Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement 307

Richard J. Herring
215.898.5613

Edward J. Kane
520.299.5066

Statement of the Shadow Financial Regulatory Committee

Qualms about the Basel III Approach to Bank Capital Requirements

February 14, 2011

Basel II proved inadequate to safeguard many national financial systems, and even helped to destabilize the global financial system. Ironically, Basel II seems to have deluded the primary supervisors of banks that failed or required government intervention. Supervisors had consistently reported that risk-based regulatory capital at these banks was above minimum standards and above industry averages as well. As a result, market participants became so distrustful of risk-based capital standards that, in assessing institutional risk exposure, investors shifted their focus to the leverage ratio of net tangible capital to total assets.

Basel II capital ratios failed to identify banks headed for failure for three reasons: (1) the denominator, risk-adjusted assets, underestimated risk exposures; (2) the measures of capital in the numerator did not accurately portray an institution's capacity to absorb loss without becoming insolvent; and (3) required minimum ratios were simply set too low. In short, the Basel II capital ratio overstated the amount of capital protection banks had.

Basel III proposes to tinker with the risk weights for assets, particularly emphasizing higher risk weights for assets in the trading book that also embody credit and counterparty risk. While this patches a conspicuous hole in the system of risk weights, it fails to anticipate the strong and longstanding incentives that will result to

arbitrage differences in regulatory risk weights.

The main focus of Basel III falls on the computation of the numerator in the capital-to-asset ratio by requiring more and better-quality capital. Basel III seeks to count as capital only instruments that are able to absorb loss without triggering bankruptcy. For tier 1 capital, the definition returns to the spirit of the original Basel Accord (Basel I), which limited Tier 1 capital to equity, retained earnings and non-cumulative perpetual preferred shares. The minimum ratio of Tier 1 capital to risk-weighted assets was set at 4 percent of risk weighted assets. From the beginning, Tier 2 capital comprised a grab bag of instruments that enabled the negotiators to reach agreement on capital standards, but obscured differences in national definitions of capital. Few Tier 2 instruments could absorb loss before an institution was declared insolvent.

In most countries, banks can deduct interest payments from taxable income, but not dividends. Thus they perceive equity to be more expensive than debt and lobbied for the inclusion in Tier 1 capital of new instruments that could be argued to be enough like equity to satisfy regulatory authorities, yet enough like debt to convince tax authorities to award a tax deduction. As a result the equity component of Tier 1 capital was lowered from 4 percent to only 2 percent. The arbitraging of risk weights and the degradation of the quality of regulatory capital contributed to an enormous increase in the actual leverage (i.e., the asset-to-capital ratio) of national banking systems. This increase in leverage is not reflected in the risk-based capital ratios.

The specified minimum acceptable ratios—4 percent Tier 1 and 8 percent Tier 1 plus Tier 2 ratio—were never justified by an economic analysis of past crisis experience. It seems likely that the main rationale for choosing these standards in Basel I was that banks in most countries could meet them without much strain. These standards were insufficient to protect the international banking system against the shocks experienced in 2007 and 2008.

In formulating Basel II, the Basel Committee on Banking Supervision (BCBS) completely ignored the numerator of the capital-asset ratio. Reaching agreement on the definitions of Tier 1 and Tier 2 had been the most contentious part of negotiating Basel I and few countries had any enthusiasm for revisiting the decision. The result was a dangerously incoherent regulatory approach. The BCBS devoted enormous energy to trying to make the denominator in the capital-asset ratio correspond to the unexpected risk that needed to be absorbed to assure a specified level of safety. Yet this denominator was compared to a numerator that had little to do with the institution's ability to absorb losses as a growing concern.

The main effort of Basel III was to raise effective requirements by strengthening the definition of the numerator. The new minimum Tier 1 capital ratio requires that eventually equity be 4 ½ percent of risk-weighted assets. This is substantially higher that the debased standard of 2 percent under Basel II, but not much greater than the original 4 percent standard under Basel I. The principal innovation is an additional requirement for a "capital conservation buffer" amounting to 2.5 percent of risk-weighted assets. This brings the total equity capital ratio to 7 percent. These escalating restrictions have the advantage of serving

as a useful corrective action mechanism for bank managers. The BCBS intends for banks to draw down this buffer in hard times, but will impose increasing constraints on their ability to make discretionary distributions of income as they do so. The Shadow Financial Regulatory Committee believes that most banks will feel obliged to maintain ratios above 7 percent. They are likely to regard the capital conservation buffer as an additional requirement that cannot be drawn-down without sending a negative and possibly fatal signal to financial markets. While this was not the intent of the BCBS, the Committee supports the effective increase in minimum equity capital requirements.

Four other innovations feature prominently, if somewhat more tentatively, in the proposal. The first is a counter-cyclical buffer to be administered by regulators under Pillar 2 (which means it will not be publically disclosed) to restrain banks from exacerbating a boom. It can amount to an additional requirement for equity of as much as 2.5 percent. In guidance issued after the publication of Basel III, the BCBS specified that the discretionary add-on by the home country should be based on the ratio of aggregate banks credit expansion relative to GDP in that country and that all other countries that conduct banking activities in that country would simultaneously place an identical capital requirement on their banks' operations in that country. But the country initiating the additional requirement must inform regulators in other countries 12 months in advance. The Committee believes this approach is unlikely to succeed. History provides little evidence to believe that a regulator will be willing to intervene before a boom is in its final stage. When the economy is experiencing a boom even experts have difficulty agreeing on whether rapid growth occurs in response to improving fundamentals or is evidence of a bubble. Moreover, banking supervisors inevitably experience great difficulty in requiring more capital from banks that appear to be profitable and in good condition. The timing of such an intervention is likely to be too late and may indeed have perverse consequences for the real economy.

The second innovation is an option to require higher equity capital from institutions designated to be systemically important. This reverses a major thrust of Basel II, which offered such institutions lower capital requirements to induce them to adopt more sophisticated risk management techniques. The motivation for this policy reversal was to require that institutions hold additional equity capital to absorb some of the costs they would impose on the system should they fail. The Dodd-Frank Act requires this for US banks, but other countries tend to resist this proposal.

The third innovation is to incorporate a supplementary leverage requirement tentatively set at 3 percent of total assets (including the loan-equivalent amount of off-balance sheet positions). The US has long required a leverage ratio in addition to the Basel standards. In practice, the leverage ratio (which does not include the loan equivalent value of off-balance sheet positions) is much more likely to be a binding constraint for most US banks than the Basel II or Basel III risk weights. The fundamental rationale for this second kind of capital requirement is to control the amount of leverage an institution can achieve. On competitive grounds, many European countries strongly object to imposing this ratio. They point out that differences in accounting standards between Europe and the United States tend to understate the leverage of US banks relative to European banks. A principal reason for this is differences in accounting for derivative positions. In constructing bank balance sheets, the US

permits many derivative positions to be netted against one another, but European regulators permit derivatives positions to be netted out only when there is a legally binding requirement to do so. Relative to their European counterparts, this tends to understate the leverage of the five large U.S. institutions that are heavily involved in derivatives dealing by a substantial amount.

Many of the provisions of Basel III will be phased in over long periods of time. To make it easier for banks to meet the higher equity requirements through retained earnings rather than by issuing new equity. This also applies to the replacement of the grab bag of instruments previously counted as Tier 2. Banks would have ten years to meet the new requirements for eliminating Tier 2 capital that cannot sustain the banks as an ongoing concern. The Committee believes a long phase-in periods are worrisome because they give bank lobbyists time to weaken the standards before they are implemented and leave the system vulnerable in the interim.

The last notable innovation seems poorly conceived. The BCBS wishes to impose liquidity requirements on banks that will limit the damaging externalities created by excessive maturity transformation and overreliance on liquid liabilities to finance illiquid assets. A strong case can be made for assessing balance-sheet mismatches in terms of final maturities, but neither the proposed liquidity coverage ratio nor the proposed net stable funding ratio truly addresses this fundamental problem effectively.