Explaining variations in compliance with Basel capital standards

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Towards over-compliance with Basel III?

- September 2010: Basel III agreement to raise equity capital requirements from 2% to 7% of RWAs
- October 2010: Swiss "too big to fail commission" announces govt will require 10% equity ratios for majors
- September 2011: UK IBC:
  - Basel III capital requirements "don't go far enough"
  - Also proposes 10% min. equity ratios for "ringfenced" banks
- October 2012: US Systemic Risk Council recommends US regulators *"significantly exceed"* Basel III minima
- Others announcing OC intentions include Sweden, Switzerland, China, India, Singapore, Philippines

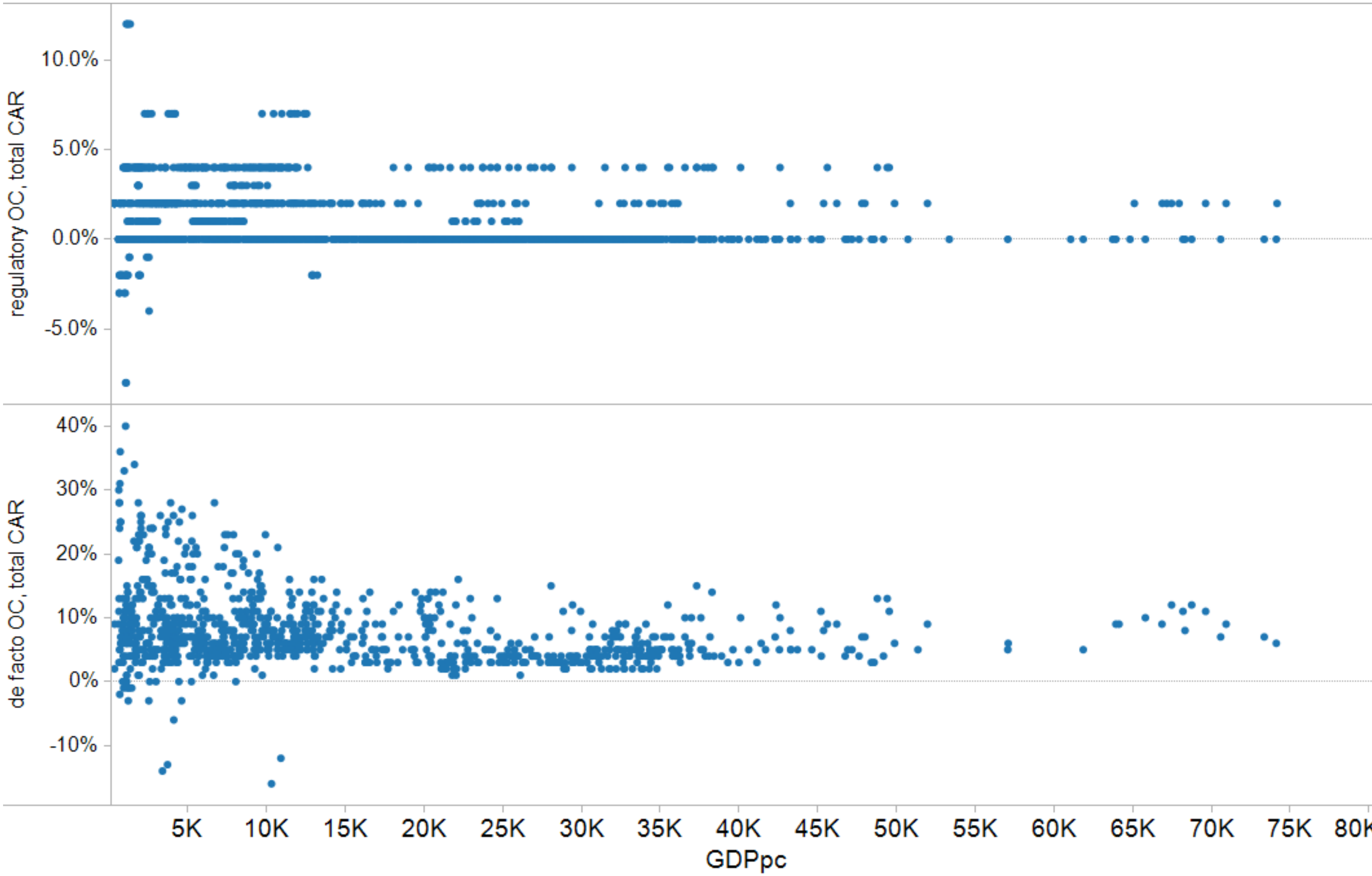
Existing theories lead us to expect OC will be:

1. **Rare**
   - OC seen as costly for bank shareholders, managers, employees, borrowers, & possibly for growth generally
   - Kapstein, Oatley & Nabors, Singer, Simmons: ask how *minimum* convergence on global standards occurs
2. **Unsustainable if adopted**
   - Arbitrage incentives & lobbying should erode domestic incentives to over-comply (Haldane, Hardy)
   - Possible growth effects suggest even OC in relatively closed financial systems might erode over time

But regulatory OC is actually common & persistent (Basel CARs)

year	Count of minimum compliers (min. total CARs)	Count of overcompliers (min. total CARs)	Total countries	**% Overcompliers (min. total CARs)**	**MEMO: % Overcompliers (min. Tier 1 CARs)**
1999	66	32	98	**33%**	**17%**
2000	66	32	98	**33%**	**17%**
2001	71	52	123	**42%**	**14%**
2002	71	52	123	**42%**	**11%**
2003	71	52	123	**42%**	**4%**
2004	72	52	124	**42%**	**4%**
2005	79	53	132	**40%**	**4%**
2006	79	53	132	**40%**	**8%**
2007	79	53	132	**40%**	**8%**
2008	79	53	132	**40%**	**10%**
2009	79	53	132	**40%**	**10%**
2010	79	53	132	**40%**	**10%**

Regulatory & de facto OC, by income per capita



Why?

- When will domestic financial stability benefits of higher minimum capital outweigh the competitiveness costs?
- *Basic (economic) model*
  - *Lower* development should promote OC: lower state LLR/insurance capacity, less stable deposit bases require higher financial sector safety buffers
  - OC by peers: should reduce competitiveness costs
  - Capital markets-based corporate finance systems: lower economic costs of OC compared to bank-based systems?
  - Higher financial openness: could raise benefits of OC (but also costs, so uncertain effects)

Testing the basic model

- Cross-sectional analysis given high dynamic stability of regulatory OC (132 countries in 2006)
- Dependent variables: *Incidence* & *level* of reg. OC
- Independent variables: *(log) GDP per capita, regional OC, financial system type, financial openness*
- Results:
  - regional OC (+), GDP per capita (-) and capital account openness (+) significant at 5% level for both incidence & level of OC
  - Financial system type generally insignificant

What about other political economy factors?

- Weak institutional environments may render minimum compliance inadequate, so regulators might push for OC
- Left govts might favour average taxpayers over banks & other beneficiaries of undercapitalization
- OC esp. likely after crises, as recent experience implies?
  - Increased taxpayer & govt sensitivity to costs of bank undercapitalization, banks need to reassure creditors
  - Stronger effect in executive-dominated systems, in which voters can more easily attribute blame?
  - But crisis aftermaths are difficult: costs of OC more keenly felt by banks, borrowers & general public; public anger generally fades

Extended model results

- Political institutions provide little additional explanatory leverage for incidence/level of OC
  - Bureaucratic quality, political system type: insignificant; rule of law sometimes significant (-)
- Left govts: higher proportion of left govts over 1992-2005 associated with ***lower*** incidence & levels of OC
  - Inconsistent with Broz's partisan cycles thesis?
  - Left fearful of driving financial business abroad?
  - Associated with lower capital account openness, perhaps reducing OC pressure

Impact of systemic banking crises

- Surprisingly, however measured, crises have no significant effects on regulatory OC
  - Though they are positively related to *de facto* OC (banks need to reassure creditors?)
  - SBCs sharpen distributional conflicts & make life difficult for govts, but without much reg. impact

What does this mean?

- OC in financial regulation not a luxury good, as food, environmental, safety standards might be (Vogel)
  - In fact, closer to an “inferior” good in the global system
  - Even SBCs do not substantially empower main potential winners from OC (taxpayers)
- Why?
  - Competitiveness vs. stability trade-off sharpest for banks in financially developed, more open countries
  - Bank creditors are increasingly often banks too
  - Technical complexity weakens consumer, taxpayer influence
  - After crises: short memories, costs often implicit, depositors bought off with state-backed deposit insurance

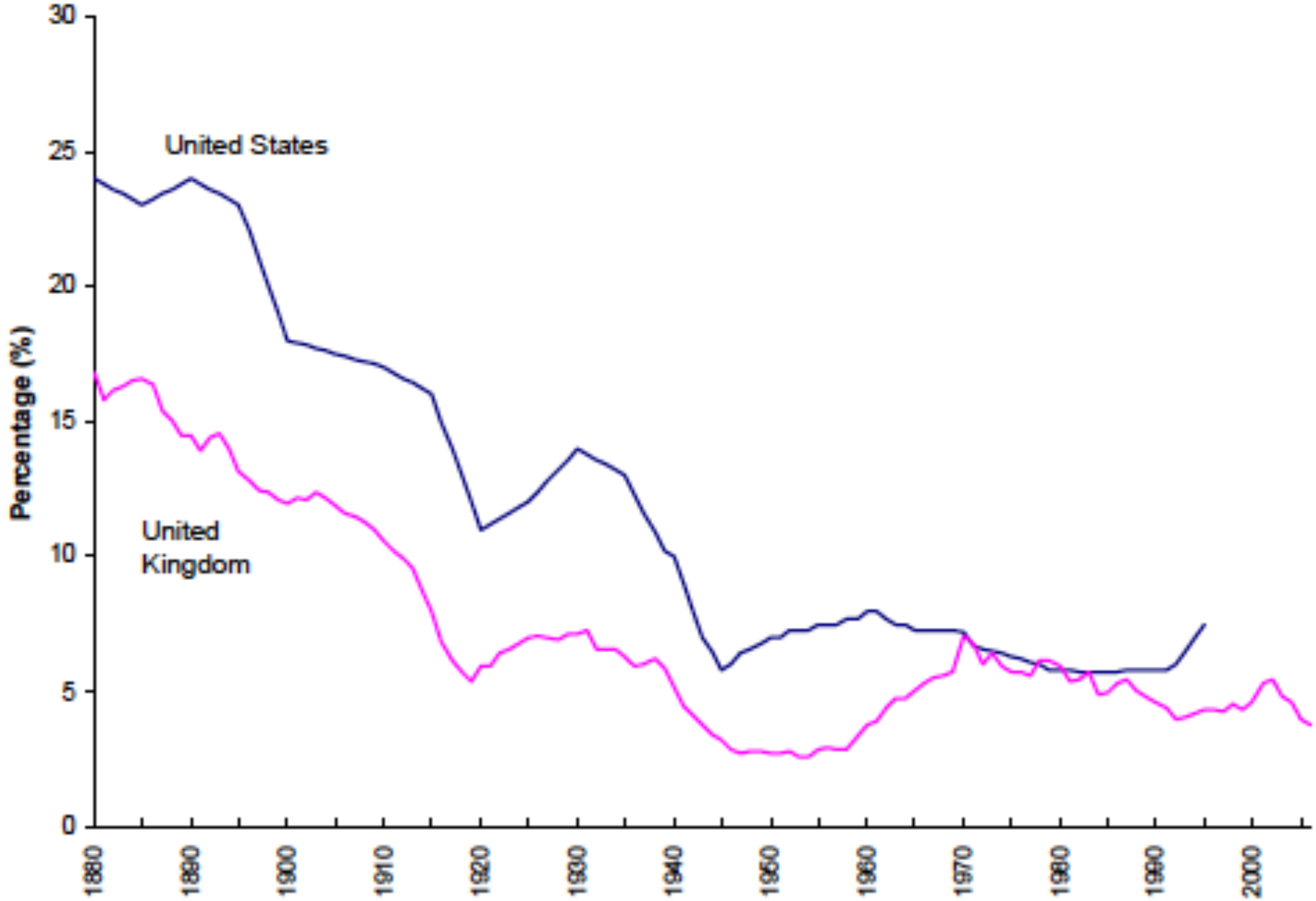
Relationship between financial development & state fiscal capacity

- Low fiscal capacity in developing countries requires (costly) OC by domestic banks
- Developed country banks need less capital as state fiscal capacity has risen
  - State protection more than market efficiency?
  - But rising financial leverage means rising implicit taxpayer subsidies to banks, their employees, & shareholders

Recent OC announcements in major countries lack credibility

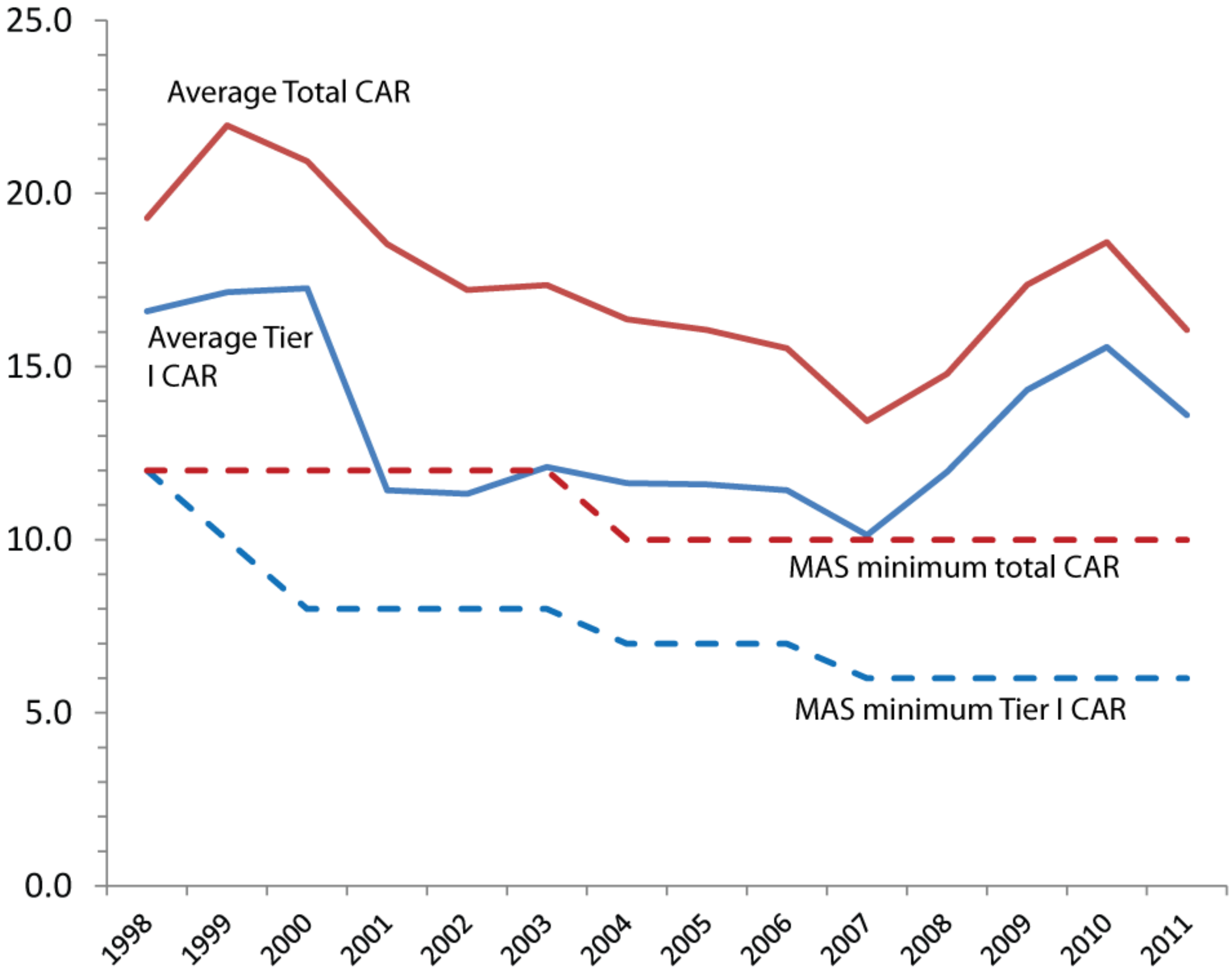
- UK has recently delayed its uncertain plans for OC; so too has China
- US, Japan, Germany & France look like non-starters
- There will be few significant “Swiss finishes”

Real capital levels since 1880, US & UK banks



Source: Haldane, Bank of England, 2009

Singapore: a rare retreat from OC



	Incidence of OC 2006 (logistic, odds ratios)		**Level of OC 2006 (robust regression)**	
	basic	extended	basic	extended
Capital account openness	1.49***	1.62***	0.003***	0.004***
OC in region (incidence, level)	14.36***	8.58*	0.85***	0.79***
ln GDP per capita	0.52***	0.58***	-0.004***	0.003**
Rule of law		0.90*		-0.003
Systemic BC count 1992-2005		1.00		0.000
N	122	122	122	122
Prob>chi², F	0.0008	0.0016	0.0000	0.0000
Pseudo R², R²	0.10	0.12	0.27	0.27

Note: Financial system type & incidence of left government omitted here