"Strengthening Global Capital
An Opportunity Not To Be Lost"
Remarks by
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Introduction

Basel III is scheduled to be finalized by year-end and presented to top regulators and central bankers for approval in early 2017. The original goals of the six-year-long effort were to "reduce the complexity of the regulatory framework and improve comparability" and "address excessive variability in the capital requirements for credit risk."1 These goals are laudable.

Unfortunately, as memory of the 2008 financial crisis has waned, the exercise has added a third objective: ensuring that the final calibration of the Basel III framework not significantly increase overall capital requirements.2 Should this occur, it would truly represent an opportunity lost. Instead of strengthening the foundation of the global financial system, as was intended with the original goals, Basel III would legitimize the inadequate status quo and undermine the long-run objective of real financial stability.

In my remarks today I will discuss key factors that are at the core of the on-going debate over what defines adequate capital. First, I will discuss the controversy over alternative measurements for judging adequate capital. Simply stated, most measurements are too complicated, set too low, and often vary by jurisdiction in ways that weaken global financial stability. Second, relying only on public information, I will note changes that the Basel Committee appears to be considering that will weaken current standards and why these changes are ill-advised. Third, I will reiterate my concerns regarding Total Loss-Absorbing Capacity (TLAC) and its use as a means to justify lower levels of capital and require firms to issue more debt.

Capital Adequacy

Capital levels are reported as a ratio, with equity capital amounts in the numerator and some measure of a firm's assets in the denominator. The simplest measure of capital, a leverage ratio, uses accounting equity (adjusted to remove intangible assets) and accounting assets. For decades, however, the Basel Committee has preferred a risk-based capital ratio, which uses a regulatory measure of capital and assets. Under this framework, regulators allowed certain debt instruments, with minimal equity-like characteristics, to be folded into the numerator, and for assets to be discounted by ever-lower risk weights in the denominator. These adjustments encouraged increased leverage among firms and were often amplified in certain jurisdictions.

During the 2008 financial crisis, markets quickly turned away from measuring bank stability with risk-based ratios and by necessity adopted the leverage ratio for its greater reliability and comparability across banks and jurisdictions. Adjusting leverage ratios to put firms on the same accounting standard quickly showed that while banks' risk-based capital ratios were often roughly equal, their leverage ratios often varied widely.

Today, the average leverage ratio for the world's largest banks is around 5.5 percent.3 This average conceals significant outliers in certain jurisdictions that have leverage ratios at pre-crisis levels of less than 4 percent, while they report risk-based capital ratios on par with the world’s strongest banks. Such inconsistency serves to undermine market confidence and financial stability, and is what the Basel Committee originally sought to fix.

One bank's recent and widely publicized experience serves to demonstrate the effects of such inconsistent standards. Its tier 1 risk-based capital ratio measured 14 percent, while its leverage ratio was 2.68 percent. It became evident that markets viewed the leverage ratio as the more credible measure of the bank's capital position, as counterparties fled at the first sign of trouble.4 For these reasons, the Basel Committee should not promise that there will be no significant increase in industry capital levels, and it would be a further mistake to enshrine such capital standards with a regulatory stamp of approval.

The last financial crisis exposed significant weaknesses in the Basel capital framework. Risk-based capital did a poor job controlling management's risk appetite. It misrepresented to the public the level of risk in banks and the industry. It resulted in large misallocations of capital, of which a significant amount was distributed, leaving banks ill-prepared and inadequately capitalized to absorb losses. For regulators to ignore these lessons and begin to recalibrate and weaken the Basel III framework before it is even fully implemented is counterintuitive and counterproductive.

The proposed recalibration of Basel III is especially disconcerting given that since 2008–2009 the largest banks have grown significantly in size and importance, and remain highly complicated and highly leveraged. These conditions underscore the dangers to the broader economy of having too little capital to absorb future losses when they inevitably arise. Looking back, for example, the amount of losses and the amount of TARP assistance that U.S. banks took in 2008 equaled nearly 6 percent of assets. This means that if a systemically important U.S. bank incurred similar losses today, its tangible capital would be gone. In response, market confidence would be shaken, which could trigger fears of destabilized firms despite the presence of the Basel III framework. In Europe, where tangible capital ratios are even lower, this level of loss would be catastrophic.

While progress has been made in strengthening the capital positions of some of the largest banking organizations, the numbers show that "improvement" is not the same as "adequate." Thus, it is disappointing that some are suggesting that now is not the time to raise capital further. The issue has even taken on a political tone, as some assert that

improving capital would be detrimental to the fragile global economy. However, easing requirements for banks that are running on razor-thin levels of capital is not the answer, and allowing banks to distribute substantial amounts of capital through dividends and stock buybacks,[5] as they have since the 2008–2009 financial crisis, does not strengthen economies. Banks would better serve the goal of stable long-term economic growth with well-capitalized and stronger balance sheets.

I would add, as I have elsewhere, that it is a fallacy to say that increased levels of equity capital in banks undermine their ability to lend and take risks, which becomes a drag on economic growth. More accurately, research shows that undercapitalized banks when under stress curtail lending, because they hold excessive debt against too little equity to absorb losses. Having higher levels of tangible equity funding assets versus debt goes a long way in mitigating a "credit crunch."[6] Thus, holding banks to higher standards of capital, judged through the leverage ratio, provides for the best long-run finance and economic outcomes.

Redesign and Recalibration

Despite these findings, the recent push for capital neutrality persists and has become a political mandate pressing regulators to weaken the leverage and risk-weighted standards under the rubric of recalibration. The United States should not follow this path nor allow its capital mandates to be compromised in this fashion.

It is no secret that I have long been a critic of the well-intentioned but impossible task of forecasting and assigning risk-weights to assets. A risk-based system is inherently ineffective for judging a bank's loss-absorbing capacity because management tends to underreport risks and maximize leverage in an effort to boost short-run returns. Following the lessons of the crisis, these risk-based standards are now being implemented in conjunction with the leverage ratio as a counterweight to these weaknesses. Regulatory authorities would be remiss in their obligations to the long-run interest of the public and the financial system if they do not ensure that the leverage ratio remains strong and uncompromised.

These lessons, in fact, suggest that the leverage ratio should be the benchmark for judging bank capital strength. It is less susceptible to management manipulation and assumes no special regulatory clairvoyance regarding bank risk. It represents a fundamental stock of non-borrowed funds that is available to absorb losses regardless of the source of such loss. It does not discern among losses that flow from credits, operations, fraudulent activities, publicly announced legal penalties, or any other risk regardless of whether it is captured in the risk-weighted measure.

Therefore, the idea of recalibrating the leverage ratio should be fully rejected if it introduces a risk-based component that would undermine these very advantages and weaken the leverage ratio’s usefulness. Proposed changes to the leverage ratio include, for example, exempting central bank placements[7] from the risk-weighted measure and allowing initial margin to be recognized as an offset to exposure.[8] Either of these

proposals, if adopted, would reduce the capital required to maintain a minimum leverage ratio and the funds available to absorb losses. A justification for such proposals is to facilitate monetary policy and to incentivize derivatives clearing. However, there is no evidence that suggests such actions would promote these goals on a sustained basis.

Adjustments to Basel's risk-weighted capital measures are also being proposed, not to capture risk but to assure capital neutrality. Modifications to risk weights under consideration include lower weights for residential mortgages, although they were at the center of the last financial crisis. Other proposals would eliminate or reduce capital charges for operational risk.9 Ironically, these proposed changes come at a time when the largest banks continue to carry troubled assets, have experienced significant operational losses, and are exposed to elevated cyber-security risks.

Confusing matters further, adjustments are being considered for risk-modeled approaches with the goal of lowering input floors. This goes against Basel's original intent to constrain this practice for measuring credit risk in the loan and investment portfolios and adjust for the weaknesses that inherently underlie models. The mere fact that risk-based approaches must always be constrained and negotiated by regulators—through the complex processes of flooring inputs and outputs, for example—only underscores the necessity of a simple, robust, and uncompromised leverage ratio.

To be sure, risk-based analysis can be an important management tool for the internal measurement and allocation of economic capital and for stress-testing bank performance. However, this use of risk-based measures does not justify it serving as a supervisory tool for determining loss absorbency. Such use has proven repeatedly to be unreliable.

Regulatory risk-based standards by their very nature are lagging measures, designed and calibrated based on each previous crisis. They involve parameters that are fiercely negotiated for years and subject to the political climate of the times, as we are witnessing first hand in Basel today. The Basel Committee's current mandate to achieve capital neutrality requires adjustments unrelated to safety and soundness. To what end? It is not designed to capture actual risk inherent in the assets subject to weighting, but rather to ensure that capital requirements for the industry remain unchanged. This policy approach does nothing to improve the stability of the global financial system; it only weakens it.

TLAC and Long-Term Debt Requirements

Intertwined in the discussion of capital adequacy and financial stability is Total Loss-Absorbing Capacity. TLAC requires large, interconnected banking firms to hold certain levels of long-term debt to improve their resolvability should they fail. The goal is laudable, but as I have noted elsewhere, it is fraught with problems. An added long-term debt requirement places earnings demands on the banking system and could be counterproductive, especially during a period of financial stress. Those familiar with

TLAC and its requirements fully understand that as firms issue large amounts of additional, and more expensive, long-term debt— increasing their leverage— they must earn commensurately higher returns to meet debt service and avoid default.

It is paradoxical to suggest that the best way to manage the effects of excess leverage and financial vulnerability is to layer on even more leverage, potentially raising financial vulnerability. For example, in a recession if earnings become insufficient to make holding company debt payments, the resources to meet the obligations would likely come out of the bank to avoid default. Unlike dividends, these payments cannot be suspended without dire consequences, and thus they undermine an operating bank's ability to retain earnings for its own capital needs following a downturn in the economy. This can only undermine financial stability and economic growth.

Furthermore, TLAC has other destabilizing features. Because it is debt, buyers can—and often do—get insurance on potential default through the CDS market. This increases the level of interconnectedness in the financial system and amplifies the risk of contagion.

The acceptance of TLAC as a capital replacement is untested, and there is no assurance that the level of debt required would be sufficient to avoid panic by both the debt and equity holders during a time of financial stress. This is no time for unsound experiments.

Conclusion

Momentum is developing within the Basel Committee to undermine measures that could increase bank capital levels, and some jurisdictions are threatening to walk away if the measures are thought too strict. The United States should avoid joining this race to the bottom. The benefits of stronger capital levels are evidenced in U.S. firms that have higher price-to-book ratios and that are viewed as the counterparty of choice among market participants.

Finally, while I have always been critical of the Basel risk-based capital framework, it does remain a principle tool in judging capital adequacy and, therefore, Basel III should be strengthened not compromised. Strengthening the framework, until recently, has been the common objective of global regulators as they increased the overall quality and quantity of capital within the risk weighted measure. In addition they increased reliance on the leverage ratio for judging the overall soundness of balance sheets. This sturdier framework will be significantly compromised if proposed changes to the leverage ratio and to Basel III are adopted. This short-term focus of the industry has been made a political mandate, but as regulators we are obligated to do better than that.

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The views expressed are those of the author and not necessarily those of the FDIC.

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