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Some Observations About Basel II/III

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A recent Op-Ed by Steve Hanke¹ (referred to below as “CCDC”), re-distributed by the Center for Financial Stability (CFS), was critical of international efforts to strengthen capital regulations, calling the implementation of Basel III “...a deadly cocktail to ingest in the middle of an economic slump.” This note presents a counterpoint to that view.

CCDC Assertion 1: “Basel III is just making things worse.”

Discussion:

(1) Basel III is not yet in effect. While the Basel Committee on Banking Supervision (BCBS) has articulated a set of principles, commonly known as Basel III, the interpretation and implementation of those principles, like other BCBS recommendations, are left to national discretion and are still being negotiated in many countries. While *uncertainty* about the future of capital regulations *may* be making things worse, there are plenty of other areas of uncertainty to worry about as well.

(2) If history were any gauge (acknowledging the familiar adage that “past performance is not necessarily an indicator...”), it will be years before Basel III applies to US banks. Even its precursor, Basel II, passed in November 2007, is still not fully in effect after more than a decade of discussions. In fact, at the time it was passed, the earliest possible start date for US banks to be fully subject to Basel II was January 2012. In addition, unlike the rest of the world, Basel II as passed in the US was required for only a handful of banks (roughly 15 out of around 8000).²

(3) It is not Basel III that is making things worse but continued economic lethargy. The global financial crisis delayed planned implementation of Basel II in the US even further. For concerns about ingesting more stringent capital requirements in the middle of an economic slump to be realized, we first have to acknowledge that recovery won’t take hold anytime soon. Perhaps that recognition is implicit in the assertion. But Basel III alone is not the culprit.

Questions for Bank Capital and Liquidity Rules Forum Participants:

- (1) How is uncertainty surrounding future capital regulations affecting expectations, investment, confidence?**
- (2) What are some of the challenges faced in devising capital regulations that ensure appropriate transparency of risk measurement and management and how might these be overcome?**

¹ Hanke, Steve, “The Chattering Classes’ Deadly Cocktail,” *Globe Asia*, October 2011.

² The US agencies have since issued a number of proposed revisions that would apply to a larger collection of institutions but to our knowledge these have not been finalized.



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CCDC Assertion 2: “[U]nder the purview of Basel III, banks in the United States, as well as those in the eurozone are shrinking their risk assets relative to their equity capital... Risk assets in the United States have all declined since May 2008, while banks’ holdings of “risk-free” government securities and cash have soared.”

Discussion: CCDC Figure 1, comparing holdings of bank assets of commercial banks in the US in May 2008 and July 2011, demonstrates the trends that are noted. However, these trends are hardly a reflection of Basel III – they are merely a result of current US capital regulations. There is no evidence provided for the assertion that risk assets have shrunk in the eurozone.

In the United States, the decline in risk assets since May 2008 is a direct reflection of the de-leveraging that occurred as a result of the crisis and the need for banks to increase capital (under *current* – i.e., Basel I -- capital regulations) in the face of significant capital erosion due to the deterioration of asset quality, particularly for those firms at risk of breaching leverage ratios. In addition, many banks were required to bolster their capital positions (and specifically their tier 1 capital, considered the “preferred” type of capital) as a pre-condition for receipt of various government funds and/or in response to the May 2009 stress tests that found 10 of the largest banks to be deficient.

As the crisis unfolded, the capital levels of European banks were oftentimes worse than those of US banks, in part because few European countries had a leverage ratio requirement as the US did. Viewed as an important “safety-net”, a leverage ratio requirement was embraced as important by the European regulatory community in proposed modifications to the capital requirements – hence it is included in Basel III. In this sense, Basel III proposes to align European banks with a provision that has existed in the US since the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA).

Questions for Bank Capital and Liquidity Rules Forum Participants:

- (1) The leverage ratio has at times been unpopular/controversial -- yet it is widely recognized as having been important during the financial crisis. Given the addition of such a requirement in Basel III, how and when should this modification be made to avoid the CCDC criticism that more stringent capital requirements could hamper recovery?**
- (2) Is now the appropriate time for firms to increase risk?**
- (3) Can firms adequately increase their risk assets in the current regulatory environment?**
- (4) Do the proposed regulatory changes create disincentives for financially-sound firms to take on appropriate risk?**

CCDC Assertion 3: An IIF report “...concluded that forcing banks to add up to \$1.7 trillion in capital to their balance sheets would reduce growth and undermine job creation at a time when the world needs more of both. The loss in GDP in Europe, North America, Japan and the United Kingdom could total 3.2% over the next five years and forgone employment of 7.5 million.”

Discussion: An examination of the report’s Table 5.1, that breaks the additional requirements down by country/region, confirms that most of the \$1.7 trillion is estimated to come from banks outside of North America.³ This is hardly surprising given the 20-year existence of the leverage ratio in the US and

³ Separately, but of similar magnitude to the IIF results, the May 2009 overview of the Federal Reserve’s stress testing results estimated that ten of the 19 firms considered needed to add \$185bn to capital buffers in aggregate, under the more adverse scenario. For more information see Board of Governors of the Federal Reserve System,



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Canada. Consistent with this fact, the report further notes that “The US economy is likely among the major economies to experience the smallest growth reduction resulting from regulatory reform.”

More importantly, Basel rules articulate *minimum* regulatory capital requirements. In practice, and particularly pre-crisis in the US, banks held well in excess of the minimum, recognizing the importance of maintaining a capital “buffer” (or “cushion”) to ensure they didn’t inadvertently breach the all-important leverage ratio – yet many still struggled during the crisis. Thus the argument that Basel rules – whether the existing version (known in regulatory circles as “Basel I”), the not-yet-fully-implemented Basel II, or the not-even-final-rule Basel III – are forcing banks to hold more capital is either incorrect or a reflection of just how dramatically their capital buffer has deteriorated in the face of a deteriorating balance sheet. Under the latter scenario, it is unclear which is worse for growth and job creation, increasing capital or failing to do so.

Questions for Bank Capital and Liquidity Rules Forum Participants:

- (1) How should/do firms determine the appropriate capital cushion to maintain in excess of minimum required regulatory levels?
- (2) What assumptions are made about the rate of buffer erosion in the face of deteriorating economic conditions?
- (3) How do firms vary their capital buffers according to the business cycle (above and beyond the variation that results from changes in the portfolio asset mix)?

CCDC Assertion 4: “Both Mr. Ackermann and Mr. Dimon are right. The cheerleaders for the imposition of higher bank capital requirements in the middle of the slump, like US Treasury Secretary Timothy Geithner and Fed chairman Ben Bernanke, are wrong.”

Discussion: Many bankers, including Mr. Ackermann and Mr. Dimon have been voicing concerns over modifications to existing capital regulations since well before the onset of the recent financial crisis. Similarly, regulators have long-worried about unintended procyclicality (implying increased capital requirements in bad times and reductions in good times), well before the latest regulatory debates.⁴ The rulemaking process in the US included a lengthy comment period and numerous meetings with industry officials to discuss and allay concerns. To suggest that US regulators are promoting procyclicality without regard to potential adverse economic implications is misleading. While it is true that as conditions deteriorated in 2008/2009 a number of banks needed to raise capital to meet regulatory requirements, that was a result of *existing* regulatory capital requirements, not, as CCDC suggests, the result of attempts to impose higher requirements.

The views of Mr. Ackermann and Mr. Dimon with respect to Basel III are more complex than CCDC suggests. Additionally misleading is the mention that “...the chairman of Deutsche Bank, Josef Ackermann, weighed in during a Frankfurt speech with a blistering attack on raising capital-asset ratios

“The Supervisory Capital Assessment Program: Overview of Results,” available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf>

⁴ See, for example, the request for comment in the 2003 Interagency Advance Notice of Proposed Rulemaking on Implementing the New Basel Capital Accord in the United States (Regulations H and Y) [R-1154], page 34, and comments in response, available at http://www.federalreserve.gov/generalinfo/foia/index.cfm?doc_id=R%2D1154&doc_ver=1&ShowAll=Yes



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in the middle of a slump”, armed with a special report produced by the Institute of International Finance (IIF). The press release the IIF issued in conjunction with the report notes:

“Dr. Josef Ackermann, Chairman of the IIF Board of Directors, Chairman of the Management Board and the Group Executive Committee, Deutsche Bank AG, said, ‘This study needs to be seen in the context of the IIF’s strong support of key financial reform measures, such as the new Basel III capital requirements and their implementation timetable.’”

CCDC cites a quote by Mr. Dimon that appeared in earlier in the *Financial Times*, “I think any American president, secretary of treasury, regulator or other leader would want strong, healthy global financial firms and not think that somehow we should give up that position in the world...” to further dismiss Basel III. At face, it seems to be an incontrovertible statement, one that regulators too might embrace. I for one certainly want strong, healthy global financial firms. The US banks in recent years have been among the global leaders – and I too do not think we should give up that position in the world.

Yet for more than two decades, the US has had some of the most stringent capital requirements in the world, and its banks have further held capital in excess of the required regulatory minimums. As recorded in notes from a 2004 meeting at the Federal Reserve with representatives from JP Morgan Chase⁵, “Economic capital tends to dominate decision-making relative to regulatory capital at JPMC and likely at other A-IRB banks [those firms that would be subject to the proposed Basel II rules], in part due to capitalization well in excess of regulatory requirements,” “A strong capital cushion serves as a signal of strength,” and “It is easy to overstate the impact of regulatory capital.” Such statements might even support the argument that US banks gained their position as a result of stringent capital requirements that both ensured viability at crucial junctures and enhanced their reputation. Of course I recognize that others might argue that success came in spite of such requirements. But to suggest that champions of stringent capital requirements are misguided or somehow less-supportive of the position of US banks in the world is misleading. In fact, in his January 2010 testimony before the Financial Services Inquiry Commission⁶, Mr. Dimon stated “JP Morgan Chase did not ask for, nor did we need, a capital infusion from the federal government. As I noted earlier, our capital ratios remained well in excess of recommended regulatory levels throughout the crisis, even excluding federal assistance.”⁷ Thus it can be argued that the maintenance of high levels of capital in the midst of an economic slump is crucial.

CCDC Assertion 5: “We can demonstrate the validity of the conclusion” [that it is wrong to increase bank capital requirements] “with ease.”

Discussion: CCDC’s discussion of the capital-asset ratio calculations fails to take into account the risk-sensitivity that is the hallmark of both Basel II and Basel III. While the analysis might be appropriate if one is evaluating the adequacy of existing capital requirements, it is curious when trying to refute Basel II/III. In fact, contrary to the assertion that “If we hold the level of a bank’s capital constant, an increase in its capital-asset ratio requires that the level of its assets must fall”, under Basel II/III, a bank would be

⁵ Available at http://www.federalreserve.gov/SECRS/2004/March/20040323/R-1154/R-1154_132_1.pdf

⁶ Available at <http://media.ft.com/cms/785b60f0-0054-11df-8626-00144feabdc0.pdf>

⁷ The testimony goes on to assert that JPMC accepted assistance at the behest of regulators who suggested it would encourage others to do the same by helping to mitigate concerns about stigma.



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able to meet higher capital-asset ratio requirements simply by shifting its exposures into higher-quality (less risky) assets. One would think this is exactly what is needed in the face of deteriorating economic conditions. Of course, an excessive flight-to-quality also can prove dangerous and present challenges for recovery. But in principle, the added risk sensitivity that Basel II/III embrace should help distinguish between these scenarios better than existing (Basel I) capital regulations would, and hence might hasten recovery. Put another way, it is important to recognize that which should come first, lower capital requirements or economic recovery, is far from clear. Higher minimum regulatory capital requirements should result if the risk associated with an exposure increases. Similarly, if the risk of that exposure decreases, the regulatory minimum should decrease as well. While it is true that increasing capital at the wrong time can inhibit the kind of investment that is needed in a recovery, one first needs to be sure that risk has begun to decline and the recovery is indeed underway.

CCDC then goes on to argue that if assets must fall, liabilities (demand deposits) must as well, resulting in a money supply contraction. Even if we accept the premise that assets must fall (which we do not), then the assertion that liabilities would similarly fall merely reflects the simple balance sheet accounting identity. Beyond that, though, there are few logical steps missing in claiming that falling liabilities means demand deposits would fall. First, while demand deposits may represent a large portion of the liabilities on a bank's balance sheet, they are by no means the only liabilities. Second, it is unclear how a decline in demand deposits would be achieved: would depositors be spooked by the decline in assets and pull their money out? Would the bank start turning away depositors?

Questions for Bank Capital and Liquidity Rules Forum Participants:

- (1) **At what point in the economic cycle should capital (both minimum required regulatory capital and a bank's overall capital) begin to increase?**
- (2) **To what extent do banks try to hold their capital levels constant?**

CCDC Assertion 6: If those who want higher bank capital-asset ratios are successful, "the United States might, unfortunately, revisit 1937, when an unexpected recession – a double dip – followed the Great Depression. One contributor to that double dip was an increase in reserve requirements imposed on US banks by the Federal Reserve."

Discussion: Reserve requirements are not the same as capital requirements, nor do they fluctuate correspondingly. The concern that reserve requirements might increase is unfounded; throughout the recent crisis, the Federal Reserve has relaxed reserve requirements in a variety of dimensions.

Questions for Bank Capital and Liquidity Rules Forum Participants:

- (1) **What role do capital requirements and reserve requirements play in economic recovery?**
- (2) **Assuming both will need to increase in the future as the recovery gets underway, what timing is appropriate for these increases?**



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Conclusion

The CFS values balanced presentation of views.

Any discussion of bank capital should carefully weigh the benefits as well as costs of more stringent capital requirements. In assessing costs, regulators have long considered – and worked to prevent – the possibility of unintended procyclicality or adverse competitive effects even as they have pushed through modifications to existing capital regulations.

The debate around these issues underscores an important point: we should be careful not to enact policy that inhibits our recovery. Whether Basel III fits into that category or not remains to be seen. The issues surrounding modifications to capital regulations are complex and Basel II, as well as its proposed successor Basel III, are far from perfect. Increasing the risk sensitivity of capital requirements moves us in the right direction by affording greater transparency regarding the riskiness of a banks' portfolio. But that same transparency may inhibit risk-taking that could help promote economic recovery. The mandated requests for comment that accompany the US rulemaking process provide an important opportunity to express concerns and alert regulators to any adverse consequences. We hope that our forum provides another.

References and further information

Basel Committee on Banking Supervision website on Basel III (contains links to Basel II documentation also): <http://www.bis.org/bcbs/basel3.htm?ql=1>

Department of the Treasury, Federal Reserve System, and Federal Deposit Insurance Corporation (2007), "Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II; Final Rule," *Federal Register* 72 (235), December 7, 2007, available at <http://edocket.access.gpo.gov/2007/pdf/07-5729.pdf>

European Commission (2006), "Directive 2006/49/EC of the European Parliament and of the Council on the Capital Adequacy of Investment Firms and Credit Institutions," June 14, 2006.

European Commission website on Regulatory Capital Developments:
http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#20050928

Federal Reserve website on Basel II: <http://www.federalreserve.gov/generalinfo/basel2/>

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