

Capital Counts in a Globally Competitive Marketplace by Raymond Natter¹

Beginning with the implementation of the Basel I Accord in 1989, the world's leading economic countries have applied a uniform risk-based capital standard for internationally active banks. While variances exist among the nations, for all practical purposes these banks are currently competing on a level field. This situation may change in the near future.

In 2004, the Basel Committee adopted a new standard, the Basel II Accord, which more closely aligns capital with risk. The proposed implementation of the Basel II Accord in the United States would subject our banks to higher minimum capital requirements than certain foreign banks.² This paper explains why this will adversely affect the competitive position of U.S. institutions.

I. The Role of Capital

Bank capital comprises the shareholders' equity investment and similar accounts that would be the first to absorb unexpected losses. In normal periods losses on loans or other activities simply reduce profits, but in extreme periods capital lessens the risk that a bank would be unable to repay its creditors. It therefore reduces potential losses to the FDIC's insurance fund in a failure. Capital requirements also control the ability of a bank to borrow and grow. A bank with only minimum required capital may not increase its loans or investments without increasing its capital base.

Capital requirements are specified as ratios. Risk-based requirements compare capital to risk-weighted assets, where riskier assets carry a greater weight than safer assets and consequently require more capital. The leverage ratio requirement compares capital to total assets, where all assets – from U.S. government bonds to speculative real estate loans – all require the same capital support.

II. Capital and Competition

Higher capital requirements adversely affect banks in three ways: it discourages growth in loans or equity investments, it enables competing institutions to gain market share, and it encourages the bank to make riskier loans.

Investors prefer companies that provide the most value for each dollar invested. A higher minimum capital level requires more shareholder investment to support the

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² Unlike almost all other countries, the U.S. also imposes a leverage requirement that is not adjusted for risk. Under Basel II the leverage ratio will likely become the binding regulatory capital requirement for many of our larger banks.

same assets. Each dollar invested in the bank with the higher requirement will receive a smaller share of earnings than if the same investment were made in a bank with the same assets and a lower requirement. Investment dollars will thus flow to the bank with the lower requirement.

Second, since the bank with lower requirement can hold more loans having the same risk with the same capital base, it can charge a lower rate for each loan, yet still earn the same (or even more) profit than a bank that is constrained by higher requirements. The bank with the lower requirement is also advantaged with respect to bank acquisitions. From the standpoint of that bank, the other bank has “excessive capital” that can be “liberated” through an acquisition. The “excessive capital” results simply from the fact that each bank is under a different regulatory regime, not from any economic difference between the institutions.

Third, a bank with higher capital will be motivated to offset these competitive disparities by increasing its earnings. Typically, this means making riskier loans and investments that provide a higher return but with greater chance of loss.

III. Why Do Most Banks Hold More Capital Than Required?

One argument made for higher capital requirements is that most banks today have more capital than is required by regulation, and therefore an increase in regulatory minimums should not be troubling. However, this argument fails to note the differences between required capital and additional capital that banks maintain.

Required capital is not accessible for business purposes. Dividends may not be paid from required capital, and required capital cannot be used for growth or other business opportunities. In a sense, it is funds that have been “spent” and are no longer available for business operations.

Capital held in addition to required amount serves many purposes. It provides a buffer against the consequences of becoming under-capitalized. It is a ready resource permitting a bank to take advantage of business opportunities, such as an acquisition. It allows a bank to meet unexpected demand for credit due to market developments. Additional capital can be used to fund an increase in dividends or for a share buy back or similar return of equity to shareholders. Unlike regulatory capital, additional capital provides a bank important flexibility and is a source of potential future growth.

IV. Global Impact of Higher Capital Requirements

If the U.S. proceeds to adopt higher minimum capital requirements than those applicable globally, our institutions will be disadvantaged. When competing for business abroad, foreign banks will be able to under price U.S. banks while maintaining their profitability. Domestically, foreign banks operating with U.S. branches will enjoy the

same ability to under price our institutions.³ Foreign banks that own U.S. bank subsidiaries will also enjoy this competitive advantage, even though the subsidiary will have to comply with U.S. rules. The foreign parent can fund the “excessive capital” held by the U.S. subsidiary bank with debt and as a result be able to more aggressively compete with U.S. institutions both domestically and overseas.

V. Conclusion

Regulatory capital protects the deposit insurance funds and helps a bank deal with unexpected losses. However, excessive capital mandates reduce profitability, limit growth, and encourages the booking of riskier loans and investments. When similar banks have different minimum capital requirements, a competitive advantage is given to the bank with the lower requirements. This advantage is not based on productivity or management efficiency, but simply created artificially by regulation. The U.S. regulators should conform the U.S. rules to the rules that apply abroad. The Basel II Accord was agreed to by all of the bank regulatory agencies, and there is no reason to diverge from that agreement. The Basel II Accord includes many safeguards including a two-year transition period. These safeguards are sufficient for the rest of the world, and – along with the continuous on-site supervision in place at large U.S. banks – can ensure that U.S. banks remain safe and sound.

³ U.S. bank holding companies and foreign banks may engage in a broad range of financial activities in the U.S., but only if the U.S. holding company or foreign bank is “well capitalized.” The Fed does not apply the leverage ratio to foreign banks, and Fed staff has stated that foreign country’s version of Basel II will be used for determining whether the foreign bank is “well capitalized,” and therefore able to engage in broader financial activities in the U.S. Domestic bank holding companies will be required to meet *both* the leverage ratio and the U.S. version of Basel II for the same privileges.