Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Other Shoe: "Basel III"*

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Elsewhere in this issue, Robert Barnett suggests that a ***cost/benefit analysis*** be conducted on the pending financial regulatory reform bill. That bill, however, is only one of many policy responses to the global financial crisis. U.S. and international financial regulators have undertaken an equally important, but less visible, effort to rewrite the capital standards for large banks and to impose a new international liquidity standard. In the wake of the financial crisis, support for strong capital and liquidity standards is almost universal. Yet, in their current form, these proposals, which have been informally dubbed "Basel III," could have unintended consequences for economic growth and stability.

The proposed standards were released by the Basel Committee on Bank Supervision last December. The comment deadline on those proposed standards closed last month, and G-20 leaders have called for their adoption by the end of this year.[1] In the United States, the standards are not self-executing. The federal banking agencies must issue proposed regulations, subject to notice and comment, before they would apply to U.S. institutions.

The key feature in the capital proposal is a revision in the definition of tier 1 capital. Under the current rule, tier 1 capital may include instruments other than common equity and retained earnings. For example, tier 1 capital now includes minority interests in consolidated subsidiaries, mortgage servicing rights, trust preferred securities and other hybrid instruments, and tax deferred assets. Under the proposal, tier 1 capital would be limited to common equity and retained earnings, with only a limited amount of other equity-like instruments permitted.

At the same time, the capital proposal calls for additional capital. It requires banking organizations to hold a capital buffer that is in excess of

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] Comments have been posted on the Basel Committee's web site. See http://www.bis.org/publ/bcbs165/cacomments.htm

minimum capital requirements (which have yet to be proposed by the Basel Committee, but are expected to be higher than the current 8% minimum). The Basel Committee also is considering a capital surcharge on systemically important banking organizations.

Recent experience supports higher capital standards. However, the potential consequences of higher capital standards need to be fully evaluated. During a recent program on the proposed standards hosted by the Federal Reserve Board, one industry panelist stated that the proposed deductions from tier 1 capital would reduce the capital for the nation's top banks by $200 billion. Such a dramatic reduction in existing capital, combined with even higher capital requirements, would reduce new credit needed for economic growth. It also would encourage some activities to migrate to firms that are not subject to the Basel rules.

The potential impact of the proposed liquidity standards may be even more severe. The Basel Committee has proposed two liquidity standards. One is a liquidity coverage ratio, which is intended to serve as a short-term (30 day) liquidity buffer. The other is a net stable funding ratio, which is intended to serve as a longer-term (1 year) liquidity buffer. For purposes of these ratios, banking organizations would be required to hold a narrow range of extremely liquid, highly creditworthy assets, principally sovereign debt. Additionally, in calculating the ratios, banks would be required to assume significant runoff in retail deposits, and must exclude GSE debt and GSE-backed securities and unused FHLB advances.

At the Federal Reserve Board program (noted above), one industry analyst noted that the proposed liquidity standards would require the top 25 U.S. bank holding companies to raise $1.3 to $1.9 trillion in new long-term debt, an amount that is 4 to 6 times the annual long-term debt issuance. If this assessment is accurate, the liquidity proposal would materially diminish the ability of banks to provide new credit for economic growth.

The liquidity ratios also may exacerbate financial shocks as banks are forced to shift from one category of "safe" assets to another. For example, the excessive reliance on sovereign debt in the ratios could have a destabilizing impact if such debt suffers a downgrade (e.g., Greece) and banks are required, en mass, to find substitute sources of liquidity.

In sum, the financial crisis demonstrated a need for better capital and liquidity standards. However, overly conservative standards can have consequences for economic growth and may even have a destabilizing effect in some cases. Fortunately, the Basel Committee has formed working groups dedicated to: (1) calibrating specific minimum capital percentage requirements and assessing the impact of those minimum requirements on the economy; (2) evaluating the trade offs between higher capital and liquidity requirements on the cost and availability of credit and the potential for regulatory arbitrage (e.g., transactions to flow to unregulated firms); and (3) reviewing potential transitional procedures based upon macro economic modeling of the impact of the proposals on GNP, inflation, and other economic indices. We can only hope that such assessments are not overshadowed by political forces that seek to punish the banks for the financial crisis. Otherwise, the Basel III could have some significant unintended consequences.

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