

Economics 435  
The Financial System  
(12/11/2019)

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# Reforms

- Basel III

<http://www.ssc.wisc.edu/~mchinn/Basel3up.pdf>

- Dodd-Frank

# Basel Committee on Banking Supervision reforms - Basel III

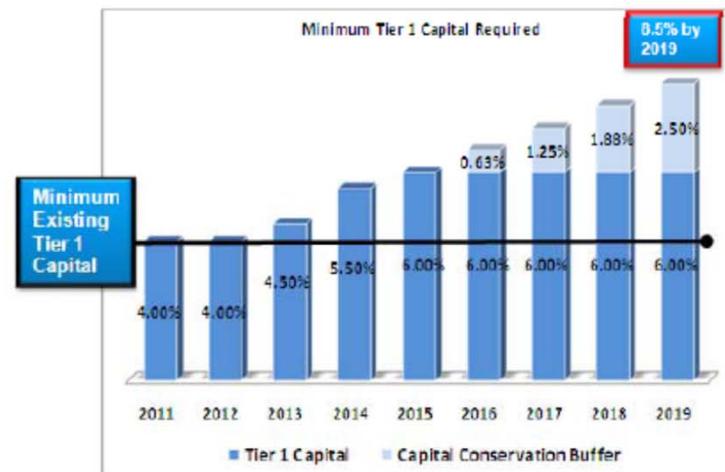
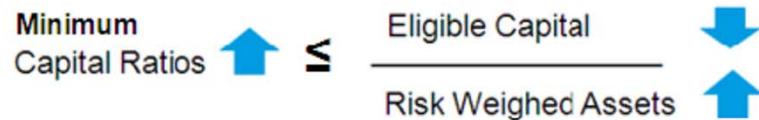
Strengthens microprudential regulation and supervision, and adds a macroprudential overlay that includes capital buffers.

Capital					Liquidity	
Pillar 1			Pillar 2	Pillar 3		
Capital	Risk coverage	Containing leverage	Risk management and supervision	Market discipline		
All Banks	<p><b>Quality and level of capital</b> Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions.</p> <p><b>Capital loss absorption at the point of non-viability</b> Contractual terms of capital instruments will include a clause that allows – at the discretion of the relevant authority – write-off or conversion to common shares if the bank is judged to be non-viable. This principle increases the contribution of the private sector to resolving future banking crises and thereby reduces moral hazard.</p> <p><b>Capital conservation buffer</b> Comprising common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Constraint on a bank's discretionary distributions will be imposed when banks fall into the buffer range.</p> <p><b>Countercyclical buffer</b> Imposed within a range of 0-2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.</p>	<p><b>Securitisations</b> Strengthens the capital treatment for certain complex securitisations. Requires banks to conduct more rigorous credit analyses of externally rated securitisation exposures.</p> <p><b>Trading book</b> Significantly higher capital for trading and derivatives activities, as well as complex securitisations held in the trading book. Introduction of a stressed value-at-risk framework to help mitigate procyclicality. A capital charge for incremental risk that estimates the default and migration risks of unsecuritised credit products and takes liquidity into account.</p> <p><b>Counterparty credit risk</b> Substantial strengthening of the counterparty credit risk framework. Includes: more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivatives; and higher capital for inter-financial sector exposures.</p> <p><b>Bank exposures to central counterparties (CCPs)</b> The Committee has proposed that trade exposures to a qualifying CCP will receive a 2% risk weight and default fund exposures to a qualifying CCP will be capitalised according to a risk-based method that consistently and simply estimates risk arising from such default fund.</p>	<p><b>Leverage ratio</b> A non-risk-based leverage ratio that includes off-balance sheet exposures will serve as a backstop to the risk-based capital requirement. Also helps contain system wide build up of leverage.</p>	<p><b>Supplemental Pillar 2 requirements.</b> Address firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges.</p>	<p><b>Revised Pillar 3 disclosures requirements</b> The requirements introduced relate to securitisation exposures and sponsorship of off-balance sheet vehicles. Enhanced disclosures on the detail of the components of regulatory capital and their reconciliation to the reported accounts will be required, including a comprehensive explanation of how a bank calculates its regulatory capital ratios.</p>	<p><b>Global liquidity standard and supervisory monitoring</b></p> <p><b>Liquidity coverage ratio</b> The liquidity coverage ratio (LCR) will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors.</p> <p><b>Net stable funding ratio</b> The net stable funding ratio (NSFR) is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding.</p> <p><b>Principles for Sound Liquidity Risk Management and Supervision</b> The Committee's 2008 guidance <i>Principles for Sound Liquidity Risk Management and Supervision</i> takes account of lessons learned during the crisis and is based on a fundamental review of sound practices for managing liquidity risk in banking organisations.</p> <p><b>Supervisory monitoring</b> The liquidity framework includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank and system-wide level.</p>
	SIFIs	<p>In addition to meeting the Basel III requirements, global systemically important financial institutions (SIFIs) must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methodology that includes both quantitative indicators and qualitative elements to identify global systemically important banks (SIBs). The additional loss absorbency requirements are to be met with a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. For banks facing the highest SIB surcharge, an additional loss absorbency of 1% could be applied as a disincentive to increase materially their global systemic importance in the future. A consultative document was published in cooperation with the Financial Stability Board, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIFIs.</p>				

# Basel III Squeezes Capital!

**Basel III has a significant impact on capital requirements**

- More strict rules on eligible capital
- Risk Weighed Assets increased for some asset classes (e.g. OTC derivatives)
- Increased capital ratios (Core Tier 1, Tier 1, Conservation buffer, Countercyclical buffer)



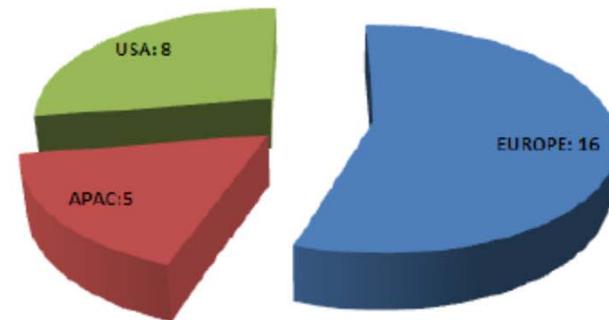
# The 29 Global-Systematically Important Banks (G-SIBs)

## G-SIFIs

For which the resolution-related requirements will need to be met by end-2012<sup>1</sup>

Bank of America  
 Bank of China  
 Bank of New York Mellon  
 Banque Populaire CdE  
 Barclays  
 BNP Paribas  
 Citigroup  
 Commerzbank  
 Credit Suisse  
 Deutsche Bank  
 Dexia  
 Goldman Sachs  
 Group Crédit Agricole  
 HSBC  
 ING Bank  
 JP Morgan Chase  
 Lloyds Banking Group  
 Mitsubishi UFJ FG  
 Mizuho FG  
 Morgan Stanley  
 Nordea  
 Royal Bank of Scotland  
 Santander  
 Société Générale  
 State Street  
 Sumitomo Mitsui FG  
 UBS  
 Unicredit Group  
 Wells Fargo

- List to be updated every year by FSB
- Additional capital buffer
- In addition: list of “domestic SIFIs” to be published by local regulators

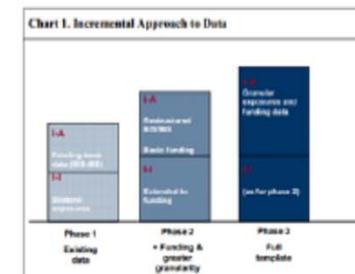


New reporting requirements to the FSB for G-SIBs:

[http://www.financialstabilityboard.org/publications/r\\_111006.pdf](http://www.financialstabilityboard.org/publications/r_111006.pdf)

Table 1. Overview of the types of information in the proposed data template

Institution-to-institution	Institution-to-aggregate	Structural and Systemic importance	Passive and Ad-hoc data
Bilateral credit exposures & funding dependencies to assess network risks and resilience	Credit exposures & funding dependencies to countries, sectors and markets to understand risk concentrations and vulnerabilities	Information to facilitate the assessment of systemic importance, and support crisis management	Predefined data “on-request” and “ad-hoc” requests to meet increased information needs to assess emerging systemic risk



## Basel III New Ratios, with Progressive Roll Out

A leverage ratio as a non risk-based metric to avoid excessive leverage



$$\text{Leverage Ratio} = \frac{\text{Tier 1}}{\text{Balance Sheet and Other Offbalance Sheet Expos}} \geq 3\%$$

**Roll out:**  
Tested 2013 to 2017  
Binding 2018

**Liquidity risk ratios:** a short term ratio (LCR) with a 30 days time horizon and a more long term one (NSFR) with a 1 year time horizon relying on regulatory factors defined for stress test scenarios



$$\text{LCR} = \frac{\text{Stock of High Quality Liquid Assets}}{\text{Net Cash Outflow Over 30 Days}} \geq 100\%$$

**Roll out:**  
Tested 2011 to 2014  
Binding 2015

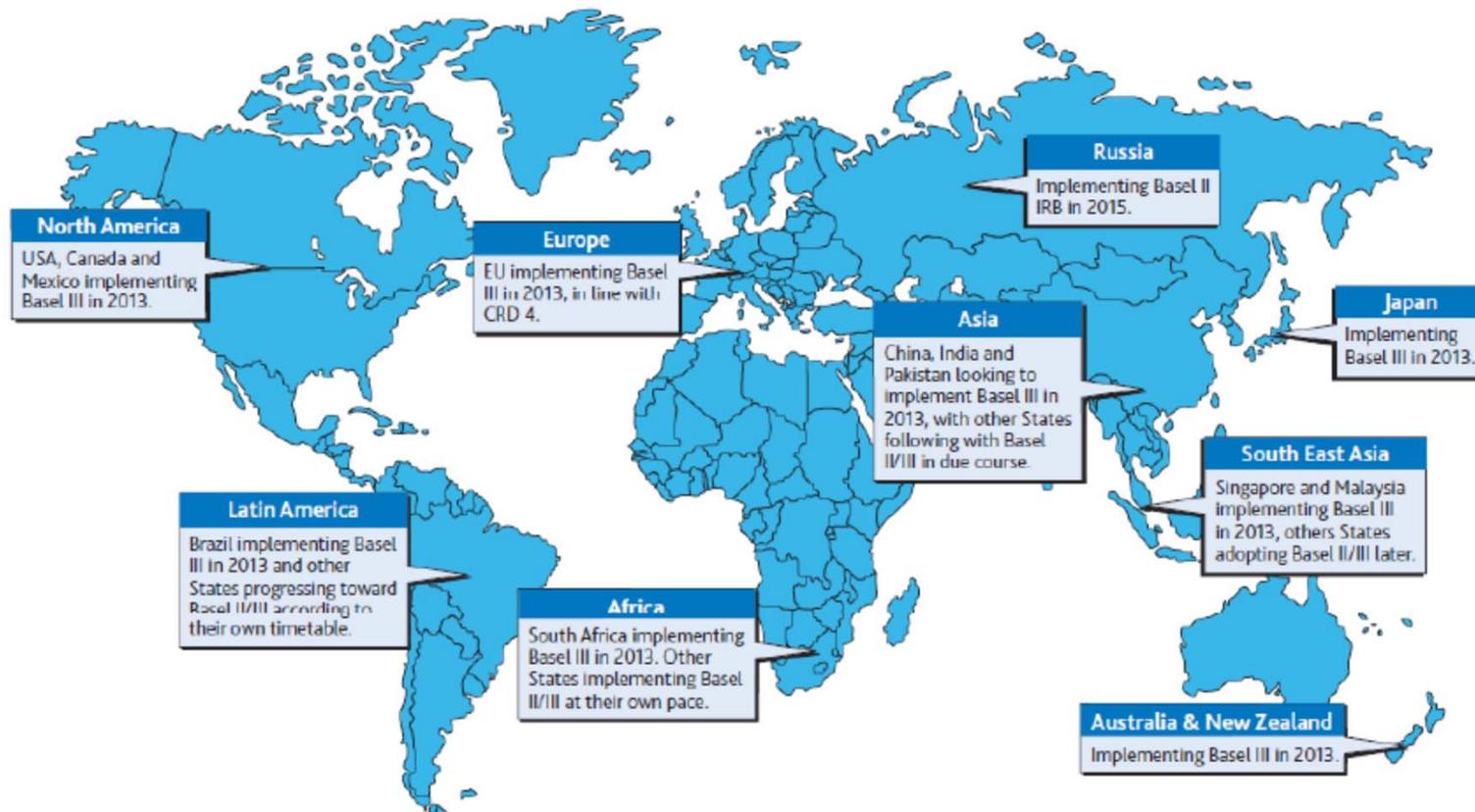


$$\text{Net Stable Funding Ratio} = \frac{\text{Available Stable Funding}}{\text{Required Stable Funding}} \geq 100\%$$

**Roll out:**  
Tested 2012 to 2017  
Binding 2018

## Rest of the World

G20 country members are committed to implement Basel III from 2013



# Basel III phase-in arrangements

(All dates are as of 1 January)



Phases		2013	2014	2015	2016	2017	2018	2019	
Capital	Leverage Ratio		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
	Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%					4.5%
	Capital Conservation Buffer				0.625%	1.25%	1.875%	2.5%	
	Minimum common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%	
	Phase-in of deductions from CET1*		20%	40%	60%	80%	100%	100%	
	Minimum Tier 1 Capital	4.5%	5.5%	6.0%					6.0%
	Minimum Total Capital		8.0%						8.0%
	Minimum Total Capital plus conservation buffer		8.0%		8.625%	9.25%	9.875%	10.5%	
	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital		Phased out over 10 year horizon beginning 2013						
Liquidity	Liquidity coverage ratio – minimum requirement			60%	70%	80%	90%	100%	
	Net stable funding ratio						Introduce minimum standard		

\* Including amounts exceeding the limit for deferred tax assets (DTAs), mortgage servicing rights (MSRs) and financials.

-- transition periods

# Four Questions

- Will the new regulatory structure make the financial system more robust to shocks by providing institutions the tools to heal themselves?
- Does the Dodd-Frank Act adequately deal with monitoring and measuring systemic risk?
- Do the provisions of the Act deal adequately with the problem of too-big-to fail institutions?
- To what extent will the Dodd-Frank Act involve the right mix of automatic “stabilizers” (e.g. higher capital requirements), fixed rules (e.g. the Volcker Rule) and discretion (e.g. Federal Reserve’s ability to lend to illiquid, potentially insolvent, institutions at flexible haircuts), to be an effective framework for financial stability?

# Dodd-Frank

# Robust to Shocks?

- The key issue is whether a financial firm or market participants will have adequate capital and liquidity to withstand adverse events whether they be due to idiosyncratic shocks or aggregate shocks.
- ... regulatory capital requirements, both under Dodd-Frank and under Basel III rules.

# Dodd-Frank and Systemic Risk

- Orderly Liquidation Authority (OLA) (FDIC)
- Liquidation versus resolution
- SIFI's versus markets (e.g., repo) or
- “herds of firms” (e.g., money market funds)

# Stabilizers vs. Rules vs. Discretion

- Stabilizers (capital requirements)
- Rules - Volcker rule specifically prohibits a bank or institution that owns a bank from engaging in proprietary trading, and from owning or investing in a hedge fund or private equity fund, and also limits the liabilities that the largest banks can hold.
- Discretion: Is liquidation necessarily the right way to go, or resolution.

# Backlash?

- The CHOICE Act of 2017
- Klein, Brookings Institution (2018)
- ‘Bank SIFI’ threshold, increased from \$50 billion, unindexed for inflation or economic growth to \$250 billion
- The Federal retains discretion to apply enhanced regulatory standards to any bank > \$100 billion assets