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**INTERNATIONAL BANKING**

Expert Analysis

# Will Strengthening Capital Standards Forestall the Next Banking Crisis?

Capital, by definition, is the lifeblood of a bank. No capital, no bank. It is as simple as that. I have written several times in the past about the capital requirements for banks and the current focus on "risk-based" capital, that is, the more risky the asset of the bank, the more the capital that the bank must maintain against it. For example, cash is not risky, corporate loans can be very risky.

As one way of addressing some of the problems that may have led to the international economic crisis of the last year, and in an attempt to forestall such a free fall again, there is an effort being undertaken on a global basis by banking regulators to explore ways of strengthening the permanent capital standards for banks. This process will take months, if not years, to accomplish, and there of course is no guarantee that there may not be another collapse in the future. However, these measures should at least build into the prudential supervisory process more trigger points when regulators must stop and assess a particular bank's condition and, if necessary, require remedial actions to be taken before a crisis occurs.

This month's column will discuss recent statements by the Basel Committee of the Bank for International Settlements (the Basel Committee, the international bank capital standards setter), the Group of 20 and the United States on proposals to permanently strengthen capital standards for banks and their holding companies.

### The G-20

At the beginning of this month (Sept. 4-5), there was a meeting held in London by the finance ministers and central bank governors of countries that are part of the Group of Twenty (G-20). The G-20, established in 1999, is made up of representatives of the major industrialized and developing countries and works toward consensus on key international economic matters.[1] Last fall and earlier this year, the G-20 developed an action plan to

KATHLEEN A. SCOTT *is counsel in the financial institutions practice at Arnold & Porter LLP.*

By
**Kathleen A. Scott**

deal with and improve the global economy and since then periodically has issued updates. At the conclusion of these Sept. 4-5 meetings, which were a precursor to the next G-20 summit Sept. 24-25 in Pittsburgh, Pa., the G-20 issued a general communiqué and a progress report on completion of the action plan.

While there has been short-term progress with respect to certain discrete matters on capital, such as international regulators' agreement to more stringent capital requirements for risky trading activities, off-balance sheet items and securitized products, progress is needed on some of the macro-prudential goals in the action plan such as: (i) enhanced quality of capital, (ii) adding "countercyclical buffers" to provide added protection during an economic downturn, (iii) development of international non-risk-based capital ratio and liquidity requirements and (iv) improving risk management parameters in the current international capital standards (called Basel II) that have been or are in the process of being adopted by countries worldwide.

> The Basel Committee proposes banking capital requirements to be adopted on an international basis and then enacted into law by each country.

As for actually reaching those macro goals, the latest progress report indicates that there has been improvement in many areas, such as issuance of additional regulatory guidance on risk management, but that more needs to be done and in fact is being done regarding developing the details for certain specific proposals such as enhancement of the quality of a bank's capital, introduction of international liquidity requirements and imposition of the countercyclical buffers. Much of that work is being done by the Basel Committee, as will be seen below.

In his own statement regarding the meeting, U.S. Treasury Secretary Timothy Geithner noted that fundamental change was necessary, and that the "great failure of regulation was the failure to prevent the buildup of excess leverage and risk within and alongside the banking system." Mr. Geithner also noted that systemically important financial firms should be required to maintain capital in excess of that currently required under the definition of "well-capitalized" for banks and bank holding companies, a concept which had been raised in the Obama administration's "Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation" issued June 17, 2009, and which I discussed in my July 15, 2009, column.[2]

### Basel Committee

Among its many tasks, the Basel Committee proposes banking capital requirements to be adopted on an international basis and then enacted into law by each country. Much of the G-20's action plan depends on the work of the Basel Committee, and on Sept. 6, 2009, the Basel Committee (on which sit senior banking officials from 27 major countries) reached agreement on a set of guiding principles and measures to enhance capital standards.[3]

Banking supervisors are to ensure that the banks in their jurisdictions are in compliance with the following guiding principles regarding capital:

- Building on the framework for countercyclical capital buffers, supervisors should require banks to strengthen their capital base through a combination of capital conservation measures, including actions to limit excessive dividend payments, share buybacks and compensation; and
- Banks will be required to move expeditiously to raise the level and quality of capital to the new standards, but in a manner that promotes stability of national banking

systems and the broader economy.

The Basel Committee also reached agreement on several specific measures, much of which already was reflected in the G-20 action plan, with more detail to be expected by the end of the year:

• Raise the quality, consistency and transparency of the Tier 1 (core capital) capital base, with the major component being common shares and retained earnings. Deductions and prudential filters are to be harmonized internationally, and all components of the capital base will be required to be fully disclosed.

• Introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework. To ensure comparability, the details of the leverage ratio are to be harmonized internationally, fully adjusting for differences in accounting.

• Introduce a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement and a longer-term structural liquidity ratio.

• Introduce a framework for countercyclical capital buffers above the minimum requirement, such as constraints on capital distributions. The Basel Committee will review an appropriate set of indicators, such as earnings and credit-based variables, as a way to condition the build up and release of capital buffers and will promote more forward-looking provisions based on expected losses.

• Issue recommendations to reduce the systemic risk associated with the resolution of cross-border banks.

• Assess the need for a capital surcharge to mitigate the risk of systemically critical banks.

The Committee also plans to carry out an assessment at the beginning of 2010, with specification of the new requirements to be completed by year-end 2010.

While a search for quality core (Tier 1) capital always has been a key goal, one interesting item in this list and in the G-20's action plan is the call for a leverage ratio, which is a non-risk weighted ratio of Tier 1 capital to total assets. The United States has been insistent in its retention of its requirement that U.S. banks and bank holding companies maintain a leverage ratio, a requirement that has garnered much criticism from the major internationally active U.S. banks, which have long seen this requirement as a competitive disadvantage for them vis-à-vis their major competitors headquartered outside the United States that are not subject to a leverage ratio. To even the playing field by adding a leverage requirement internationally, as opposed to eliminating it in the United States, must come as a form of vindication for those U.S. regulators who have long seen the leverage ratio as an important indicator of the capital adequacy of a bank or a bank holding company.

### Proposed Enhancements

Prior to Secretary Geithner's departure for the Sept. 4-5 meeting in London, the Treasury Department issued a new policy statement on capital, "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms."[4] The press release contained language similar to that in Mr. Geithner's statement on the G-20 meeting, namely that the "global regulatory framework failed to prevent the build-up of risk in the financial system in the years leading up to the recent crisis." The policy statement outlines eight proposed standards (which, similar to the Basel Committee's proposed standards adopted on Sept. 6, reflect many elements of the G-20's action plan):

• Capital requirements should be designed to protect the stability of the financial system on a macro level, not just the solvency of individual banking firms.

• Capital requirements for all banking firms should be increased, and capital requirements for financial firms that could pose a threat to overall financial stability should be higher than those for other banking firms.

• The regulatory capital framework should put greater emphasis on higher quality forms of capital, with voting common equity constituting a large majority of Tier 1 capital.

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• Risk-based capital requirements should be a function of the relative risk, including systemic risk, of a banking firm's exposures and current financial condition.

• The procyclicality of the regulatory capital and accounting regimes should be reduced and consideration should be given to introducing countercyclical elements into the regulatory capital regime, such as building capital buffers for support in a downturn.

• Banking firms should be subject to a simple, non-risk-based leverage constraint, including incorporation of off-balance-sheet items.

• Banking firms should be subject to a conservatively defined yet explicit liquidity standard.

• Stricter capital and liquidity requirements for the banking system should not be allowed to result in the re-emergence of an under-regulated non-bank financial sector that poses a threat to financial stability.

As with the Basel Committee proposed timetable, the statement recommends standards being agreed upon internationally by year-end 2010, with legislation to be adopted by each country by year-end 2012.[5]

### Specific Requirements

In carrying out these goals, developing specific standards might be difficult in some cases to do. For example, regulators can easily agree that Tier 1 capital should include more common voting shares; agreement on the actual percentage of Tier 1 capital that must consist of common voting shares could take time. Agreement on even more complex topics, such as development of specific liquidity and leverage ratio requirements, concepts with which some countries may not be familiar, could take far longer than proposed in these statements.

### Conclusion

Good ideas, lofty goals. However, it is a long road to enactment and implementation and we can only hope that a recovering economy, and the potential for short-sightedness of some legislators who may see the crisis ease and turn their attention away from long-term change, do not derail these efforts at lasting reform.

1. Information on the G-20 may be accessed through its Web site, www.G-20.org.
2. "International Banking: U.S. and EU Proposed Regulatory Reforms: Chance for Real Change?" NYLJ, July 15, 2009.
3. See http://www.bis.org/press/p090907.htm.
4. See http://www.treas.gov/press/releases/tg274.htm.
5. In May of this year, members of the European Parliament adopted amendments to its Capital Requirements Directive to strengthen the financial markets in the European Union. The Directive addresses specific areas such as loans to one borrower, securitizations and credit default swaps, but it also calls for, by no later than the end of the year, a review by the European Commission of the entire Directive to address many of the macro-prudential issues raised in the Treasury, G-20 and Basel Committee statements discussed in this column. See http://www.europarl.europa.eu.