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Statement of the Shadow Financial Regulatory Committee on

Regulation of Bank Capital and Liquidity

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The Shadow Financial Regulatory Committee believes that increasing regulatory capital and liquidity requirements – particularly for large institutions that receive too-big-to-fail subsidies – are essential for stabilizing the global banking system. Both the Dodd-Frank Act of 2010 and the new Basel III standards recognize this need to raise capital requirements and introduced liquidity requirements. Both U.S. and European regulators are currently seeking comments on proposals for enacting higher standards.

However, the conceptual approaches to prudential regulation embodied in the Basel III and the U.S. approaches suffer from fundamental deficiencies that require remediation. These deficiencies include (1) relying upon fixed risk weights for measuring risk-based capital that are arguably inaccurate, 2) relying upon fixed weights that, even if initially measured properly, inevitably will be wrong as market conditions change and will invite increased risk taking that misallocates banking resources, (3) constructing increasingly complex formulas used to measure liquidity in the new requirements, which are not sufficiently grounded in a sound conceptual framework, and that give a false impression of precision and adequacy, (4) establishing capital adequacy standards that are too low relative to either total assets or to any proper definition of risk-weighted assets, and (5) failing to institute any actions that address the problems of regulatory and institution forbearance that tend to result in a failure to promptly measure and respond to asset losses and capital impairment.

These problems reflect fundamental design flaws in the Basel III approach, and have characterized both Basel I and Basel II as well. Namely, they place too much reliance upon highly discretionary judgments of both bankers and regulators in measuring risk and capital. This resulted in the establishment of increasing detailed and complex formulas and that have also been subject to significant political bargaining that are often at odds with economic realities.

It is both possible and desirable to construct simpler and more effective rules for capital requirements. For example, one positive outcome of the Basel III process was the adoption -- for the first time -- of an internationally-agreed upon leverage ratio. However, that minimum ratio should be much higher. We are skeptical of arguments that higher equity requirements will increase the cost of credit significantly. Moreover, any increases in loan rates must be weighed against the benefits of increased safety and protection of taxpayers. We note that before the advent of federal deposit insurance, banks held much higher levels of capital.

What is new in the new Basel III rules is the establishment of liquidity requirements, but the Committee believes they are but another step in the wrong direction. The standards mandate that banks maintain sufficient liquidity, defined as meeting two different regulatory liquidity ratios: (1) the liquidity coverage ratio (LCR), that measures the ability of the bank to meet all of its required cash outflows during a period of funding stress lasting 30 days, and (2) the net stable funding ratio (NSFR), that focuses on the bank's longer-term liquidity position. But, the Basel Committee has not provided any theoretical or conceptual basis for these particular requirements.

The regulators state that there is a direct tradeoff between lengthening the maturity of bank liabilities as an alternative to holding more liquid assets. Reduced short-term debt is not necessarily a substitute for increased cash assets from the standpoint of ensuring liquidity. Moreover, changes in the maturity structure of bank assets and liabilities are not a substitute for increased capital. The recent financial crisis has reinforced the fact that institutions that have insufficient capital (and that may even be economically insolvent) are the ones most likely to experience funding and so-called liquidity problems. In fact, runs by short term creditors can, in the absence of too-big-to-fail, be the principal source of market discipline. Consequently, the relationships among asset liquidity, debt structure and capital are complex and are not independent from changes with market conditions.

To make matters worse, Basel III permits non-cash assets to qualify as liquid assets (with specified haircuts that lack an empirical basis). Some of those assets are not dependably liquid, and the haircut approach does not ensure that banks will actually have sufficient asset liquidity when they need it as market conditions change. Moreover, the approach fails to consider the fact that during a financial crisis, liquidity is dependent upon the existence of willing buyers of assets that banks may need to sell. In other words, asset liquidity is not a static characteristic of an asset, but rather is dynamic and varies with market conditions.

The Committee believes it would be better to focus liquidity regulation on requiring banks to maintain sufficient cash assets, narrowly defined to include vault cash and interest bearing deposits at the central bank. If liquidity requirements were defined in terms of holdings of such balances averaged over a specified period of time, like a month, then those reserve holdings would be available, perhaps subject to regulatory approval, to meet unanticipated needs for temporary (i.e. less than a few days) liquidity. Using an averaging period of a few weeks or a month would then allow an institution to meet a temporary liquidity need while allowing sufficient time to replenish its liquidity reserve position.

Finally, there are also severe problems with the Basel Committee's approach to measuring the liquidity risk inherent in different liabilities of differing maturities. The assumptions underlying the approach are both arbitrary and subject to great uncertainty. For example, there is no empirical basis for the assumptions made about the relative runoff risks associated with different liabilities. In particular, the assumption of 10 percent maximum run-off rate for "unstable," wholesale deposits may or may not be unduly optimistic, especially in light of the recent crisis.

We encourage U.S. regulators to walk away from Basel III and to enact regulation and enforcement strategies that are superior to the Basel III approach. An improved framework would be based on simpler rules for minimum ratios of capital to total assets and cash to assets that are less reliant on discretionary regulatory judgments about how to measure risk, capital, and liquidity. Such rules must be designed to be hard for bankers to get around through regulatory arbitrage, and hard for regulators and supervisors to ignore either because of politically-motivated forbearance or regulatory capture.

If effective capital and liquidity requirements were enacted, along with credible means of ensuring timely recognition of losses, it would more effectively protect society from the social costs of banking crises and bailouts of too-big-to fail banks, and permit regulators to minimize intrusion into bank activities in an attempt to preserve systemic stability. Banks, in turn, would be able to pursue business models that revolve around the logic of the market rather than the logic of gaming the safety net.