Opinion

Markets are the best judge of bank capital

SEPTEMBER 23, 2009 by: Andrew Kuritzkes and Hal Scott

Leaders of the Group of 20 summit (http://www.ft.com/indepth/g20) begin their summit in Pittsburgh on Thursday determined to increase the resilience of a financial sector that was brought to its knees last autumn. To this end, the G20 finance ministers, together with the Basel Committee on Banking Supervision, the international body that sets bank capital rules, have called for banks' mandated minimum capital ratios to be raised and for large banks to hold even more capital. This is an understandable reaction to the financial crisis. But do regulators really know how much capital the banking system needs?

The current regulatory capital framework, established by the Basel Committee, provides no empirically justified answer. The Basel framework's core regulatory capital requirement – that banks hold a minimum of 8 per cent Tier I plus Tier II capital relative to risk-weighted assets – has been in place for more than 20 years. While the recent 10-year effort to update the Basel accord refined the complex risk weights that are at the core of the regulatory framework, the Basel Committee intentionally "calibrated" the system to ensure the total amount of required capital would not be increased. The regulators thus failed to address the fundamental question of whether this historical amount of capital was sufficient to protect individual banks or the system as a whole.

Not surprisingly, given the lack of a solid foundation, regulatory capital requirements have not acted as a binding constraint on the amount of capital banks actually hold. In 2007, before the crisis, the regulatory capital ratio for the top 20 US banks (accounting for almost two-thirds of US banking assets) averaged 11.7 per cent. This was nearly 50 per cent above the minimum regulatory requirement of 8 per cent, and 17 per cent above the "well capitalised" standard of 10 per cent.

Large institutions that became distressed during the crisis maintained even greater capital buffers relative to regulatory minimums. The five largest US financial institutions subject to Basel capital rules that either failed or were forced into government-assisted mergers in 2008 – Bear Stearns, Washington Mutual, Lehman Brothers, Wachovia and Merrill Lynch – had regulatory capital ratios ranging from 12.3 per cent to 16.1 per cent as of their last quarterly disclosures before they were effectively shut down. The capital levels of these five banks were between 50 per cent and 100 per cent above the minimums and 23 per cent to 61 per cent higher than the well-capitalised standard. The strong implication is that capital levels for most banks – and especially for large institutions that raise systemic risk concerns – are set by market expectations, not regulatory rules.

Raising regulatory capital requirements to a level where they could become a genuine constraint leads to trade-offs. For a given level of risk, higher capital requirements would mandate a larger capital "cushion" to absorb losses and so provide greater protection against bank failure. However, to the extent that capital requirements are imperfectly linked to bank risk-taking, higher capital requirements could lead banks to seek a greater return on the additional capital. The higher requirements would also tend to drive financing out of the banking sector into less regulated sectors such as insurance or hedge funds. Indeed, we already have seen a great deal of both these phenomena during the financial crisis.

Given the evidence that market expectations play a more important role than regulatory minimums in setting bank capital levels, we should find ways to strengthen market discipline. Arguably, one of the most effective policy responses during the crisis was the Federal Reserve's stress-testing of the 19 largest US banks (http://www.ft.com/cms/s/0/f67cd12c-3b23-11de-ba91-00144feabdc0.html) – a clear departure from the Basel framework. The Fed's release of stress test results (http://www.ft.com/cms/s/0/e86d2a1a-3b27-11de-ba91-00144feabdc0.html), an unprecedented disclosure of a regulatory examination, steadied the market. It helped to stem the free-fall in bank share prices and paved the way for banks to raise about $87bn of capital in the market.

Indeed, a key lesson from the credit crisis is that, regardless of the level at which the minimum is set, regulatory capital, by itself, is not sufficient to prevent large banks from failing. We need to complement regulation with more effective market discipline. This requires better information, which could perhaps be provided by regular stress tests. It also demands a more credible resolution regime to ensure that equity and debt investors in all banks, even those considered systemically important, will suffer adverse consequences from bank failures.

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