DEBATINDLÆG

BANK CAPITAL BUFFERS AREN'T WORKING

Langelinie Allé 47
2100 København Ø
www.nationalbanken.dk

Telefon: 3363 6363

kommunikation@
nationalbanken.dk

AF NATIONALBANKDIREKTØR LARS ROHDE,
BRAGT I FINANCIAL TIMES 9. DECEMBER 2020

Regulators must rethink overlapping Basel III requirements before the next crisis

The way bank capital requirements are designed has changed for the better since the 2008 financial crisis. Yet, regulators are becoming increasingly concerned that here, as in many aspects of life, too many cooks may spoil the broth. We must all review our regulations to make sure that the capital buffers can serve their purpose and genuinely allow banks to absorb losses when the next crisis hits.

Bank business models are complex and so is the regulatory landscape. Lenders have to comply with a wide range of requirements and meet them all simultaneously. Each one targets specific risks, but the interaction among them might render some of them futile in practice.

That is the case for banks' capital buffers — a cornerstone of post-2008 financial regulation. Banks were asked to build up extra capital to allow them to maintain lending during sharp economic downturns. However, many cannot fully draw down these buffers because they find themselves breaching other requirements first. International regulatory bodies must urgently address this problem of limited buffer usability.

Here is the problem: under the Basel III regulatory framework adopted after the crisis, bank capital requirements consist of both minimum requirements and capital buffers.

Minimum requirements are "hard" mandates that send a bank into resolution when breached. Capital buffers, on the other hand, are "soft" requirements that allow banks time to try to recover. If the buffer is breached, the bank's ability to pay dividends and bonuses is restricted until its capital stock is rebuilt.

Ideally, capital buffers should work like a fire sprinkler system, seeking to contain a fire before the emergency services move in. Just as effective sprinkler systems buy time for firefighters to put out the flames, capital buffers create leeway for banks so they can continue to provide credit to the real economy even in times of economic distress.

To continue the comparison, a prudent property owner may still want an insurance policy on top of any fire prevention measures. And a prudent society probably still wants to sustain a well-equipped fire department, no matter if all properties have state-of-the-art sprinklers. The destruction caused by a great fire is simply too large, as history has shown.

Likewise, even if measures such as mandatory capital buffers may help contain the impact of adverse shocks to banks, a prudent society may still want an insurance policy against potentially disastrous rare events. That means setting up a way to wind down failing banks properly without using taxpayer money. In banking regulation, such an insurance policy is called MREL, the minimum requirement for own funds and eligible liabilities. This aims to ensure that bank shareholders and creditors bear the losses of when banks go bust.

Banks need to fulfil the mandatory capital buffer requirements and MREL simultaneously. But that is where the problem lies: when the fire alarm sounds, you want the sprinkler system to start before the fire trucks arrive. Similarly, banks should be able to use their capital buffers long before being put into resolution mode. This is currently not the case for all banks. For many of the largest Danish banks — as well their European peers — MREL quickly becomes the binding requirement well before the capital buffers are depleted. This means that the capital buffers cannot fulfil their purpose and contain the fire.

To make matters worse, MREL is not the only overlapping requirement. The introduction of a binding leverage ratio requirement next year will further reduce capital buffer usability. In practice, this means banks will not be able to use as much of their buffers as intended by the regulation.

The Covid-19 economic shock is the first big crisis since the full implementation of the Basel III capital buffers. So far, banking sector losses have remained lower than feared. That is primarily due to unprecedented government measures to alleviate the strains from the sharpest plunge in economic activity many countries have ever experienced. Unlike in 2008, this crisis did not emerge from economic imbalances or from too much risk-taking in the financial sector.

But that is no excuse for entering the next financial calamity unprepared. In light of what we have learnt from this experience, it is time to review the regulatory framework so that capital buffers can better serve their purpose.