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Increased Bank Capital Requirements: Neither Panacea nor Poison

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Abstract

Common understanding of the effects of increased bank capital is that the more capital banks have relatively to risks inherent to their portfolio, the safer the economy automatically becomes. On the other hand it is often argued that if capital requirements are increased, economic growth needs to be sacrificed. However there exist scientific and statistical evidence that higher capital requirements alone will not make banks safer and they will neither ruin them nor have a significant negative impact on bank lending hence on the economic growth.

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Keywords: Basel III; Impact of increased capital requirements; Bank stability

1. Introduction

One of the main lessons that regulators took from the financial crisis was that the banking system held insufficient capital and post crisis regulatory framework should increase minimum capital requirements. Consequently common understanding of the effects of increased bank capital under Basel III is that the more capital banks have relatively to risks inherent to their portfolio, the safer the economy automatically becomes. On the other hand it is often argued that if capital requirements are increased, economic growth needs to be sacrificed as banks will not be able to lend to the economy under the same conditions or even that they will not be able to collect additional capital and lend at all.

The goal of this paper is to show that the reality is not that simple and that effects of increasing bank capital requirements in the context of Basel III are more mixed. There exists scientific and statistical evidence that higher

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capital requirements alone will not make banks safer and they will neither ruin them nor have a significant negative impact on bank lending hence on the economic growth.

2. Capital requirements under Basel III in a nutshell

General principles of the redefined capital requirements are outlined in "Basel III: A global regulatory framework for more resilient banks and banking systems" (BCBS, first published in 2010, revised 2011 version is referenced going forward). First of all Basel III introduced two new capital buffers: a capital conservation buffer and a countercyclical capital buffer.

Capital conservation buffer represents capital that banks need to build up above minimum regulatory capital levels. In case banks comply with minimum regulatory capital ratios however fail to reach levels of capital conservation buffer, their profit distribution options will be limited until additional capital is collected either on capital markets or thanks to retained earnings. Other aspects of banks' operations will not be impacted as it would be in case if their capital levels fell below regulatory minimum. Even profit distribution options are not prohibited absolutely but only limited to the extent of the capital shortfall. The value of the buffer has been set up to 2,5% of risk-weighted assets (RWA) and needs to be covered with the top quality CET 1 capital.

As for countercyclical capital buffer, banks will be required to build up additional time-varying capital buffer gradually as imbalances in the credit and real estate markets are identified during times of excessive credit distribution. The amount of required additional capital varies between 0% and 2,5% of RWA which needs to be met by CET 1 capital. Thus accumulated capital can be released to cover for losses on credit portfolios in the event of negative market development, improving institutions' resiliency against systemic vulnerabilities and increasing the loss-absorbing capacity of the sector. The countercyclical capital buffer might also contribute to smoothing of credit and economic cycles as the additional capital requirements will evolve in the opposite direction as the economic cycle, the buffer being activated only in times of credit expansion which is generally associated with a booming part of the economic cycle. On the other hand in the event of a crisis, financial institutions will be able to release the buffer to cover for the losses as capital requirements will be lower and they will not need to cut on the credit distribution which would make the crisis even worse.

Not only has Basel III introduced additional capital requirements, a new and stricter definition of capital has been established as well as apart from quantity, quality of available capital was an issue as well. Both quantity and quality of Tier 1 capital was raised and it needs to be predominantly composed of Common Equity Tier 1 (CET 1) which is mainly common shares and retained earnings, additional Tier 1 capital such as preferred stocks is limited. Tier 2 capital is simplified and reduced and Tier 3 capital is completely eliminated. In terms of quantitative changes CET 1 minimum capital ratio increases from 2% to 4,5 % of risk-weighted assets, Tier 1 capital ratio is 6% at minimum and the importance of Tier 2 capital is reduced to the ratio of 2% of RWA. The 8% minimum requirement level as such has not been changed.

However taking into account additional buffers, required levels of CET 1 capital have raised considerably to between 7% and 9,5% of RWA depending on macroeconomic circumstances and total required capital to between 10,5% and 13%.

3. Increased risk based capital levels alone will not make banks safer

As inadequate banking regulation was blamed as one of the main causes at the origin of the financial crisis 2007-2009, Basel III Accord was reached in a much faster way than its predecessor in less than 2 years and its implementation is probably to be more universal than that of previous Basel Accords including the US fully on board. What is also important is that credit, market and operational risk adjusted capital requirements do no longer stand alone. Apart from already mentioned additional capital buffers and stricter capital definition, the financial crisis taught regulators additional lessons.

Events of the recent financial crisis clearly showed that capital adequacy regulations alone are not sufficient to make financial institution immune from risks. Northern Rock had one of the highest capital ratios in the UK when it failed (Walter, 2010), the 26th October 2011 issue of World Finance magazine even mentions a total capital adequacy ratio of 14.4 percent only eight days before it was nationalized in the times when eight percent was