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RESEARCH SUMMARY

How Global Banking Regulations Can Affect Ordinary Americans: Some Unintended Consequences of Basel III

Following the 2008 financial crisis, US regulators implemented "Basel III" revisions to existing banking standards intended to increase bank stability and prevent future crises. In "On Regulation and Excess Reserves: The Case of Basel III," Stephen Matteo Miller and Blake Hoarty examine how the US Basel III capital adequacy regulations and liquidity regulations (implemented in 2013 and 2014, respectively) could have given banks incentives to increase holdings of excess reserves through 2015, when holdings reached their post-crisis peak, rather than holding more loans.

WHAT ARE THE BASEL STANDARDS AND WHY WERE THE REVISIONS IMPLEMENTED?

The guidelines from the Basel Committee on Banking Supervision concerning capital adequacy standards provide a voluntary framework that national bank supervisors may adopt or tweak. They emerged from the 1988 Basel Accords, which sought to establish global minimum standards for a bank's capital ratio (capital relative to total risk-weighted assets). US supervisors also adopted a non-risk-based "leverage ratio" (capital relative to total assets) in addition to the risk-weighted capital ratio. The guidelines have been revised numerous times, and US supervisors implemented the so-called Basel III revisions in 2013 in response to the 2007–2009 crisis. Under Basel III, the largest banks are subject to a "supplementary leverage ratio" as well, which further increases required capital.

The Basel standards may have unintended consequences, perhaps made worse under Basel III. The complex nature of risk-weighted capital requirements creates opportunities for banks subject to the regulation to increase their capital ratio. They can meet standards not only by increasing capital but also by reducing holdings of business and personal loans, which have higher capital requirements, and by increasing holdings of excess reserves and US Treasuries, which have lower capital requirements.

ONCE EXCESS RESERVES COULD ACCRUE INTEREST, BANK INCENTIVES CHANGED RADICALLY

Before Congress authorized regional Federal Reserve banks to pay interest on reserves, banks minimized holdings to little more than what was required to meet depositor withdrawals. With the authorization of interest payments during the crisis in 2008, the largest banks substantially increased their holdings of reserves. This was owing in part to the capital requirements, the rate of interest on reserves, and also the rate of return on assets that might serve as a substitute for reserves.

- If the rate of interest paid on excess reserves is high enough (relative to similar alternative investments such as US Treasuries), banks may have incentives to hold more excess reserves to bolster their capital ratio without adding more capital, especially because capital requirements for the largest banks increased under Basel III guidelines.

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- Before the implementation of Basel III in 2013, banks the size of JPMorgan Chase, Wells Fargo, and Goldman Sachs already held about $400 billion in excess reserves. By 2015 their excess reserves had jumped to over $1 trillion, and more than half of the increase may be owing to capital regulation. After 2015, excess reserves trended downward until the COVID-19 pandemic.

KEY TAKEAWAY

Because the largest banks are subject to complex and stringent capital and liquidity regulation, they may choose excess reserves over more traditional, riskier bank assets, such as loans. While perhaps well intended, risk-weighting means that banks (especially the largest) may not expand their lending when capital requirements increase. Even as the largest banks offer valuable services that smaller banks cannot, risk-weighted capital requirements may be undermining their ability to contribute to postcrisis recovery as they manage their balance sheets to meet regulatory capital requirements.