Bank Capital Requirements: History and Issues

Bank Capital Is A Long Standing Micro-Prudential Tool

- Protects stability of <u>individual</u> bank
- Not a requirement to hold or reserve funds.
- Affects balance between debt and equity.
- Requirement to hold equity acts as a constraint on leverage (limit on bank borrowing)
- Equity can absorb losses and stands between bank and potential taxpayer bailout
- A traditional means to ensure solvency.

But Capital / Equity Requirements Are Relatively Recent

- Date back to only the Basel Agreement of 1988

- Were originally sold as a form of deregulation

The Evolution of Capital Regulation

- Movement toward capital regulation began in 1983
- Background is 1982 Mexican default and third world debt crisis
- Banks did not hold capital against loans to third world countries

Banks Argued That Capital Requirements Would Impact Competitiveness

- Lower capital held in European banks – permitted more borrowing
- Wanted international agreement to keep even playing field
- 1988 Basel Accord

Capital Requirements Seen As A Form Of Deregulation

- Replaced older reserve requirements that actually did require banks to “reserve” funds
- Replacing reserves with capital regulation would improve bank profitability
- Capital requirements were consistent with the deregulatory movement toward reliance on market forces rather than government intervention.
- Relied on profit-driven equity investments in private markets, not reserves with central bank.

Strengths, Weaknesses, and Issues Involved With Capital Regulation

- Stands between bank and potential bailout
- Can limit economic externalities associated with excessive borrowing
- Can be supplied from retained earnings through provisioning
- However, experience has shown many potential problems associated with capital regulation

Can Procyclicality Be Controlled?

- Markets will supply capital in a boom and withhold capital in a downturn.
- Can exacerbate economic instability
- Changes in asset prices increase the procyclicality of capital regulation – especially when you must mark to market.
- This is particularly true for risk-adjusted capital
- Possible solutions -- countercyclical capital buffers, capital requirements based on "stressed" asset prices

Can Be “Gamed”

- Capital arbitrage
- Capital risk adjustments can be manipulated by banks
- Lower quality capital – cannot be used to absorb losses
- Activities migrate to unregulated “shadow banks” with no capital requirements

Overly Market/Profit Driven?

- Is capital primarily attracted by profits? If so, does that increase incentives to take risk?
- Can a regulatory tool that depends on market responses to profitability ensure soundness?
- Will larger capital requirements for banks ensure balanced economic growth?

Macro-Prudential / Systemic Effectiveness?

- Capital can be an effective tool for individual bank solvency
- Can it be extended to ensure stability of the overall financial system?
- Increased capital charges to deter risky activities, excessive size, interconnectedness?

Potential Additional Dodd-Frank Changes

- Additional capital charges for large/interconnected institutions.
- Additional capital charges for especially risky activities (Volcker Rule)
- Macro-prudential regulation in addition to capital regulation.
- Capital requirements for non-bank financial entities ("shadow banks").

Changes In Capital Rules – Basel III

- Tier 1 (high quality capital) requirement increased from 2 percent to 7 percent.

- Counter-cyclical capital buffer of an additional 2.5 percent reserved during booms.

- Absolute leverage limits set in addition to risk-adjusted capital requirements.

Changes In Capital Rules – Basel III

- "Stressed" capital charges -- based on asset prices from a period of economic stress.
- Unspecified additional capital charges for large and interconnected organizations.
- Will not be fully phased in until <u>2019</u>.

Do We Need to Do More – Possibly Move Back Toward Reserve Requirements?

- Reserves can be created and extinguished as needed on a countercyclical basis.
- Reserves held with the Fed are not marked to market; they retain their face value.
- Reserves maintain investor confidence

Or Can Strong Implementation of Bank Capital Reforms Bring Greater Stability At Low Cost?