The Urgent Task of Recapitalizing Banks: Doing it Gradually

On September 12th 2010, two years (less three days) after the Lehmann bankruptcy plunged the global financial system into crisis, the Basel Committee announced enhanced capital requirements for banks as part of what is now known as Basel III. Those who believed that regulatory reform was needed urgently to avoid further crises will no doubt be a little disappointed by the time table proposed for these changes.

Nothing much happens before the start of 2013 and it takes until 2018 before the changes are fully complete. While rushing into new arrangements could be unwise, and obtaining global agreement is a complex task, the timetable does seem a little drawn out. But not according to bankers, who seem to believe that they should be allowed to operate relatively unencumbered with leverage (equity/asset) ratios of below five percent compared to around fifty percent for most other businesses.

Basel III (at the moment) involves five fundamental changes to capital requirements. First, the minimum capital requirement of 8 per cent of risk weighted assets (RWA) is augmented by a capital conservation buffer, comprising common equity, of (eventually) 2.5 per cent. If a bank's capital falls below the 10.5 per cent level, constraints are placed on distributions (dividends, bonuses, etc).

Second, within the aggregate level, banks will be required to have (eventually) common equity of at least 4.5 per cent of RWA (plus another 2.5 per cent in the capital conservation buffer). Third, the "quality" of allowable capital will be increased by limits on acceptable hybrid instruments, greater required deductions (of things like deferred tax assets, equity investments, goodwill etc) in calculating common equity, and an increase in the "Tier 1" part of the total from 4 to 6 per cent of RWA.

Fourth, a non-risk-weighted leverage ratio will be introduced (with a minimum ratio of common equity to assets of 3 per cent being trialed until a final decision on the minimum value is made in 2017). Finally, increased risk weights (which increase RWA and thus required capital) had already been announced in December 2009 for various bank activities (such as securitization and trading).

Should we regard these changes as harsh, punitive, measures which will adversely affect banks and the economy? Is it really necessary to drag the adjustment process out so long? No, and no.

Whatever risks banks take are ultimately born by their suppliers of funds – shareholders, debtholders and depositors (and the taxpayer under deposit insurance schemes or bail-outs). Requiring shareholders to bear more of the risk by higher capital requirements simply shifts risk from other stakeholders.

That may increase the cost of bank funding (due to equity capital being more expensive financing) if other stakeholders do not reduce their required return on funds to reflect lower risk. That is likely (*ceteris paribus)*, because depositors generally treat their deposits as risk free anyway due to implicit or explicit government support.

But that effect is not a social cost. Rectifying a distorting, existing, subsidy to bank shareholders (and management) creates a more level playing field for other non-bank finance activities. (Although bankers will, no doubt, point to such things as tax concessions for superannuation as an offsetting distortion).

It will not either, necessarily, stifle economic growth. It will increase loan interest rates for a given level of deposit interest rates, but not by much. (Shifting from 5 per cent equity funding to 6 per cent, at a required rate of return of 15 per cent, when deposits or other funding costs 5 per cent, increases the average cost of funding from 5.50 per cent to 5.60 per cent, ie 10 basis points. At a macroeconomic level, the RBA is able to take that into account in setting its target cash rate.

Also relevant is whether increasing the relative stake of shareholders vis a vis depositors will improve bank governance and affect bank risk-taking. Probably not, given how little effective say shareholders have in determining bank boards, and that is reflected in other Basel initiatives around improving bank governance which are focused on boards and management, but with hardly a reference to the role of shareholders.

Regarding the timetable for meeting new capital requirements, there are undoubtedly some complications internationally arising from the timing of the run-off and replacement of previously allowed hybrid capital instruments, weak equity positions of some international banks, and dealing with government equity stakes due to nationalizations. But dragging out the equity raising requirements for banks over eight years appears to place little faith in the ability of capital markets to adjust to pre-announced, required, changes in financing patterns.

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