Senate Bill May Make It More Difficult for Large Banks to Satisfy Capital Reserve Requirements

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The Restoring American Financial Stability Act passed by the Senate on May 20 (discussed in an earlier post) includes an amendment authored by Sen. Susan Collins (R-Maine), which would toughen the risk-and size-based capital standards facing financial institutions. Sen. Collins has stated that smaller financial institutions should no longer be subject to more lenient standards than large institutions because the “failure of larger institutions is much more likely to have a broad economic impact” and having different standards creates the incentive for banks to become “too big to fail.” The amendment would hold banks with assets above $250 billion to capital requirements at least as stringent as those applicable to smaller institutions.

Under U.S. rules, bank regulators look to the ratio of a financial institution’s Tier 1 capital to total risk-adjusted assets as a key indicator of financial health. Tier 1 capital, which includes common stock and some preferred stock, serves to cushion banks in the event of potential loss. The language in Senator Collins’ amendment apparently orders federal bank regulators to set minimum leverage and risk-based capital requirements for all banks, implies that trust-preferred securities will no longer be included within the definition of Tier 1 capital, and implies that all banks would need to comply with this new rule immediately. In an interview with the American Banker, however, Senator Collins said that what’s intended is that the new measure would apply only to “systemically important firms,” would be phased in over time, and that the language of the amendment will be changed before the bill is passed to reflect these intentions.

While supporters of the Collins amendment contend that trust-preferred securities are debt and don’t offer much protection when trouble hits, financial institutions who issue these securities stand to have their Tier 1 capital ratios significantly diminished, making them appear less healthy almost overnight. According to Jaret Seiberg of Washington Research Group, a division of Concept Capital, publicly owned bank holding companies’ capital ratios would fall by more than 2 percentage points on average. Some financial institutions have openly criticized the amendment and hope that should the amendment be passed that there would be a transition period before it would be effective.

One possible effect of this amendment being passed is that banks may need to either raise additional capital or divest assets in order to maintain the minimum Tier 1 capital ratio.

We plan to track events related to this amendment.