that otherwise should be treated uniformly by the regulators. Second, the logical conclusion of a competitive equality argument is that no “taxing” regulations should exist at all, as this would be the greatest and most competitive incentive. Thus, for domestic policy considerations, the competitive equality reasoning is more an add-on, concluding that if some form of capital adequacy regulation is necessary, then it is best that it be uniform in content and application.

Another type of domestic add-on justification is the need for transparency in regulation. A transparent regulatory system places everyone affected by the system on a "level playing field" with respect to access to information about the system. Thus each such affected party (whether depositor, bank owner, bank manager, bank regulator, deposit insurer, potential investor, or competitor) is on an equal footing in evaluating its economic position. Concerning the importance of (yet enormous complexities inherent in) transparency in bank regulation and supervision, one leading international central banker has commented:

The freer the financial system, the greater the need to be able to understand what is going on—and the more difficult to meet this requirement. As any economics textbook will tell you, the free flow of information, and equal access to it for all market participants, are essential for the satisfactory working of a competitive system. However, simply stating this general proposition does not get one very far. The question of transparency is raised at the level of both individual financial firms and the system as a whole.

Adequate and publicly available reporting on the accounts of financial firms in general, and of banks in particular, is not a simple and uncontroversial matter, even in "traditional" circumstances. A few words, first, on the lack of simplicity; the valuation of assets or liabilities is an inherently tricky matter; assessing the riskiness of credit exposures is a difficult business even for a management with access to all detailed information; the measurement of a financial intermediary's liquidity position is also fraught with difficulties, not only in practice, but also conceptually. All these problems are considerably aggravated by current developments. Securitisation increases the difficulty of valuing assets and liabilities. The multiplication of off-balance-sheet items is, of course, another important example. But what worries me most, in more general terms is the growing heterogeneity of financial assets and liabilities. The lack of standardisation of existing products, and the almost daily emergence of new ones, seriously undermine the information value of disclosures. At the same time, the complexity of some of the new financial conglomerates is going to make it more and more difficult to assess the interdependence between their various components, in particular between the banking component and the rest. How, in these circumstances, can one expect the banks to be able to evaluate each other's creditworthiness, as I have just recommended?

Transparency of financial accounts is not only a technically difficult matter, it is also a controversial one. The central question, I believe, is whether banks should fully disclose to the general public the size and the composition of their capital base and the extent of their provisioning against possible losses . . . . In an era of worldwide financial integration, the persistence of sharply differing practices among banking systems represents a genuine danger to the proper working of the markets . . . .

The question of transparency also arises at the level of the system itself. One of the main tasks for economists and statisticians in government service or international organisations is to identify the channels of interdependence that have been created as a result of the "globalisation" of our financial system. The most difficult part of this task will be to understand the "insurance" mechanism fully: how are the risks being redistributed? Who are the "insurers"? Within or outside the financial system? This is not a task for the supervisors, but your community has a clear interest in this task being properly performed.283

In the capital adequacy area (assuming such regulations are to exist), regulatory transparency is of particular importance. With the inherent definitional problems with bank capital, the assessment complexities involved with bank capital adequacy, and the confidentiality and subjectivity surrounding capital adequacy on the examination level, it is difficult, without open and uniform regulations, for all affected parties to be able to assess intelligently and prudently the impact of such supervisory practices.

C. International Policy Considerations

The past two decades have evidenced significant changes in the international financial marketplace, which have placed large strains on the capital position of international banking institutions.\textsuperscript{284}

1. Safety and Soundness

The expansion of international banking operations has required large amounts of support capital. These capital needs and the impact of converging international money and capital markets have led to substantial product innovation which, in turn, has entailed new and different risks being assumed (on- and off-balance sheet) by such institutions. For instance, in certain transactions, banks are now assuming market and other noncredit risks, as well as traditional credit risks.\textsuperscript{285}

Such risk taking raises concerns over the possible adverse impact upon the "safety and soundness" of the international banking system and of the financial soundness \textit{inter se} of the banking institutions operating within this system by distorting prudent capital bases for these institutions (many of which have suffered already a qualitative deterioration in their asset portfolio). Further, the rise of global competition in the international financial markets has extended the financial and managerial wherewithal of these international banking institutions and has led to more "cut-throat" bank pricing practices and more aggressive business policies.\textsuperscript{286}

Moreover, as referenced below, there have been various bank scandals or crises of international dimension, which have led to the reform of regulatory practices in the prudential supervision area.

The difficulty with hinging capital adequacy regulations for international banking institutions on the "safety and soundness" of the international banking system is that there does not exist any such system as a formal coordinator, nor does there exist any comprehensive framework for the orderly conduct of banking activities on an international level. What exists are national banking systems. Thus, when one speaks of concern for the "safety and soundness" of the international banking system, one is really talking about an apprehension that a major disruption in the marketplace network of international banking activities or in the financial condition of a major domestic banking institution engaged in significant international

\textsuperscript{284} See R. Perotti, \textit{ supra note 2, at 44–50.}
\textsuperscript{285} See generally \textit{Cross Report, supra note 3.}
\textsuperscript{286} See M. Watson, \textit{ supra note 57, at 40–44.}
operations will jeopardize the "safety and soundness" and systemic stability of a particular domestic banking system.

Yet, none of the recent international banking crises (whether Herstatt Bankhaus, Franklin National Bank, the Secondary Banking Crisis, Ambrosiano, or Continental Illinois) were rooted in a capital adequacy problem. Herstatt failed because of fraudulent bookkeeping concealing exposed foreign exchange positions; Franklin National, because of a volatile wholesale deposit base and excessive speculation in foreign exchange markets; the Secondary Banking Crisis, because of the decline in the U.K. property market and a large wholesale deposit base for the unsupervised "fringe banks"; Ambrosiano, from excessive concealed losses on foreign loans (which as a result did lead to a capital deficiency and insolvency) and serious gaps in prompt and effective international cooperation among the relevant national supervisory authorities; and Continental Illinois, from imprudent international and energy lending practices and a volatile wholesale deposit base.287

Certain of the domestic policy justifications for capital adequacy standards may be applicable, roughly speaking, to the international arena; however, these justifications are attendant with similar types of criticism. For example, these standards can be seen as enhancing the solvency of banks operating internationally. However, such standards increase an institution's costs of doing business, which might lead to a noncompetitive position in the international financial marketplace, to greater risk taking, or to underpricing such institutions. Also, it is inconceivable that higher, uniformly accepted standards would have made any real difference in protecting international banks against the unexpected and monumental strains of the Third World Debt Crisis.

Arguably, higher uniform capital requirements might increase public confidence in international markets. But many banks (e.g., Japanese) have operated very successfully internationally without having high visible levels of capital. The confidence that is increased by these standards is that of the regulators, who subjectively believe these standards will provide a needed buffer to avoid or to minimize shocks or "contagion" effects of a financially distressed or failed international banking institution, especially in the absence of any international regulatory structure, international lender-of-last resort, or government or intergovernment deposit protection scheme.

Certainly, the bank regulators had a genuine concern in the late 1970s and in the 1980s for the trend indicating erosion of bank capital internationally and for the severe detrimental effect the Third World Debt Crisis was having on the capital bases of the international banks. 288 However, notions of "safety and soundness" and "system stability" based solely on the apprehensions of the regulators lend themselves to broad, catchall, and possibly uncritical policy supports for capital adequacy regulation.

287. For further discussion, see R. Dale, supra note 191, at 156-67.
288. See, e.g., COMMIMITTEE ON BANKING REGULATIONS AND SUPERVISORY PRACTICES, REPORT ON INTERNATIONAL DEVELOPMENTS IN BANKING SUPERVISION 1981, at 7 (1982).
2. Competitive Equality and Transparency

The two more convincing policy rationales for international capital standards appear to be the twin needs of transparency, and competitive equality within the international banking system. This is not to say that the "safety and soundness" goal is not important, at least in terms of regulatory concern. Certainly, these three policy needs are interrelated, as a nontransparent and competitively unequal system may tend to erode safety and soundness, solvency, and stability within the system. However, transparency and competitive equality by themselves possess greater specificity for formulating sustainable governmental policies to support international capital adequacy that can be implemented in a meaningful manner.

a. Transparency

Internationally, product innovation has accelerated at a rapid pace and has largely been off-balance sheet; thus, the transactions have been largely nontransparent. In addition, with the absence of an internationally uniform regulatory framework, limited transparency has existed concerning the nature and impact of related bank regulations or examination and supervision practices—whether for banking institutions, bank customers, the financial markets, or the regulators themselves. A transparent international banking system is desirable as it helps the private participants better evaluate transactions and financial instruments and their inherent risks, the pricing of such transactions and instruments, and the implications of any regulator's requirements or burdens.289

A uniform framework for internationally acceptable capital adequacy standards (particularly a risk-based system), in one sense encourages transparency for and among the regulators, because it gives a visible concentration to the entire gamut of banking activities in a risk context (at least for regulatory accounting purposes), brings the growing off-balance activities back within a uniform financial framework, and adds clarity and consistency to the regulatory rules respecting the capital issue. In effect, the regulators are not operating in the dark. Increased transparency, where the rules are known by all parties, also encourages impartial and consistent implementation of the rules. Conversely, it is easier to detect whether a foreign banking institution is being "hometowned" by the domestic regulators (i.e., being treated less fairly than domestic counterparts under the same rules). But where the rules (though uniform) are so highly complex, transparency may be defeated or rendered meaningless for the public.

b. Competitive Equality

Internationally, the precept is that an efficient banking system requires a "level playing field" for all banking institutions, with the national rules to be applied as uniformly as possible. Divergent national rules or gaps in rulemaking or supervision

289. For discussion of international aspects of the transparency issue, see R. Pecchioli, supra note 2, at 96–100.
are to be eliminated, or at least minimized, so that neither discriminatory regulatory burdens nor unfair competitive advantages can be exploited. A uniformly consistent regulatory system also promotes system fairness and equity: all that are similarly situated are treated the same. Moreover, international competitive equality tends to create domestic symmetry in the domestic regulators' work on capital adequacy by adjusting national interest for broader international objectives, which will aid ultimately the economic strength and competitiveness of the national systems and banking institutions.290

With respect to the goal of competitive equality, the importance of and the tensions in an internationally-oriented capital adequacy standard, such as a risk-based scheme, are summarized by Mr. Paul Volcker, former Chairman of the Federal Reserve Board:

I cannot emphasize strongly enough our interest in the competitiveness of U.S. banks. Only a strong, competitive, and profitable banking system can remain healthy in the long run and fulfill the strategic role that banks play in our economic and financial system.

In considering the issue of competitiveness, it is possible that banks that are permitted to operate with lower capital levels may have a competitive advantage, at least in the short run, over the banks that are required to meet higher capital standards. But, from the standpoint of appropriate public policy, those considerations have to be balanced against the long-run safety and soundness of the banking system.

In striking that balance, questions have inevitably been raised about the effect of the risk-based proposal on U.S. banks' ability to price competitively certain banking services. This is especially true of those off-balance-sheet instruments . . . .

We are aware of the potential pricing implications of the risk-based proposal . . . . However, I am concerned that competitive pressures may have eroded spreads on some of these instruments to the point that banks are not being fully compensated for the credit risks involved. To the extent that this is the case, the risk-based capital proposal may encourage a more rational and appropriate pricing structure that is consistent with the long-run stability and health of our banking system.

Another dimension of this issue relates to the capital requirements of nonbank financial institutions that have become major competitors of commercial banks. In my view, as U.S. banks come into increasing competition with nonbank financial institutions, including thrift institutions and investment banks, appropriate efforts should be made to ensure that capital requirements among different institutions conducting the same activities are brought into closer alignment . . . .

The need for parity of capital standards on an international basis is . . . pressing . . . . The prospect of major international banking organizations operating throughout the world with vastly different capital requirements and capital resources is not, in my view, in the best long-run interest of sound, stable, and competitive international banking and financial markets . . . . 291

VI. CONCLUDING OBSERVATIONS: THE PARADOXES OF CAPITAL ADEQUACY STANDARDS

A paradox inherent in attempts to provide a meaningful and uniform definition to bank capital adequacy is that, as more regulatory precision is given to the concept,

290. See Cooke, supra note 282; Lamfalussy, supra note 283.

more definitional problems arise. Instead of narrowing the gap of comprehensibility, the flood gates of ongoing complexity and incomprehensibility are opened. Even if uniform measurement standards are achieved, they are incomplete—if only because they look only to credit risks. For example, the Federal Home Loan Bank Board also is looking at interest rate risks in an institution’s portfolio. Moreover, with the rise of asset securitization, market risks should be incorporated also. The regulators, in solving one definitional problem, create several even more difficult problems.

Also the capital adequacy standards are measurement standards. These measurement standards are true only if the underlying quality of the assets to which the standards relate is true. But how does one evaluate asset quality? Certainly, the presently proposed risk categories are only very crude measures. Further, one cannot talk about uniform capital adequacy standards unless the relevant accounting and tax treatment is also uniform. These matters have yet to be dealt with. Thus, the road to uniformity soon becomes as all-encompassing as the road to perfection. The present level of definitional analysis by the regulators only makes apparent the great length of the journey that must be undertaken to obtain a meaningful and uniform definition of capital adequacy.

A historical paradox stemming from the role of capital adequacy is that the notion arose, and is still spoken of, as one of many examination or prudential assessment tools of the bank supervisor; yet, this tool really has been transformed into a broad regulatory objective with a life of its own. Instead of the tool helping to understand the problem, the regulators have created an ever-increasing framework for trying to understand the tool. Moreover, the more publicity that has been given to the subject, the more the notion takes on the appearance of a prophylactic for every bank ailment—from Third World Debt to such problems as unprecedented bank failures, bank scandals, poor bank management, and the Japanese banks’ world expansion.

Certainly, the regulators have cautioned about the limitations of capital adequacy standards, but if these limitations are correct then the significance of capital adequacy has been grossly exaggerated. However, notwithstanding what the regulators may indicate, the proposed risk-based capital schemes will have enormous practical implications for affected banking institutions and their management that will permeate all levels of bank management and operations. Bank lending, investment, growth, and competitive and profit strategies will have to be rethought; cost and pricing structures reviewed; operational policies revised; and new compliance and accounting practices implemented. There is no question that the new proposed capital standards have practical significance and impact far exceeding any examination tool or limited supervisory standards. Whether these standards should have this disproportionate impact can only be justified by overriding and compelling policy considerations.

This disproportionate impact is further portrayed in the international dimensions of capital adequacy among the international banking supervisors through the Basle Committee. Detailed standards are being devised on a multilateral basis, albeit their

292. E.g., Bisenius, Thrift Capital Requirements, 42 CONSUMER FIN. L.Q. REP., Spring 1988, at 92, 93.
implementation remains on a national level. But the national regulatory approaches
are being shaped by these international efforts, which lack any firm organization or
legal roots.

A further paradox appears when considering the policy justifications for uniform
capital adequacy standards. The search through capital adequacy for such policy
goals as transparency and competitive equality, safety and soundness, and manage-
ment discipline may (in many ways) pollinate conditions that might ultimately
undermine these very goals. The more complex the standards become, the less
transparent and the less useful they become. To whom will these elaborate standards
be transparent and, therefore, useful? Certainly not to bank depositors, bank
creditors, bank investors, or even to ground level bank examiners. Transparency may
come to exist only for an elite "club" of high level bank supervisors. "Club"
transparency is really a denial of true transparency for all affected parties.

Moreover, the new capital standards will have a real cost and a regulatory tax for
affected institutions. Will this make such institutions uncompetitive with respect to
competing nonbank financial institutions? If it does, then the goal of competitive
equality becomes hollow. Further, it becomes dangerous as uncompetitive conditions
for banking institutions may lead to unsafe and unsound practices (e.g., underpricing
or excessive risk taking) or conditions (e.g., diminished profitability and capital).
Also, the use of capital adequacy as a management discipline device is questionable.
In a free and competitive marketplace, it may be just as imprudent for bank
management to be overly constrained by artificial risk categories and standards as it
would to be overly unrestrained.

A similar legal paradox may exist, inasmuch as the desired effect of legal
regulation to produce a transparent, fair, certain, and competitive environment may
(because of the weighting complexities of these regulations) lead to less comprehen-
sibility, the potential for discriminatory application of the standards, and legal
loopholes giving rise to a further proliferation in product and strategic innovations.

Is capital adequacy a legitimate regulatory concern for prudential supervision of
banking activities? Certainly, at some level or levels it may be. For example, if kept
as a useful (but limited) examination or supervisory assessment tool, capital adequacy
standards appear to be sustainable. Perhaps, even on an international level for the
elite group of multinational banks, uniform capital adequacy standards may be
supportable as a common price of admission by banking institutions to world
financial markets.

But the universal metamorphosis of capital adequacy (for all banking institutions
and for broad supervisory purposes) from a limited supervisory means or tool into a
general, formalized bank supervisory goal appears to be unsustainable unless it
ultimately serves as a catalyst for integrating the regulatory treatment of competing
bank and nonbank financial institutions on a domestic level and on an international
level.

Without ever really knowing where and how far these standards will go, the
bank regulators have signalled the capital adequacy train to leave the station. It has
gone beyond the examination stage into the realm of a regulatory goal or objective
and now it appears to be creating a yet-to-be known destination by its own force. Disparate domestic and international bank supervisors have cautiously joined the journey. Domestic and international securities supervisors are contemplating joining also.

Despite its questionable pedigree as a major supervisory goal, capital adequacy has had a therapeutic effect in bringing into better focus the magnitude of, and the practical need for, sensibly addressing the pervasive present regulatory dilemma of how to accommodate a deregulating, internationalizing, and innovating banking and related financial services environment within a safe and sound domestic and international banking system. The proverbial "next shoe" has yet to drop.293

293. Cf. Remarks by W. Ryback, Deputy Associate Director, Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System, Fifth Annual Institute of Law of Banking Institutions, Southern Methodist University, Dallas, Texas (Oct. 21, 1988) (copy of audio tape on file with the author).