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Statement of the Shadow Financial Regulatory Committee on

**Making Bank Capital Requirements Simpler, More Comparable
& More Transparent**

September 23, 2013

Since the International Accord on Capital Adequacy in 1987, the Basel Committee on Banking Supervision and US regulators have published thousands of pages on capital regulation and how to make it more risk-sensitive. In the aftermath of the financial crisis, national supervisory authorities and the Basel Committee issued new and more detailed regulations intended to reduce the depth and frequency of future crises. The consequence has been a flow of increasingly complex standards that make it difficult to compare risk profiles across institutions and over time, are costly to comply with and monitor, and may not capture the risk exposures they are intended to regulate.

In a refreshing departure from this trend, the recent Basel Committee discussion paper (June 2013) on “The regulatory framework: balancing risk sensitivity, simplicity and comparability” provides a welcome change in perspective, which the Committee applauds. It asks whether it might be possible to achieve the same degree of safety with less complex and more comparable measures of capital and risk. Although the Basel Committee stops short of suggesting how this might be accomplished, the Shadow Financial Regulatory Committee believes that many of these concerns can be addressed by employing measures of capital and leverage ratios that are simpler to compute and easier to understand.

At about the same time as the release of the Basel paper, the US banking agencies published final rules for implementing Basel III capital standards and aspects of the Dodd-Frank Act, employing somewhat different definitions of the ratios, as well as putting forth a new proposal for higher leverage requirements for eight U.S. bank holding companies that have been identified as Global Systemically Important Banks (G-SIBS or “covered banks”) and their depository institution subsidiaries. If these proposals are adopted, covered banks will be subject to at least 15 risk-weighted capital asset ratios (which cannot be meaningfully compared across institutions or over time) and 3 leverage ratios with differing denominators. Unlike banks in the rest of the world, large banks in the United States will also be subject to the Collins amendment which requires that risk weights derived from banks’ internal models to be no less stringent than those applicable to smaller banks under the Basel III Standard Approach. While these requirements appear to address the objective of requiring banks to hold both more and higher quality capital, the consequent additional complexity associated with varying the numerators and denominators of applicable ratios makes the system still more complicated and raises compliance costs for both regulated entities and monitoring costs for their supervisors.

The Shadow Financial Regulatory Committee has long been critical of the increasing complexity and conceptual inadequacy of the Basel risk-based capital approaches. In the Committee’s view, the main goals that should be addressed in a reform include: (1) raising capital resources to absorb losses; (2) making measures of capital more comparable across institutions both domestically and abroad; (3) reducing the ability of institutions to game the system by adopting models or restructuring transactions that reduce their risk-weighted assets without reducing their actual risks; and (4) enhancing the willingness and ability of supervisors to monitor and enforce meaningful capital requirements.

The Committee believes that these objectives can be accomplished with much less complexity. We favor maintaining a leverage ratio as well as reducing the number of risk-weighted asset ratios to a single ratio. We would suggest a leverage ratio employing Tier 1 capital in the numerator and the Basel proposed definition of total on- and off-balance sheet exposures in the denominator. For the single risk weighted capital ratio we would recommend using Tier I capital in the numerator and using a denominator based on the risk weights specified in the Basel Committee’s Standardized Approach. Although we see no harm in distinguishing the various components of the Tier 1 numerator (the conservation buffer, a potential counter-cyclical buffer and a G-SIB add-on as defined in Basel III) we do not, however, see any value added by specifying separate sets of ratios for Common Equity Tier 1, Tier 1 and Tier1 plus Tier 2 capital and separate ratios for each of the components of capital.

Reliance on the Standardized Approach for determining risk weights would remove the supervisors from their current role in screening and evaluating internal models for large institutions. The Standardized approach will result in the computation of risk-weighted assets in a way that is comparable across institutions and lowers monitoring cost for supervisors. Institutions would then be free to develop models for their own risk management purposes, but would not be obliged to build additional models for regulatory compliance.

The demonstrated problem with relying solely on a measure of risk-weighted assets for prudential purposes is that institutions are likely to find numerous ways to understate their risk-weighted assets so that the system may not be adequately capitalized. The overstatement of capital and underestimate of loss exposure were clearly critical problems in the recent crisis. This supports the need for having a back-up leverage ratio that would help ensure that the system is adequately capitalized, even if risk weights turn out to be misleading and result in inappropriately low capital requirements.

The US emphasis on raising leverage requirements for the largest institutions is another welcome development. The denominator suggested in the Federal Reserve's proposal is an improvement over the traditional US leverage ratio that includes only on-balance sheet assets, but it is inferior to the denominator in the Basel leverage ratio. The Basel approach is more comprehensive in its measure of off-balance sheet positions. Not only does the Fed's narrower denominator introduce unnecessary complexity, but it also defeats the intent of the Basel Committee to introduce a measure that is comparable across countries and over time.

Combining a single leverage ratio and a single risk-adjusted capital ratio would advance the Basel Committee proposal for greater simplicity and comparability and help meet the Shadow Financial Regulatory Committee's objectives for reform. The required capital increases in Basel III, along with the proposed leverage add-on for large US banks, should help ensure that the banking system is better capitalized. The requirement for institutions to meet both a leverage ratio and a risk-weighted asset ratio also reduces the opportunities for gaming the system. Using the Basel Committee's agreed upon definition for Tier I capital for the numerator and the denominator specified in the Basel Committee's June proposal in computing the leverage ratio will enhance the comparability of capital standards across institutions and across countries. In addition, reliance on the Standardized Approach for risk weights will greatly reduce the opacity implicit in a system which relies upon a combination of standard and internal models and which according to at least one estimate requires several million calculations. Moreover, this simplification should greatly improve the ability of supervisors to administer and monitor capital requirements. Finally, public disclosure of simple measures will improve market discipline as well provide an incentive for supervisors to enforce them better.