

A PRIMER ON THE EVOLUTION AND COMPLEXITY OF BANK REGULATORY CAPITAL STANDARDS

While banks play a fundamental role in financial intermediation, banking systems may occasionally experience crises. To mitigate losses when a bank's investments perform poorly, regulators have implemented a variety of banking reforms, including minimum capital requirements. The requirements for minimum capital have been evolving over the past few decades, becoming increasingly complex. The amount and types of capital that banks are required to hold vary according to the types of assets they hold as well as the size of the bank. The situation has grown so complex that it is difficult to determine whether a bank is following the regulatory guidelines.

In “[A Primer on the Evolution and Complexity of Bank Regulatory Capital Standards](#),” James R. Barth and Stephen Matteo Miller review the recent history of regulatory capital standards and examine the current standards and how regulators enforce them. Finally, they propose a much simpler minimum required capital ratio.

THE BASEL CAPITAL ACCORDS

In 1974, the G10 countries established an organization that would eventually be known as the Basel Committee on Banking Supervision.

- *Three Basels.* The Basel Committee was created in 1974 in response to several high-profile international bank failures following the collapse of the Bretton Woods system. After the Latin American debt crisis of 1982, Congress passed the International Lending and Supervision Act of 1983, which culminated in the 1988 Basel Accords that established international standards for capital requirements, known as Basel I. Basel I called for a minimum capital ratio and divided capital into two tiers, each with a different requirement. Further revisions in 2004 (Basel II), which the United States never adopted, and again in 2010 (Basel III) have resulted in the Basel capital adequacy standards becoming much more complex.

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- *Current requirements.* The Basel III capital adequacy standards have retained key features of Basel I but have added higher requirements for capital, including buffers for systemically important banks to provide a cushion during business cycles, and for capital conservation. Looking toward the future, a longer-term net stable funding ratio will be phased in by 2018 and a liquidity coverage ratio by 2019. Basel III also includes a non-risk-based leverage ratio, which is determined by dividing the bank's total capital by the total amount of the bank's consolidated assets.

CAPITAL REQUIREMENTS IN THE UNITED STATES

Bank regulators have followed Basel III guidelines in finalizing new US regulations concerning capital adequacy. The increasingly complex nature of the capital adequacy standards since Basel I is reflected by the growth in the number of pages needed to summarize the final rules, which cover, among other things,

- *Risk weighting of assets.* The United States has standardized and advanced approaches for determining the risk weighting of bank assets that adjust capital requirements based on the asset risk. These approaches lower risk weights for seemingly safer assets and increase them for seemingly riskier assets. Banks with more than \$500 million in assets must apply the simpler standardized approach. The largest internationally active banks are required to use both the advanced approach and the standardized one in accordance with the Dodd-Frank Act.
- *Systemically important banks.* Since the recent crisis, banks that use the advanced approach and another set of banks on the list of global systemically important banks are now subject to rules even more stringent than the rules for other banks. These banks must do multiple tests to determine their minimum capital requirements, choosing the highest requirement determined by the tests.
- *Corrective action requirements.* Bank regulators are required to take prompt corrective action to resolve capital deficiencies. The level of pressure from regulators to resolve deficiencies differs depending on how well the bank is capitalized. It also depends on what kind of capital the regulator is looking at.
- *Stress testing requirements.* During the banking crisis of 2007–2009, banks were required to go through the Supervisory Capital Assessment Program to assess their capital positions. Since the passage of the Dodd-Frank Act, banks with \$50 billion or more in total consolidated assets are required to go through Comprehensive Capital Analysis and Review and supervisory stress testing to further assess whether they would have adequate capital under stressful conditions. Unfortunately, supervisory stress testing has not been transparent.
- *What counts as capital?* The required components of capital have varied since Basel I. After the 2007–2009 crisis, regulators emphasized common equity Tier 1 capital, which includes qualifying common stock, retained earnings, certain other comprehensive income elements, and qualifying common equity Tier 1 minority interests. This shift reflects the

shortcomings of many accounting-based measures of capital—shortcomings that market participants ignored during the crisis in favor of a simple common-equity-based measure.

PROPOSAL FOR A MINIMUM REQUIRED CAPITAL RATIO

As an alternative to the growing complexity of regulatory capital requirements, policymakers could eliminate most regulatory capital requirements in favor of a simpler, non-risk-based equity leverage ratio similar to the one prescribed in Basel III. This ratio is fairly straightforward and easily understood by market participants.

Since the 1980s, bank regulatory standards have become increasingly complex, especially for large banks. Because it is so difficult to understand what counts as capital and how requirements vary from bank to bank, risk-based capital ratios no longer serve as good signals about whether banks are adequately capitalized. In fact, they can be misleading signals to both markets and regulators. For these reasons, a straightforward, non-risk-based equity ratio would provide better information and simplify the regulatory process.