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Basel needs a firm hand and fewer delays

By David Scharfstein and Jeremy Stein

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This weekend top central bankers announced agreement on **Basel III**, the new rules to enhance global capital standards for banks. The agreement, which will now be presented to the Group of 20 leading nations summit in Seoul this November, represents a significant and welcome increase in the capital that banks will be required to hold. However, worries that a rapid transition will cut lending and deepen the global recession mean the full increase will be delayed until 2019.

These transitional concerns are understandable, but a long phase-in period is unnecessary and potentially harmful. Instead, a much shorter period should be implemented, with regulators forcing banks to meet the new requirements by going to the market to raise **fresh capital**. If carefully managed, this approach could avoid any adverse effect on lending and the economy.

Banks have argued that higher capital requirements raise their financing costs and thus reduce their willingness to lend. But there is now widespread understanding in the regulatory and academic community that this argument is overstated. Research, including our own, shows that the long-term impact of higher capital on loans is too small to have a big impact on growth. More capital makes banks safer, lowering the returns demanded by shareholders and creditors. Overall their costs increase only slightly, hence the reason why regulators feel comfortable raising standards after a period of adjustment.

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The planned long phase-in suggests that this adjustment period is the regulator's main worry. Left to their own devices, banks are reluctant to increase capital by issuing new shares, which could lower their stock price. While **Deutsche Bank** recently announced plans for a substantial **equity raising**, history suggests such issues are a banker's last resort.

Indeed, even after the subprime crisis first hit, banks issued relatively little new equity to beef up their capital – even though it became obvious that both their losses and the risks in the financial system had risen dramatically. The US government's controversial rescue programme after the failure of Lehman was needed in part because banks did not raise enough capital on their own.

Under the current plan, this reluctance to raise capital will create problems, especially if regulators do not place restrictions on how banks meet the rules. The Basel agreement asks banks to hit a specified ratio of capital to risk-weighted assets, not an amount of capital alone. A bank could adjust to the more stringent target either by raising new dollars of capital or by shrinking its assets, which means a cutback in lending.

Given the unwillingness to issue new shares, the brunt of any adjustment would likely take the form of lending cuts. Thus, unless the transition is managed carefully, the banks have a valid point when they say the new rules could lead to a period of tighter credit. This is what happened during the first round of Basel, announced in 1988 and implemented by the end of 1992. Research suggests that this phase-in was partially responsible for a significant credit crunch during this period.

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What can be done to avoid repeating this mistake? Lengthening the phase-in, as under the current agreement, is one approach. This allows banks to build up their capital over time by retaining earnings, without having to seek new external funding. But this approach is risky, especially if banks feel pressure to demonstrate to the market they can get their figures in order well before the official deadline. If so, extending the deadline will do little to reduce the incentive to cut lending. Even on a best-case scenario banks will be less stable during the phase-in period too.

A better approach would see regulators push those banks who are falling well short of the overall target to make the adjustment more quickly. Rather than simply granting a long phase-in period, the regulator would encourage these banks to raise fresh capital – perhaps by forbidding dividend payments or limiting executive compensation until they did so.

While this approach is not the norm in capital regulation, and while it will likely be unpopular with the banks themselves, it was a central feature of the supervisory capital assessment programme – the “stress tests” run by US regulators in 2009. Each bank subject to the tests was set a target for a total of new dollars of capital they had to raise, not for how their capital ratio needed to be adjusted. Combined with the strong incentives that banks had to satisfy these targets, the programme was highly successful in generating new equity for the banking system, with more than $125bn raised by the end of 2009.

The stress tests taught us an important lesson about the benefits of a firm regulatory hand, one that is directly relevant for managing the phase-in of Basel III. In short, a clear and forceful emphasis on getting additional dollars of capital into the banking system is needed, and can do much to alleviate the risk of a new credit crunch during this critical period for the world economy.

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