

Public Hearing CRD IV:
The right conclusions from financial turbulences, the proper framework for European Supervision?

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0. Background

The global financial crisis that started in August 2007 and that culminated in the fall of Lehman Brothers in September 2008 has had significant costs in terms of fiscal expenses and output losses. The IMF estimates the crisis-related costs to European banks in the years 2007–2010 to be in the range of 8% of EU GDP. This estimate not even includes the costs of the current sovereign debt and banking crisis in Europe.

The Basel Committee for Banking Supervision has released guidelines for a new financial architecture, and the CRD IV proposal is the first step towards implementing these guidelines into national regulations. The CRD IV reforms are not intended to address the current risks on European financial markets. They aim at laying the basis for a stable banking and financial system and to mitigate systemic risk in the future. At the same time, the current crisis shows the urgent need to provide banks with significantly higher capital and liquidity buffers and to develop effective mechanisms for crisis resolution.¹

1. Higher capital buffers mitigate systemic risk.

Current banking regulations and rules governing capital adequacy of banks focus mainly on the solvency of *individual* banks. *Systemic* linkages between financial institutions are not adequately reflected in the risk weights attached to specific balance sheet positions; high correlations between risks taken by individual banks and the price effects of system-wide deleveraging are not taken into consideration sufficiently.

The fact that many banks were inadequately capitalized prior to the crisis is, to a large extent, the result of capital adequacy regulations under the model-based approach used to

¹ The following policy recommendations are largely based on a report of the Advisory Council to the German Ministry of Economics (2010). For an English version see Hellwig (2010).

address market risks. In the context of the model-based approach, holding core capital of 10%, implies that core (tier one) capital amounts to 10% of risk-weighted assets; depending on the structure of the bank's assets and the calibration of the risk model, the ratio of equity capital relative to total assets of the bank can be as low as 1–3%. Such low levels of capital do not provide sufficient buffers against risks, and they do not protect banks against possible errors in their risk models.

A low degree of capitalization of banks implies that the deleveraging of banks' balance sheet positions gives rise to sizeable multiplier effects: if, e.g., core capital is 4% of the balance sheet total, then a loss of one Euro of core capital requires the sale of assets by the amount of 25 Euro to maintain the required ratio between capital and risky assets. This multiplier would be substantially smaller (6.7 Euro) if the required capital ratio would be, say, 15% of the bank's assets.

A significant and sustained increase in bank capital is crucial for the success of the current regulatory initiatives. In this regard, the current reforms do not go far enough. Significantly higher capital requirements are required, and capital requirements should be calculated relative to the unweighted balance sheet total (*leverage ratio*). They would ensure that bank capital can fulfil its role as a shock absorber, and systemic effects of distress events at individual banks can be contained. Any adjustment of capital requirements to such higher levels will have to be phased in gradually in order to minimize negative implications for credit supply.

Higher capital requirements alone will not make the banking and financial system more stable. Instead, complementary reforms are needed that include a special resolution regime which eases the unwinding of balance sheet positions and imposes penalties on equity owners. Intervention and resolution mechanisms need to be coordinated internationally. Instruments which strengthen the personal liability of banks' management and supervisory councils are needed. The Second Pillar of the Basel Framework should be enhanced in order to strengthen discretionary power to detect and prevent regulatory arbitrage. This is particularly important in order to mitigate the incentives for regulatory arbitrage and for an evasion to the shadow banking system, which are inherent in any proposal for stricter regulations. Finally, national authorities should have the permission to adopt tighter regulatory standards within a general set of rules if needed.

2. Higher capital requirements are not costly.

Higher capital requirements, being phased in gradually and backed by complementary reforms of the governance of the financial sector, need not be costly. Banks can adjust to higher capital requirements not only by deleveraging their balance sheets; they can also raise new equity at unchanged or even higher total asset volumes. It is often argued that

bank capital is costly. To a large extent, this is due to the fact that many tax systems favour debt finance compared to equity finance. If capital requirements are increased, the cost of equity finance might even fall: If, as a result of the regulatory change, banks invest into less risky assets, the risk premium on equity finance falls.

Empirical studies show that the costs of higher capital requirements for the real economy in terms of higher lending rates are modest in the mid- to longer-term. Moreover, these costs must be weighted against the benefits in terms of increased financial stability. Also, banks are likely to maintain the level of assets even with higher capital requirements. Hence, even for a given risk structure of assets, banking risks would be buffered by higher capital stocks. Historically, capital levels of banks have been significantly above the levels currently observed without impeding economic growth or innovation.

3. Zero risk weights on government bonds set the wrong incentives.

The calibration of risk weights underlying capital requirements is based on the assumption that banks' risk is measurable *ex ante*. The key underlying assumption behind the current risk weights is that the risk of a particular financial institution can be assessed without taking into account the state of the financial system as a whole. In reality, though, the risks of different asset positions are highly correlated, they depend on the solvency of the counterparties and thus on the state of the entire financial system. Moreover, the search for regulatory loopholes and regulatory arbitrage has caused the inadequate capitalization of the banking system prior to the crisis: banks have replaced activities subject to high risk weights by (risky) activities subject to low risk weights.

More specifically, under the CRD IV proposal, zero risk weights on governments bonds issued by Euro Area governments will be maintained. For a given set of assets with the same default probabilities, banks will thus have an incentive to invest into government bonds rather than other types of assets. Additional incentives to investments into government bonds result from liquidity regulations and from the ability to use these assets as collateral for central bank refinancing. Yet, the current situation shows that sovereign risk is real, and this needs to be reflected in the risk weights.

Moreover, applying zero risk weights to sovereign debt could prove inconsistent with future private sector involvement in debt restructuring cases. The draft of the ESM treaty specifies that the scale and scope of private sector involvement depends on the risk of contagion and on the spill-over of crises into other member states. This risk is higher the lower the capitalization of banks and the higher the exposure of banks to the crisis country. Zero risk weights on government bonds may cause the banking sector to be over-exposed to sovereign risk. This creates incentives to unduly delay debt restructuring.

4. Smaller financial institutions can be of systemic relevance.

The discussion on systemic risk in the financial sector typically focuses on large banks. Indeed, large financial institutions can be of systemic importance because of the sheer size and because of their connectedness to other financial institutions. However, systemic risk not only emanates from large financial institutions. Instead, the common exposure of many small financial institutions to the same macroeconomic risk factors can have systemic effects as well. This is shown by recent empirical work which studies the response of banks of different size to macroeconomic factors. Also, one trigger of the Savings and Loans crisis in the United States in the 1980s has been the exposure of many smaller banks to the same macroeconomic risk factors. Therefore, smaller banks and financial institutions should not be exempt from tighter regulations.

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