Banks Best Basel as Regulators Dilute or Delay Capital Rules

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More than 500 representatives from 27 nations, including top regulators and central bankers, met dozens of times this year to hammer out 440 pages of new rules to govern the world's banks.

What's not in the documents published by the Basel Committee on Banking Supervision, and the escape hatches that are, may have more impact on how financial institutions will operate following a global credit crisis that led to $1.8 trillion in bank losses and writedowns.

The committee's most significant achievement, members say, an agreement to increase the amount of capital banks need to hold, won't go into full effect for eight years. Other measures that regulators had hoped would prevent future crises -- liquidity standards, a capital surcharge on the biggest lenders and a global resolution mechanism for failing firms -- were postponed, allowing banks to escape the toughest rules that would force them to change the way they do business.

"There will be changes, but not fundamental changes to the banking model," said Sheila Bair, who as chairman of the U.S. Federal Deposit Insurance Corp. sits on the Basel committee's top decision-making body. "Hopefully there'll be some pressure for banks to get smaller and simpler."

Bair, 56, is one of five U.S. representatives on the board. She has assailed bankers for exaggerating the impact of planned regulations in an effort to scare the public and politicians. In an interview in June, she questioned "whether regulators can place any reliance on industry analysis of the impact of proposals to strengthen capital rules."

Bank Lobbying

Banks carried out a yearlong campaign to blunt international regulations, arguing that efforts to rein them in would curb lending and impede economic recovery. The lobbying effort was led by the Institute of International Finance, which represents more than 400 financial firms around the world and is chaired by Josef Ackermann, Deutsche Bank AG's chief executive officer. Ackermann and other IIF members wrote hundreds of letters to the Basel committee, met with regulators and addressed forums from Seoul to Washington.

In June, the group published a report estimating that the proposed capital rules would result in 9.7 million fewer jobs being created and erase 3.1 percent of global economic growth -- estimates the Basel committee later challenged.

"There is no question that increased costs to banks of core capital and funding will have to be largely passed along, which inevitably will take a macroeconomic toll," Ackermann, 62, said when he presented the report.

Battle Lines

Banks also reached out to their home regulators, arguing that some rules would disadvantage them more than other nations' lenders. That helped draw the battle lines inside the Basel committee, according to an account pieced together from interviews with half a dozen members who asked not to be identified because the deliberations aren't public. Germany, France and Japan led the push for softening rules proposed last December and stretching out their implementation. The U.S., U.K. and Switzerland opposed changes or delays.

The committee agreed in July to narrow the definition of what counts as bank capital, focusing on common equity, which includes money received for selling shares and retained earnings. During the crisis, other forms of capital permitted under current rules, such as future benefits from servicing mortgages and tax deferrals, failed to provide a buffer against losses. Those are mostly disallowed under Basel III, as the rules published last week are known.

Canada Switch

The capital requirements might have been stricter had it not been for Greece. Escalating concern that the country wouldn't be able to service its debt, culminating in a May bailout by the European Union and a $1 trillion rescue package for other member states that may need it, darkened prospects for economic recovery. That led some committee members to bend to bank pressure, according to policy makers, central bankers and others involved in the process.

By September, when the committee met to set the actual capital ratios, the U.S. was pushing to require that banks have common equity equal to 8 percent of their risk-weighted assets, members said. It ended up at 7 percent, after Canada switched sides at the meeting, tipping the balance toward the German camp. Canada's banks pressed their regulators to lower the ratio because they said they would be punished unfairly as healthy lenders that survived the crisis unscathed, the members said.

Even after being weakened, the new ratios and definitions would require banks to hold about $800 billion more capital, the committee said last week. Most lenders will be able to raise the money by retaining profits before the rules go into effect.

Leverage Ratio

In addition to pushing for a higher capital ratio, Bair also argued for a global leverage ratio that would cap banks' borrowing -- something the U.S. has had on its books since the 1980s. In July, when the committee was debating how to define capital, the U.S. agreed to some easing in exchange for Germany and France accepting a leverage ratio, some members said.

Proponents of the leverage ratio, or equity as a percentage of liabilities, say it's a more straightforward way to prevent lenders from becoming too indebted. Unlike capital ratios, which are based on risk-weighting and can be manipulated, the leverage ratio counts all assets regardless of their risk.

The more bankers borrow the more they can maximize profit per share, a yardstick for determining compensation. The more they borrow the higher the risk that a small decline in asset prices can wipe out equity and make the bank insolvent.

No Correlation

The Basel committee adopted a 3 percent leverage rule in July, meaning that for every $3 of capital, a bank can borrow no more than $97. While the percentage is tentative and subject to review before it goes into effect, it has since come under attack by banks in Europe and Asia, which say it will restrict their borrowing capacity and inhibit lending.

The EU may exclude the leverage ratio when it converts Basel rules into law next year. Several member nations have advocated dropping the rule, people close to the discussions said last month. A majority of the 27 EU countries oppose adopting the ratio, these people said.

“The argument is that this will restrain lending -- I hope our colleagues in Europe don’t buy into this,” Bair said in an interview earlier this month.

Recent academic research supports Bair. A July paper by Jeremy Stein, a professor of economics at Harvard University, and two colleagues looked at data going back to the 1920s and found no correlation between higher capital ratios and costlier lending by banks. An October paper by Anat Admati and three other professors at Stanford University concluded that increased equity levels don’t restrict lending.

‘Continuing Bickering’

“In the long run, higher capital has small impact on lending,” said Stein in an interview. “But banks don’t like to go out and get it. And regulators bought the banks’ arguments on this. They could have been tougher.”

Bair, who first advocated the idea of an international leverage ratio in a speech to committee members in Merida, Mexico, in 2006, said she still expects global adoption.

Barbara Matthews, managing director of BCM International Regulatory Analytics LLC, a Washington-based company that advises on financial regulation, said the leverage ratio may not make it in the end.

“Beyond tightening the definition of capital, nothing can be really counted as having been achieved,” Matthews, a former bank lobbyist, said of the Basel committee’s work this year. “There’s continuing bickering over liquidity and leverage regimes. They’re still studying too-big-to-fail issues, and it might be too late to finalize them as events take them over.”

$6 Trillion

The Basel committee, established in 1974, proposed its first liquidity standard, which would require banks to hold enough cash or easily cashable assets to meet their liabilities for up to a

year. Running out of cash was behind the 2008 collapse of Bear Stearns Cos. and Lehman Brothers Holdings Inc. in the U.S. and Northern Rock Plc in the U.K.

After banks showed they'd have to raise as much as $6 trillion in new long-term debt to be in compliance, the committee delayed a final decision on the rule, setting up an "observation period" of four to six years. It will likely be revised, according to members.

"Liquidity is very important and still an outstanding issue," said Douglas Elliott, an economics fellow at the Washington-based Brookings Institution and a former JPMorgan Chase & Co. banker. "They're trying to do it in the next couple of years, but it could take many more years. Or it might never get done if it proves too contentious."

Resolution Mechanism

Lehman's collapse also showed the need for a cross-border mechanism to wind down failing banks that have a global reach. More than 80 proceedings against the firm, involving hundreds of subsidiaries worldwide, have complicated recovery by creditors and destroyed much of the value of its assets.

The Financial Stability Board, which includes most Basel committee members as well as finance ministers from the Group of 20 nations, struggled to come up with such a resolution mechanism this year. The FSB postponed a decision until next year after divisions among nations proved too wide to bridge, members said. The group has been unable to agree on how to distribute losses among countries when a global bank fails and how different legal jurisdictions can recognize a single authority to pay creditors, the members said.

Too Big to Fail

The FSB is also responsible for determining which banks are systemically important and whether to impose additional capital requirements on them. The group may propose setting up national resolution authorities, rather than an international body, members said. Instead of a global accord on a surcharge for the largest banks, it may suggest a menu of options.

"Nobody's been able to fix too-big-to-fail around the world because nobody knows how to do it," said Hal Scott, a Harvard Law School professor who also is director of the Committee on Capital Markets Regulation, a nonpartisan group of academics and business executives. "Even figuring out how to resolve giant banks nationally is tough. How can you do it internationally? That was the biggest lesson of the crisis, systemic risk, but that's still unresolved."

Many issues may never be resolved, said Frederick Cannon, co-director of research at Keefe, Bruyette & Woods Inc. in New York, a firm that specializes in financial companies. G-20 leaders meeting in Seoul last month sounded as if they were claiming victory for regulatory reforms, even if they weren't completed, Cannon said.

"Before Seoul, I was expecting more reforms to be concluded next year," he said. "But now, more and more, I believe this is what we're getting, nothing more. They got a 7 percent common equity requirement -- the rest is all uncertain to ever happen."

‘Glass Half Full’

Charles Goodhart, a former Bank of England policy maker and professor at the London School of Economics, said he is more optimistic that differences will be resolved in coming years.

“There is still lots to be done, but we haven’t lost the momentum,” Goodhart said. “We’re 50 percent of the way there. We need to see it as the glass half full.”

Bair, who is stepping down from her FDIC position when her term expires in June, said she hopes the reforms will continue after she leaves the Basel committee. One remaining challenge, she said, is the reliance on banks’ internal models for measuring risk.

While smaller banks use standard risk-weightings prescribed by Basel, the largest banks use their own formulas to determine how much risk to assign their assets in calculating capital ratios. That leads to wide variations in how risk-weighted assets are tallied, Bair said.

“We have to get beyond too much reliance on banks’ internal models, their own views on risk,” she said.

--With assistance from Jim Brunsden in Brussels. Editors: Robert Friedman, Steve Dickson