



More Capital and Robust Growth Can Peacefully Coexist

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The next stage of financial regulatory reform is rulemakings to determine how much capital banks must hold to buffer against potential losses. A key question policymakers will need answered is the extent to which tougher regulatory standards will reduce lending and inhibit economic growth. On the one hand, banks and their supporters will be inclined to describe any increase in capital and liquidity buffers as an implicit tax on lending. On the other, pro-regulatory forces may use this opportunity to enact punitive restrictions on bank risk-taking in pursuit of social goals or an ideological agenda.

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Recently, the Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS) published reports to confront the perception that tougher capital standards would retard economic growth. Banks argue that the capital increases proposed by Basel III and those implicitly embraced through the Dodd-Frank legislation will stifle economic growth. Banks also argue that forcing them to issue hundreds of billions of dollars of higher-cost equity to fund loans would increase their average cost of capital – an increase they say would be passed through to borrowers, making it more costly for businesses and households to fund investments, mortgages, and consumption.

The first report from Basel provided a framework for considering the economic benefits of a more stable and resilient financial system. The report finds that each 1 percentage point reduction in the annual probability of a crisis yields an expected benefit per year equal to 0.6% of output (when banking crises are allowed to have a permanent effect on real activity).

This conclusion begs the question of whether implementing Basel III would help to reduce the likelihood of a crisis. Providing a definitive answer is nearly impossible. But the marginal effect is likely to be particularly strong given the undercapitalized nature of the banking system. As the report explains, “the decrease in the likelihood of crises is three times larger when capital is increased from 7% to 8% than when it is raised from 10% to 11%. Intuitively, the further away banks are from insolvency, the lower is the marginal benefit of additional protection.” This means that when banks hold capital equal to 7% of adjusted assets, a 1% increase is likely to do more to reduce the probability of insolvency than the same 1% increase when the bank holds 10% capital.

The Basel paper is also a response to a much-discussed paper from the Institute of International Finance (IIF), which argued that implementing the Basel III capital requirements would reduce the GDP of the U.S., Japan, and the European Union by 3.1%. However, the IIF did not project any corresponding benefit from the higher capital standards, acknowledging only that it would lead to “stability gains.” Given the dramatic decline in output in the



industrialized world since the third quarter of 2008, one would think that the economic value of “stability gains” could be quite significant if they reduced the probability and severity of financial crises.

The Basel paper disputes the IIF cost estimates. The IIF’s economic impact assumes that the cost of the new requirements is transmitted to borrowers through higher interest rates. But according to the Basel paper, “Banks have various options to adjust to changes in required capital and liquidity requirements other than increasing loan rates, including by reducing ROE, reducing operating expenses and increasing non-interest sources of income. Each of them could cut the costs of meeting the requirements.” The more likely scenario is that banks will adjust to the new regulations by holding less risky assets, which reduces required rates of return and the cost of capital. With banks’ return on equity (ROE) fixed at 15%, each percentage point increase in capital raises lending rates for businesses and households by 13 basis points (0.13%). However, if the returns to bank shareholders are reduced to 10% as a result of holding safer securities, each percentage point increase in the capital ratio can be recovered by a 7 basis point rise (0.07%) in lending rates. The only way to reach the IIF paper’s results is to assume that there is no change in bank behavior and that borrowers bear 100% of the costs of new regulation. This is an unlikely outcome in a competitive market, and one, were it to come to pass, that would be highly suggestive of a cartelized industry in need of trust busting.

Appearing in the Basel paper is a table containing estimates of the net economic impact of increases in capital and liquidity standards. The zeroes in the first row (7%) represent the baseline scenario – 7% capital to risk-weighted assets with no new liquidity requirements. Each row measures the net economic

impact as a percent of GDP associated with a one percentage point increase in capital. The lower portion of the table measures the net GDP impact of a one percentage point increase in capital plus the imposition of a new liquidity standard to ensure banks can survive in the absence of wholesale (bank-to-bank) lending as occurred following Lehman’s bankruptcy. The noteworthy finding is that the capital ratio could be increased to 15% – more than double current levels – with the new liquidity regime before the net benefits fall to zero. This means that regulators could nearly double current capital requirements without imposing any net cost on the economy once the benefits of a safer financial system are taken into account. And even this case relies on the (unrealistic) assumption that the cost of a financial crisis does not linger.

Expected long-run annual benefits and costs of tighter regulatory standards (benefits and costs are measured by the percentage impact on the level of output per year)					
Capital ratio	Expected costs	Expected benefits (moderate permanent effect)	Net benefits (moderate permanent effect)	Net benefits (no permanent effect)	Net benefits (large permanent effect)
Liquidity requirement not met					
7%	0.00	0.00	0.00	0.00	0.00
8%	0.09	0.96	0.87	0.20	2.32
9%	0.18	1.62	1.44	0.31	3.87
10%	0.27	1.98	1.71	0.33	4.70
11%	0.36	2.23	1.87	0.31	5.23
12%	0.45	2.39	1.94	0.27	5.54
13%	0.54	2.50	1.96	0.21	5.73
14%	0.63	2.58	1.95	0.15	5.84
15%	0.72	2.64	1.92	0.08	5.90
Liquidity requirement met					
7%	0.08	0.76	0.68	0.15	1.83
8%	0.17	1.40	1.23	0.25	3.33
9%	0.26	1.82	1.56	0.29	4.30
10%	0.35	2.10	1.75	0.28	4.91
11%	0.44	2.29	1.85	0.25	5.30
12%	0.53	2.42	1.89	0.20	5.55
13%	0.62	2.52	1.90	0.14	5.70
14%	0.71	2.60	1.89	0.07	5.80
15%	0.80	2.65	1.85	0.00	5.85

The second Basel paper supports the conclusions of the first. It finds that after accounting for the change in banks’ behavior, a “1 percentage point increase in the target ratio of tangible common equity (TCE) to risk-weighted assets is estimated to lead to a decline in the level of GDP by a maximum of about 0.19% from the baseline path after four and a half years (equivalent to a reduction in the annual growth rate of 0.04 percentage points over this period).” This is



roughly one-third of the impact measured by IIF, with the important caveat that new capital standards are assumed to be phased-in over a four year period. After eight years, the level of GDP is found to be just 10 basis points (0.1%) below the baseline. The paper also finds that a 25% increase in liquid asset holdings would reduce GDP by a maximum of 0.13% of GDP, but that this cannot be interpreted as an incremental economic cost because “efforts to meet the capital requirements make it easier to meet the liquidity requirements, and vice versa.”

As argued by e21 previously, it’s a mistake to pin hopes for future financial stability on the Basel III process. Yet, it was refreshing to see the Basel Committee fight back strongly with serious efforts to quantify the cost and benefits of reform. Moreover, the estimates did not account for the large “risk premium” society would likely pay to ensure that the economic collapse after the fall of 2008 is never again repeated. Even if capital standards were raised to the point where expected benefits equaled costs in a strict, actuarial sense, society would likely take that bargain if it meant never again having to deal with a sudden evaporation of 40% of household wealth and a persistently high unemployment rate.