Regulatory Reform: A Scorecard

Stephen G. Cecchetti

www.moneyandbanking.com
The Five Pillars of Regulatory Reform
Ensuring Resilience

1. **Capital**: Requirements & levels are up, but not enough
2. **Liquidity**: One requirement is enough ⇒ LCR
3. **Resolution**: Progress, but framework remains untested
4. **Central Clearing**: Need sufficient safeguards
5. **Systemic Regulation**: Very early days
**Capital Requirements**

<table>
<thead>
<tr>
<th>Table 1: Comparing Basel III and Basel II Risk-weighted Capital Requirements for the Largest Systemic Banks: Impact of Basel III Capital Definition</th>
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Source: [Basel Committee on Banking Supervision](https://www.bis.org) (2010) and authors’ calculations.
## Table 1: Comparing Basel III and Basel II Risk-weighted Capital Requirements for the Largest Systemic Banks: Impact of Basel III Capital Definition

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The reason capital requirements are 10+ times higher than before the crisis is because they were so low!
Capital Levels

Capital levels are up:
- Risk-Weighted: +6.6pp
- Leverage: +3.0pp

Figure 1: Risk-Weighted and Unweighted Capital Ratios
Fully phased-in Basel III definitions

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Basel Committee Quantitative Impact Study (QIS) estimated ratio of common-equity tier 1 capital to risk-weighted assets or tier 1 capital to total assets. Data from 2011 to 2016 are from a consistent sample of 92 large internationally active banks with capital in excess of €3 billion.

Capital: Is it enough?

- Strong banks lend more and lend better!
- Social costs of higher equity are overstated (at current levels)
- TLAC is an admission that requirements are too low
- Leverage ratio guards against getting risk-weights wrong
Capital: Is it enough?

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- Social costs of higher equity overstated (at current levels)
- TLAC is an admission that requirements are too low
- Leverage ratio guards against getting risk-weights wrong
- Solution: Raise equity requirements substantially

IMF and FRB Minneapolis $\Rightarrow$ 20+% risk-weighted.
Liquidity Requirements

- **LCR**: Match *runnable* liabilities with *liquid* assets
- **NSFR**: Fund *illiquid* assets with *stable* liabilities
Liquidity Requirements: Simple Case

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1) no off balance sheet exposures
2) assets either perfectly liquid or illiquid
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\[
\text{LCR:} \quad \text{Liquid} \geq \text{Runnable} \\
\text{NSFR:} \quad \text{Illiquid} \leq \text{Stable}
\]
Liquidity Requirements: Simple Case

- LCR: Liquid – Runnable ≥ 0
- NSFR: Stable – Illiquid ≥ 0

Identity

Total Assets = Total Liabilities ⇒

Liquid + Illiquid = Runnable + Stable

Liquid –Runnable = Stable – Illiquid

Simple Case: LCR & NSFR are identical!
LCR implies a shadow NSFR

- Rigorous HQLA $\Rightarrow$ higher implied req. stable funding
- Higher run-off rates $\Rightarrow$ lower implied avail stable funding

We only need one liquidity requirement:
Adjust the LCR!
Resolution

- Regime for roughly 100 banks globally, 13 in US
- Large, complex, opaque, interconnected, many jurisdictions
- Progress
  - Living wills
  - Temporary public backstops (debt-in-possession financing)
  - Increase in loss-absorbing capital
  - Single-point of entry
  - TLAC (?)
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System remains untested!
Central Clearing

- LTCM: August 1998 had $1¼ tr interest rate swaps
- AIG: June 2008 had $446 bn notional CDS
- Amaranth Advisers: Sept 2006 lost $6bn in 3 weeks
Gross Notional Value of Derivatives
(Trillions of dollars)
Central Clearing

• Progress:
  US:  80% interest rate & credit derivatives in CCPs
  Globally: 76% interest rate swaps are in CCPs

  Gross notional exposure fallen by half!

• New risks: CCPs themselves
Central Clearing: The Risks

- CME has $30+ trillion of gross notional outstanding
  - Margin: 0.50%
  - Guarantee fund: 0.02%
  - CME’s contribution: 0.0007%

- CFTC stress tests: CCPs passed two-thirds of time

- Key vulnerability: still no resolution/recovery regime (and instant recovery is what will be needed)

Should we be worried?
Systemic Regulation

- Financial stability is a common resource (non-excludable but rival)
- Agents can deplete stability through hidden actions
- Require dynamic macroprudential policy
- Long list of tools (countercyclical capital, sectoral risk weights, LTVs, concentration & fx limits, …)
Systemic Regulation

- Adjusting tools is NOT:
  - Primarily about managing credit cycles
  - Leaning against asset price booms
- Focus of macropru: **maintaining resilience**
- Stress tests are the most powerful tool

Requires global coordination!
Is the system resilient enough?

- **Capital**: Equity requirements need to be **higher**
  (combined with shift to activity-based regulation)
- **Liquidity**: Need **one**, not two requirements
- **Resolution**: Assure global institutions can be resolved
- **Central Clearing**: Ensure sufficient safeguards
- **Systemic Regulation**: We need metrics, models, tools, governance structures, & international coordination
The Five Pillars of Regulatory Reform

Let's make sure that regulation remains strong!
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