Capital Requirements and Basel III

Knowledge@Wharton: There has been a lot of new rules, re-regulation, new regulatory regimes, and there is a lot of prep work from what you have said that needs to be done. But there still is a lot of uncertainty.

Bill Schlich: Well, I think right now the biggest area of uncertainty is the capital requirements. How much capital does an organization have to hold? We know those requirements are going up. But how far are they going to go, and in what jurisdiction? Will it be different country-to-country? I suspect it may be? And how does it impact my business model?

It is very difficult to be strategic today when you don’t know the capital requirements in each jurisdiction. You don’t know the liquidity requirements. All we do know is that jurisdictions want things ring fenced and they want to be able to understand the business in their jurisdiction, and they want to make sure there is enough capital and enough liquidity there. With that backdrop though, then you have to figure out – to Professor Herring’s point – who are your customers? How are you going to make money? And can you make it in a way that’s profitable given this increased cost to capital? ROAs [return on assets] are coming down, there’s no doubt. And how far they come down I don’t know. But it will be interesting to see how far the ROAs come down and then it will be interesting to see how investors react.

Donald Vangel: The Basel III process has certainly gone a long way towards calibrating at least the first stage of increased capital requirements. The Basel III framework articulates new definitions for what qualifies in effect as good capital and raises requirements for how much of that capital should be held.

But it leaves still undetermined how much if any additional capital should be held to deal with pro-cyclicality issues, that is, to put in place a counter cyclical buffer on top of the conservation buffer. How much additional capital, if any, should systemically important institutions have to hold on top of that? The G-20, while it endorsed the Basel III framework, pretty strongly also deferred to each jurisdiction to deal with systemically important institutions within its boundaries with respect to additional capital and liquidity requirements. So, it does run the risk of on top of having consolidated capital requirements that still have a ways to go in terms of: How much capital will you need to hold (and how much liquidity) in specific jurisdictions if you are viewed to be systemically important within them. So there’s a question of trapped capital as well as the absolute level of capital that needs to be held.

Richard Herring: I think you’ve made an important point about the way the Basel committee works. We have explicit capital requirements as a minimum at 4.5% that are basically equity to risk weighted assets. We have another 2.5% that is supposed to be a capital offer of sorts, yet it is put together in such a way that it really becomes required capital, because although the regulators say they want banks to feel free to use it whenever they want, they will, in fact, if they do use it, withdraw their right to pay dividends and bonuses and things like that.

So it really does become capital that is explicit. And as you mentioned, re: other things that were controversial -- they stuck under Pillar 2 [under Basel II] where its’ really a private matter between the regulator and the regulatee and [the public] won’t get to know about that. And it is going to make for a very unlevel playing field. There is some hope that they are going to migrate a leverage ratio after some calibration. But given the resistance in Europe – and they have a long way to go to meet a leverage ratio that is anything like the U.S. banks – there is some doubt that that will ever see the light of Pillar 1.