

# Basel II: A Bridge Too Far

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# Purpose of Basel II

- The purpose of Basel II, like Basel I, was to introduce into the bank capital computation the element of risk that the market would introduce if the regulation of banks had not blunted market discipline

# Effect of Market Discipline

- Where market discipline is present and unimpaired, debt holders require companies to hold enough capital to reduce the risk of failure
- This capital requirement is risk-based—the amount of capital is related to the risks of the company as perceived by the market
- Banks, perceived as government backed, are required to keep less capital than other businesses

# Government must protect itself against weak bank capital

- Government must protect itself against the consequences of its backing and regulation of banks
- If banks are not holding enough capital, government will suffer losses
- Bank failures could cause economic decline and other systemic effects
- The best way to do this would be for the government to replicate what the market would do

# But: can a model replicate reality?

- This is very doubtful
- Although the impact of tax policy changes on government revenues has been modeled by generations of economists, this year the forecast for the deficit missed the mark by \$172 billion
- the original OMB forecast was \$420 billion; the actual deficit was \$248 billion
- This does not say much for the ability of this model to replicate the real world, and this model has been refined and re-refined for 50 years

# Basel II is another model

- Basel II is another model
- In QIS-4 the 26 banks that used the advanced Basel II approach showed *reduced* capital requirements—The median reduction was 26%
- Even more troubling—7 banks in one test showed huge differences in how they rated the risk of the *same* portfolio (80% LTV ARMs of mortgagors with 660 credit scores)
  - The range was 1% to more than 60%

# Do banks themselves have sufficiently sophisticated models?

- This suggests that the banks themselves haven't got a good handle on the risk-weights to be attached to their assets
- And if the bank inputs are wrong the outputs of the Basel II formulas will be wrong
- Also, without any clear understanding of the correct risk-weights there are opportunities for gaming the system so as to meet regulatory requirements

# Need for a Leverage Ratio

- Under these circumstances, a leverage ratio—the ratio of equity capital to total assets—seems the most sensible approach
- Otherwise, we open the prospect that bank capital levels will be significantly reduced and our largest banks will be unprepared for some event in the future that we cannot foresee today.

# Using the market through sub debt

- If the goal is to replicate the market, the best method is to use the market itself
- Several years ago, the Shadow Financial Regulatory Committee proposed that banks issue a special kind of subordinated debt for replicating market discipline

# Sub debt—a class of at-risk holders

- a class of uninsured and unprotected claimants, who cannot “run”—i.e, get their principal back—when bank capital weakens
- Sub debt would have the following characteristics:
- It would be subordinated to all liabilities of the bank, and could not be insured by any government agency, backed by any credit enhancement device, collateralized, or convertible into equity.
- As an extra measure, the FDIC and other government agencies could be prohibited by law from providing any financial assistance to the holders of the debt, either as part of a “too-big-to-fail” bailout or a least-cost resolution of the bank.

# Sub debt (cont.)

- It would count as Tier 1 capital to the same extent as equity,
- But in order to qualify for this purpose, the sub debt would be required to have at least one year remaining until maturity and would have to be equal to no less than 2 percent of the bank's assets.
- It would contain a covenant permitting the issuing bank, at the request of its supervisor, to withhold the payment of interest and principal
- if the issuing bank's capital should fall below a specified percentage of its assets. Such withholding would become mandatory if the bank's capital were to decline further.
- It would be sold in arms'-length transactions to parties unrelated to the bank or its holding company.

# Sub debt advantages

- Subordinated debt with these properties would go a long way toward providing bank supervisors with a market-based signal
- In order to lower the interest rate on its subordinated debt, a bank would have incentives to take two important steps
- First, it would have to increase its equity capital to the optimal level necessary to reassure the holders of its subordinated debt,
- Second, it would be obligated to disclose information about its risks in sufficient detail to satisfy its sub debt holders, its supervisors, and the market generally.

# Sub debt and Prompt Corrective Action

- A subordinated-debt requirement could also be integrated into the prompt corrective action and early closure regimen required in FDICIA.
- Thus, if the yield on a bank's sub debt falls to junk levels, it could be treated as undercapitalized under FDICIA, no matter what its actual reported capital level.
- This would bring into play some of the regulatory restrictions on operations that are required for prompt corrective action. FDIC insurance premiums could be raised and an examination required.

# Final Point: Why do large banks want lower capital?

- This makes very little sense, unless one assumes that the taxpayers will pick up the tab
- However, under current law, all banks—and primarily the big banks—have to pay for BIF losses
- Lower capital requirements increase the risks of all banks, and particularly the big banks