

A Pinch of Basel?

BY DAVID A. PRICE

On Dec. 16, 2010, the Basel Committee on Banking Supervision — a group of senior officials of central banks and bank supervisory agencies from 26 countries and the Hong Kong Special Administrative Region — released a final draft of its framework of banking regulatory reforms. That framework, known as Basel III, is a response to the 2007-2008 financial crisis, and is expected to be adopted by bank regulators worldwide, including in the United States.

The reforms set out by Basel III are wide-ranging, but at the center are increased capital requirements. Capital requirements are intended to act as a buffer, ensuring that financial institutions are able to withstand some level of losses; they are typically expressed as a ratio of capital to assets, or to some risk-adjusted measure of assets. Of course, banks also maintain capital reserves for self-interested reasons — for instance, to maintain the confidence of investors. It is widely believed, however, that many of the risks created by low capital levels are felt not by the bank, but by the financial system as a whole (including government programs such as deposit insurance), thus warranting regulation of minimum capital levels.

Today, U.S. regulators generally require a 4 percent capital ratio for “Tier 1” capital (mainly shareholders’ equity and retained profits net of accumulated losses) and an 8 percent capital ratio overall. Under Basel III, these requirements will become more stringent. The framework calls for the minimum Tier 1 ratio to go up to 4.5 percent in 2013, continuing to increase to 5.5 percent in 2014 and 6 percent in 2015. The minimum total capital requirement will remain at 8 percent, but it will be supplemented under Basel III by a “capital conservation buffer” of common shareholder equity that will kick in at 0.625 percent in 2016 and rise to 2.5 percent in 2019. Banks that do not meet the buffer requirement would be restricted in their ability to pay dividends and bonuses and to buy back their shares.

Thus, roughly speaking, the total Tier 1 ratio will effectively double from 4 percent to 8.5 percent (6 percent plus 2.5 percent), and the minimum total capital ratio will increase from 8 percent to 10.5 percent. Additionally, the framework contemplates a “countercyclical capital buffer,” also based on common equity. The buffer would vary from 0 to 2.5 percent at the discretion of national regulators. The concept is that regulators would require this additional buffer during an expansion, and would reduce it during a downturn to maintain the availability of credit.

The framework states that systemically important banks — banks of such a size that they may be considered too big to fail — “should have loss-absorbing capacity beyond the minimum standards.” Basel III does not specify what addi-

tional standards should apply to systemically important banks, instead indicating only that “the work on this issue is ongoing.” (Systemic risks to the financial system are also newly addressed within U.S. law by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which provides for regulation of systemically important bank holding companies and nonbank financial institutions.)

No congressional action is needed for the Basel III framework to take effect in the United States. To meet the implementation date of Jan. 1, 2013, the Federal Reserve System and the other bank regulatory agencies are expected to issue a proposed notice of rulemaking this year for rules incorporating the Basel III capital requirements into U.S. regulations. It is likely that regulators will invite comments from the public on the proposed rules before they become final. It’s also worth noting that the Basel III reforms are not binding: Countries have discretion to disregard or not fully implement certain provisions.

What will be the macroeconomic effects of the increased capital requirements? That is the trillion-dollar question.

A 2007 literature review by David VanHoose of Baylor University, published in the *Atlantic Economic Journal*, concludes that heightened capital requirements are likely to lead to reductions in bank lending. In the short run, banks facing increased capital requirements may be reluctant to issue new equity to bring their capital ratio into line with those requirements, given the costliness of raising equity capital. Thus, they will tend to respond on the asset side, slowing the growth of their assets, rather than on the capital side.

Another potential unintended consequence of higher capital requirements is the risk of regulatory arbitrage. If capital requirements create a modest cost disadvantage for banks, then an increasing share of lending activity could move to vehicles outside the bank regulatory system, such as private equity funds or securitization.

No one yet knows whether the increased capital requirements of Basel III are sufficiently high to produce appreciable macroeconomic effects or regulatory arbitrage, or whether the minimum capital ratios could be set even higher without such effects. Given the lengthy phasing-in of the requirements, regulators will have the opportunity to assess the extent of those effects in coming years.

“There’s a lot of uncertainty about what the right amount of capital is,” says Richmond Fed economist Huberto Ennis. “It depends on the costs and benefits of having additional capital. Incrementally, how costly would it be to ask for 15 percent capital? We don’t know. As far as I can tell, it’s people making calls based on soft information and hunches. We know capital is good, we know it may be costly. The question is, what’s the right amount?” **RF**