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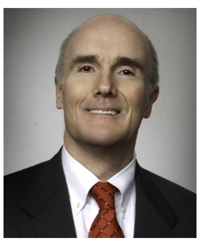
RISK MANAGEMENT

Capital

Towards a Better Measure of Regulatory Capital



By Charles M. Horn

Regulatory capital continues to dominate the financial reform debate, and the intensity of that debate has recently increased. In the past several months, influential financial regulators and legislators have raised questions about the overall effectiveness and viability of the Basel risk-based capital accord, with some suggesting that higher levels of leverage capital, especially for large banks, would better address and contain systemic and other banking risks. In addition, questions have been raised about the effectiveness of higher capital levels in warding off the adverse financial and social effects of ''too big to fail'', and their corresponding impact on bank profitability and competitiveness.

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The debate over capital, however, has not yet resulted in any broad consensus about what would be an optimal regulatory capital framework going forward. In part, the failure of consensus reflects nothing more, or nothing less, than the fact that the two primary regulatory capital models—leverage capital and risk-based capital—both suffer from significant design flaws. Those who question the effectiveness of leverage capital point out, correctly, that leverage capital is an overly simplistic tool that fails to capture the material risks on a bank's banking and trading books, including off-balance sheet risks. By the same token, those who question the efficacy of risk-based capital argue, also correctly, that risk-based capital creates incentives for regulatory capital arbitrage, may encourage banks to overcommit to asset classes whose riskiness may change over time, and depends on modeling assumptions and methodologies whose effectiveness is compromised by their inaccuracy and sheer complexity. In other words, everyone is right, here. So, is there a consensus to be found, and, if so, what should that consensus be?

Turning first to risk-based capital, we can see that Basel III is becoming increasingly unpopular in the U.S. Several key regulators have publically raised questions about its overall effectiveness, and others, such as Senators Brown and Vitter, would like to do away with it. But Basel III's unpopularity does not mean that it will or should go away. Notwithstanding the dissenting voices, the U.S. regulatory agencies as a group still are committed to Basel III implementation. Further, Basel has been many years in the making and has become one of the foundations of the international financial regulation framework. For the U.S. supervisors to turn their backs on Basel III at this late stage of implementation would send a highly troubling and potentially destructive message to the international supervisory community, and might seriously compromise ongoing and critical initiatives on international financial regulatory cooperation. In addition, risk-based capital, if intelligently applied, may hold out better prospects for assuring that a bank's regulatory capital levels properly reflect the nature and tenor of financial risk a bank has taken on, both on and off the balance sheet.

Basel Implementation Issues

But there are serious issues with the development and implementation of Basel III in the U.S., and those issues should be addressed. In particular, the current U.S. regulatory proposals to apply large portions of Basel III to the U.S. banking community in general, and not just to the large banks, need to be rethought. The application of complex risk-based capital requirements to the community and regional bank populations will substantially raise compliance costs and risks for these institutions. Further, the balance sheets of most community banks are far less likely to contain banking or trading risks that cannot be adequately captured by a leverage capital requirement, and for those few smaller banks that choose to embark on exotic balance sheet management or trading adventures, the existing supervisory system is more than capable of putting an early stop to those activities; hence, the stability of the U.S. banking system is not likely to be compromised by omitting smaller banks from Basel III's purview. It also is no accident that Basel II and its progeny, Basel III, were designed primarily for the large, internationally active banks, and scaling the U.S. proposals back to apply only to the large U.S. banks could be done without undermining in any material respect the Basel Accord or compromising its international implementation.

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By contrast, the appeal of leverage capital lies largely in its transparency and simplicity, particularly for the community banks. But the current leverage capital requirements do not reflect the variations of risk that exist on a bank's balance sheet and thus provide no capital incentives for banks to manage their balance sheet risk profiles (which is one reason why risk-based capital was created in the first place), nor do they currently capture off-balance sheet risk. Basel III, which creates an international leverage capital requirement, and the proposed Brown-Vitter legislation in the U.S., try to address the latter shortcoming by creating a leverage standard that incorporates certain off-balance-sheet exposures, whereas Brown-Vitter would materially increase core leverage capital requirements for all banks (but especially large banks). These changes, in turn, could substantially improve the efficacy of leverage capital. In addition, more discipline and consistency in what constitutes ''good'' capital—common Tier 1 equity—can be adapted and applied to the broad U.S. banking community without much difficulty.

That being said, if leverage capital were to become the foundation capital requirement in a future U.S. regulatory environment, the current levels of required leverage capital are too low and need to be increased. Increasing current leverage capital requirements, however, is not at all inconsistent with Basel III, and also fits reasonably well within the Dodd-Frank Act capital framework. Whatever capital arbitrage risks are presented by leverage capital (and risk-based capital creates its share of arbitrage opportunities), it is conceptually straightforward in principle and amenable to implementation at all levels of the US banking industry.

Room for Leverage and Risk Based Capital

Putting this all together, both leverage capital and risk based capital have a place in the U.S. regulatory framework, but the current emphasis on risk-based capital needs to be modified. A strong leverage capital requirement that is measured against balance sheet assets and extends to the most important classes of off-balance exposures should be more than sufficient to reasonably assure the financial soundness of most of the U.S. banking industry, even if it lacks the tailored ''perfection'' of risk-based capital. By the same token, risk-based capital should be fundamentally a large bank capital management tool, and it should be a ''one way'' tool, namely, one that would require more, rather than less, regulatory capital for banks whose balance sheets or off-balance sheet exposures present higher levels of credit, trading or operational risk. And we would do well not to demonize regulatory capital by claiming that too much of it will reduce bank profitability or competitiveness. Requiring U.S. banks to hold more capital might reduce bank returns to some extent, but, if this impact extends across the whole banking industry, no one gains a competitive advantage, at least domestically. Nor should it materially impact U.S. bank competitiveness vis-a-vis the international banking community, which will be required to increase its capital levels under Basel III and a variety of other international implementation initiatives.

At the same time, we do need to recognize the essential limitations of capital as a regulatory risk management tool, and that more capital cannot solve all of whatever ails the financial services industry. In particular, additional capital—whether risk-based or leverage—will not ''cure'' the too-big-to-fail problem. At best, it can only reduce the likelihood that a large, failing U.S. bank will need to be shored up by U.S. governmental assistance. The regulatory agencies continue to speak as if the too-big-to-fail problem can be solved by more capital, orderly liquidation, and better systemic regulation, and others—including Senators Brown and Vitter—believe it can be solved by prohibiting taxpayer subsidies for failing financial institutions. But the too-big-to-fail problem cannot be solved, if only because when (not if) the time comes in the future that a large, interconnected bank comes close to failure, the U.S. government will—and should—do whatever it takes to prevent a financial system meltdown. To put it colloquially, when it comes to eliminating too-big-to-fail, the perfect is very much the enemy of the good, and our overtaxed regulatory resources can be far better used to achieve that which is good, rather than that which is

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perfect. And the same principle should apply to the regulatory capital implementation process.

To sum up, the U.S. regulatory capital debate might be moving in the right direction, and we can hope that what emerges is a more manageable and confidence-inspiring regulatory capital measure that is suited for small and large banks alike, as well as their federal and state supervisors, and benefits the financial system in general. This approach might be too simplistic for some, but it is a way forward that all can understand and accept.