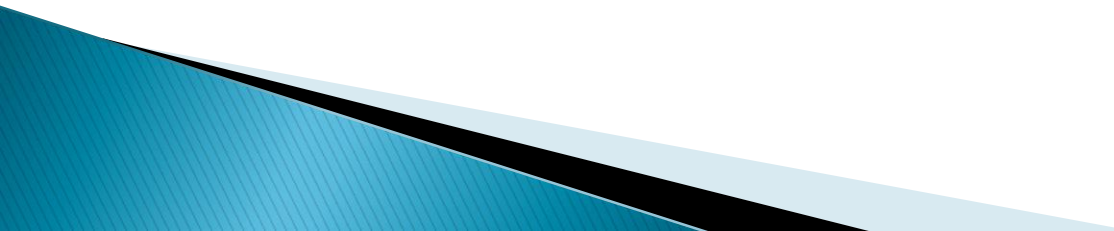


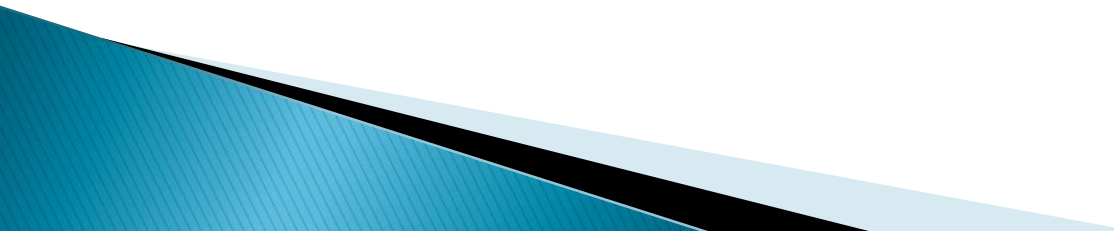
# Bank Capital Requirements: History and Issues



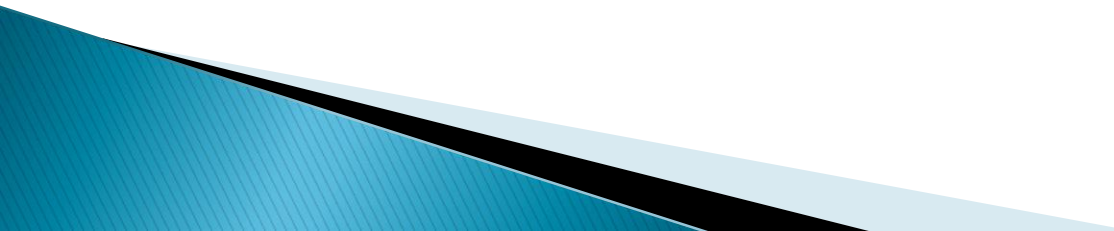
# Bank Capital Is A Long Standing Micro-Prudential Tool

- ▶ Protects stability of individual 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.
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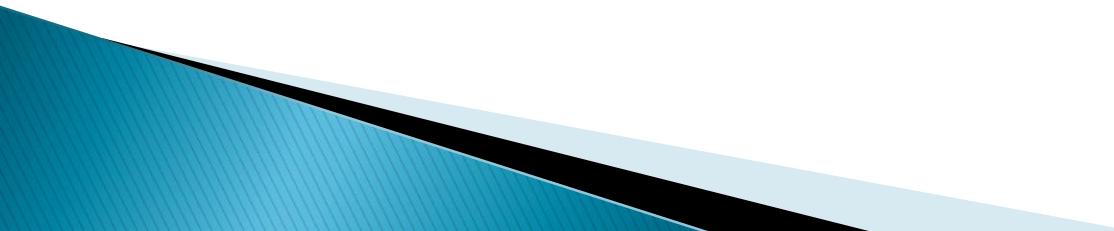
# But Capital / Equity Requirements Are Relatively Recent

- ▶ Date back to only the Basel Agreement of 1988
  - ▶ Were originally sold as a form of deregulation
- 

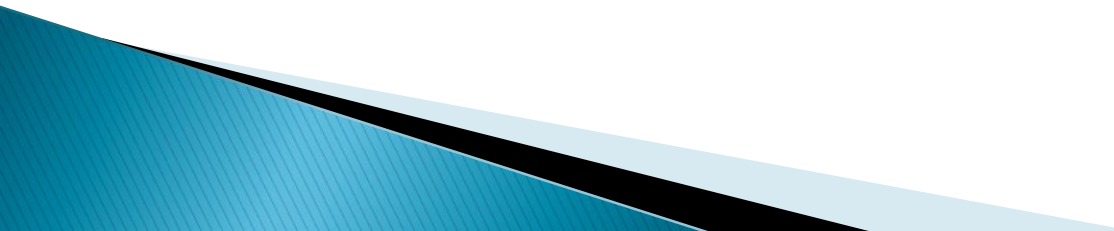
# The Evolution of Capital Regulation

- ▶ 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
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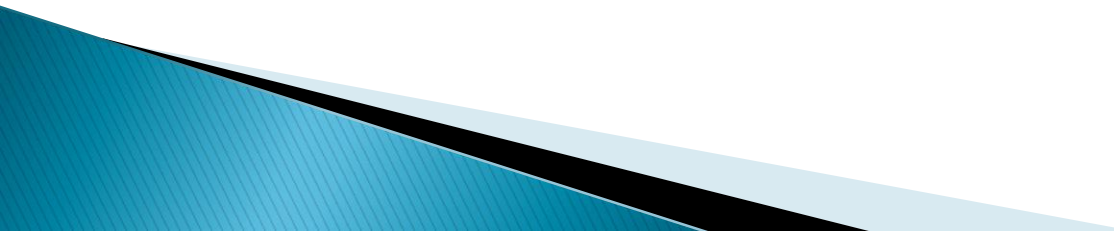
# Banks Argued That Capital Requirements Would Impact Competitiveness

- ▶ Lower capital held in European banks – permitted more borrowing
  - ▶ Wanted international agreement to keep even playing field
  - ▶ 1988 Basel Accord
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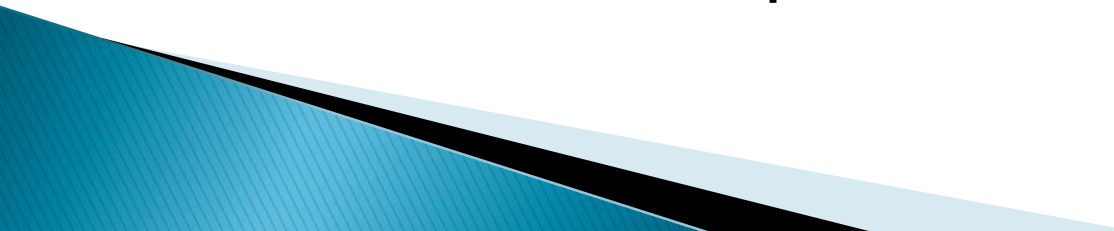
# Capital Requirements Seen As A Form Of Deregulation

- ▶ 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.
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# Strengths, Weaknesses, and Issues Involved With Capital Regulation

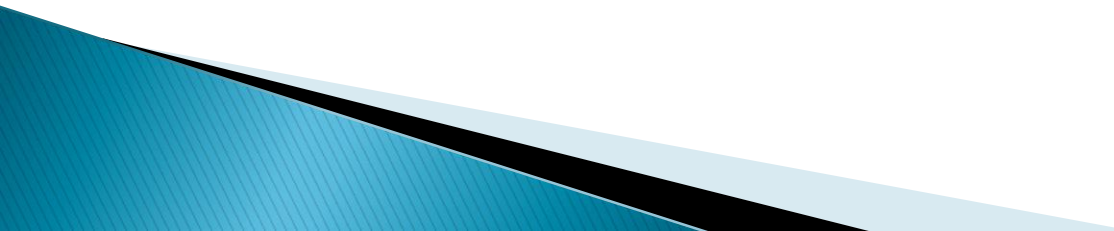
- ▶ Stands between bank and potential bailout
  - ▶ Can limit economic externalities associated with excessive borrowing
  - ▶ Can be supplied from retained earnings through provisioning
  - ▶ However, experience has shown many potential problems associated with capital regulation
- 

# Can Procyclicality Be Controlled?

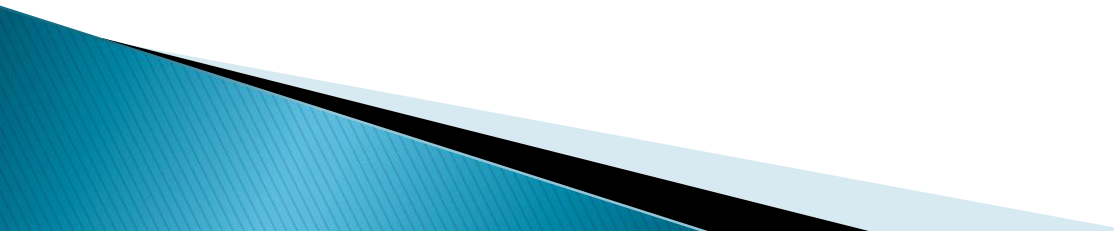
- ▶ Markets will supply capital in a boom and withhold capital in a downturn.
  - ▶ Can exacerbate economic instability
  - ▶ Changes in asset prices increase the procyclicality of capital regulation – especially when you must mark to market.
  - ▶ This is particularly true for risk-adjusted capital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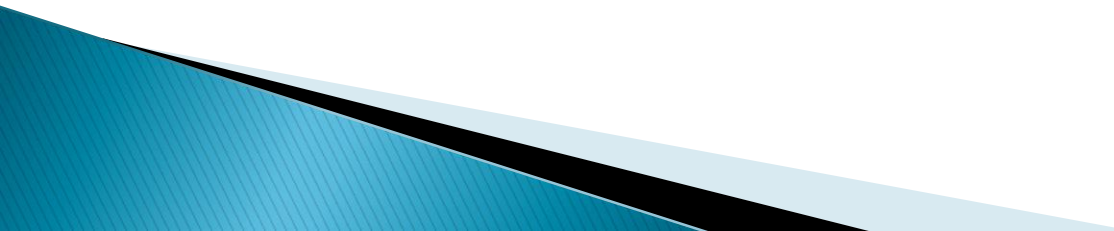
# Can Be “Gamed”

- ▶ 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
- 

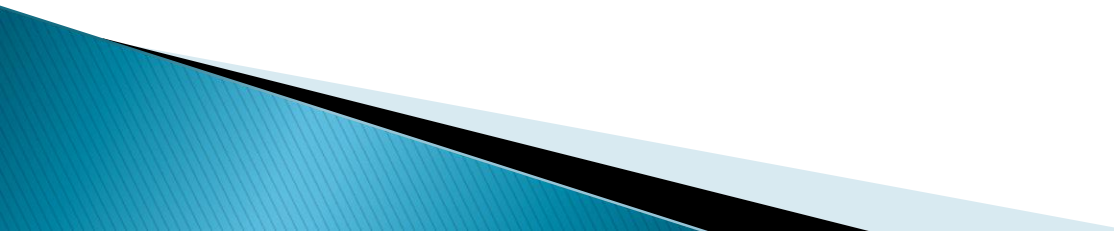
# Overly Market/Profit Driven?

- ▶ 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?
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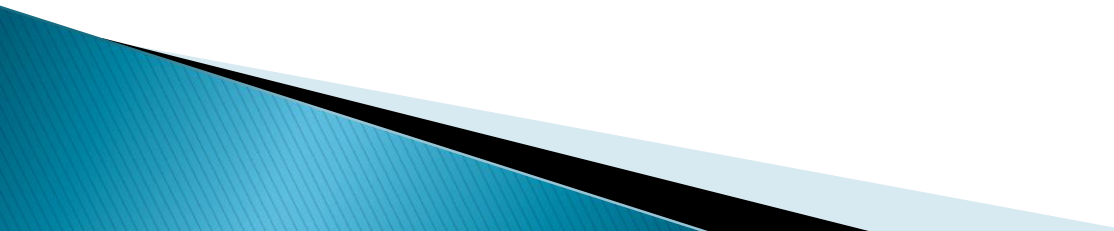
# Macro-Prudential / Systemic Effectiveness?

- ▶ 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?
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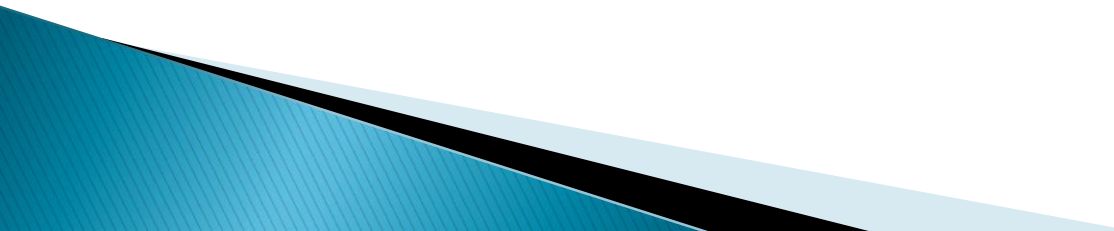
# Potential Additional Dodd–Frank Changes

- ▶ 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”).
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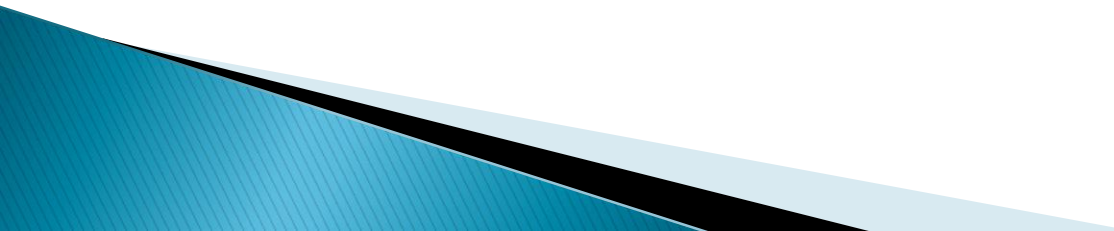
# Changes In Capital Rules – Basel III

- ▶ 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 2019.
- 

# 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?**

