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## **Basel III, the Banks, and the Economy**

By November, banking regulators are likely to complete an international agreement that will determine how strong banks must be. Tough new rules on capital and liquidity are being negotiated through the Basel Committee on Banking Supervision (Basel Committee). The agreement, which is known as “Basel III” because it will be the third version of these rules, will have a large effect on the world’s financial systems and economies. On the positive side, newly toughened capital and liquidity requirements should make national financial systems -- and indeed the global financial system -- safer. Unfortunately, enhanced safety will come at a cost, since it is expensive for banks to hold extra capital and to be more liquid. It is beyond serious dispute that loans and other banking services will become more expensive and harder to obtain. The real argument is about the degree, not the direction.

The banking industry argues that Basel III will seriously harm the economy. For example, the Institute of International Finance (IIF) calculated that the economies of the US and Europe would be 3% smaller after five years than if Basel III were not adopted. My own analyses, and those of other disinterested parties, generally suggest a much smaller cost that would seem to be considerably outweighed by the safety benefits. As the recent crisis clearly attests, severe financial crises can cause permanent damage to the world’s economy, imposing economic loss and emotional pain on hundreds of millions, if not billions, of people. It is worthwhile to give up a little economic growth in the average year in order to avoid these major impacts, as my work suggests would be the case. On the other hand, if the industry is right, the additional safety is probably not worth the cost and a more modest regulatory revamp would be preferable.

This paper explores the following questions about Basel III.

- What is Basel III and who is making the decisions?
- What is the timetable for Basel III?
- What are capital and liquidity?
- What are the current rules?
- What are the proposed changes from the current rules?
- What stays the same?
- What are the major areas of disagreement?
- Will the originally proposed changes or timetable be modified?
- What are the likely effects of Basel III?

## **What is Basel III and who is making the decisions?**

Basel III is a set of proposed changes to international capital and liquidity requirements and some other related areas of banking supervision. It is the second major revision to an original set of rules, now known as Basel I, which was promulgated by the Basel Committee in 1988. The committee was established in the mid-1970's, after the failure of a small German bank (Herstatt) sent shudders through the global financial system as a result of poor coordination between national regulators. The Basel Committee is composed of banking regulators from a number of industrialized countries, with a core membership concentrated in the traditional banking powers within Europe, plus the US and Japan.

The Basel accords are not formal treaties and the members of the committee do not always fully implement the rules in national law and regulation. One prominent example of this is in the United States. We had not implemented the Basel II revisions for our commercial banks by the time of the financial crisis, which put any such changes on hold. It is not clear whether we would eventually have implemented them, despite having been closely involved in the negotiations that led to that agreement. In truth, few countries choose to implement every detail of the Basel accords and they sometimes find unexpected ways to interpret the aspects they do implement. Despite this, the accords have led to much greater uniformity of capital requirements around the globe than existed prior to Basel I. In fact, the uniformity extends well beyond the countries represented on the Basel Committee, as most nations with significant banking sectors have modeled their capital regulation on the Basel rules.

The Basel Committee is loosely affiliated with the Bank for International Settlements (BIS) which is often referred to as the club for the world's central bankers. The BIS provides certain financial services to central banks and also serves as a vehicle to promote cooperation between them. In addition, it provides support services to the Basel Committee and several other multi-lateral bodies focused on the world's financial systems. Prominent among these is the Financial Stability Board (FSB) which was charged last year by the heads of government of the Group of Twenty (G-20) nations with the mission of promoting financial stability around the world. In that capacity, it has been a prominent advisor to the Basel Committee in its work on Basel III.

## **What is the timetable for Basel III?**

The G-20 heads of government have charged the Basel Committee with finalizing the Basel III rules in time for the G-20 meeting in Seoul, Korea on November 11-12, 2010. The process leading to that started with the issuance of consultation papers in December of 2009 that outlined the changes proposed by the Basel Committee for the capital and liquidity requirements<sup>1</sup>. Comments were solicited by mid-April of 2010 and many parties responded at length. In parallel, the Basel Committee, with assistance from the BIS and the FSB, has been conducting a Quantitative Impact Study (QIS) to estimate the potential effects on the financial markets and the economy of putting in place the proposed changes. It appears that the QIS has been completed in draft form and is being reviewed by the Basel Committee and the

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<sup>1</sup> The two papers can be found at: <http://www.bis.org/publ/bcbs164.htm> and <http://www.bis.org/publ/bcbs165.htm>

member regulators. Release to the public is expected in September, although there is no announced deadline for this. The QIS will presumably influence the Basel Committee's choices on the levels of certain key ratios and on any revisions that it deems necessary to the elements of the original proposal.

The intention is to implement Basel III by the end of 2012, although it seems clear that there will be transition periods, observation periods, or phase-ins for a number of the more important requirements, as well as "grandfathering" of certain features of existing regulation. All of these exceptions would be intended to ease the transitional impact of Basel III, which could potentially be quite large by the time it is entirely phased in.

### **What are capital and liquidity?**

"Capital" is one of the most important concepts in banking. Unfortunately, it can be difficult for those outside the financial field to grasp, since there is no close analogy to capital in ordinary life. In its simplest form, capital represents the portion of a bank's assets which have no associated contractual commitment for repayment. It is, therefore, available as a cushion in case the value of the bank's assets declines or its liabilities rise. For example, if a bank has \$100 of loans outstanding, funded by \$92 of deposits and \$8 of common stock invested by the bank's owners, then this capital of \$8 is available to protect the depositors against losses. If \$7 worth of the loans were not repaid, there would still be more than enough money to pay back the depositors. The shareholders would suffer a nearly complete loss, but this is considered a private matter, whereas there are strong public policy reasons to protect depositors.

If bank balance sheets were always accurate and banks always made profits, there would be no need for capital. Unfortunately, we do not live in that utopia, so a cushion of capital is necessary. Banks attempt to hold the minimum level of capital that supplies adequate protection, since capital is expensive, but all parties recognize the need for such a cushion even when they debate the right amount or form.

The subject of capital, and regulatory capital requirements, is a complex one and will only be summarized here. A more complete discussion can be found in "Bank Capital: A Primer"<sup>2</sup>. As explained in that paper, common stock is not the only type of security that is considered to be capital because of the protection it provides depositors and other parties that regulators care about. Certain forms of preferred stock, and to a limited extent debt, can also serve as capital.

It is worth noting that bank regulation generally uses the reported accounting numbers as the basis for calculating capital levels, without adjusting for market valuations except to the extent they are captured by standard accounting rules, such as occurs with certain "mark to market" requirements. In particular, the market capitalization of bank stocks in the heart of the crisis tended to be substantially lower than the accounting value of the equity of these banks. Essentially, the market believed that accounting

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<sup>2</sup> Please see

[http://www.brookings.edu/~media/Files/rc/papers/2010/0129\\_capital\\_elliott/0129\\_capital\\_primer\\_elliott.pdf](http://www.brookings.edu/~media/Files/rc/papers/2010/0129_capital_elliott/0129_capital_primer_elliott.pdf)

values were overstated or that substantial new losses would occur in the future or the market was too low for technical reasons unrelated to expectations of future performance. None of these factors would directly affect regulatory capital levels, although regulators are always wise to note these divergences in case they indicate that the market has determined that the banks are in worse shape than appears on the surface.

“Liquidity” refers to the ability to sell an asset, or otherwise convert it to cash, without incurring an excessive loss in doing so. Liquidity almost always increases the longer the timeframe being considered. A house, for example, may be a very illiquid asset if one needs to sell it within a week, but may be quite liquid if one is given five years to manage the sale. More broadly, the liquidity of a bank often refers to the matching of its obligations with its funding sources. A bank with highly liquid assets would generally be considered fairly liquid even if its funding sources were of quite short maturities, since the assets could be liquidated as needed to cover any loss of funding. A bank with less liquid assets might be fine if its funding sources were locked in for long periods, but could be in serious trouble in a panic if it relied on short-term debt or deposits that might flow away.

### **What are the current rules?**

The core of the Basel rules on capital reflects a belief that the necessary level of capital depends primarily on the riskiness of a bank’s assets. Since capital exists to protect against risk, it stands to reason that more is needed when greater risks are being taken. The focus is on the asset side because liabilities are generally known with great precision, since a deposit or a bond must be repaid based on specific contractual terms. (This is a major contrast with the insurance industry, where the future costs of promises to protect against various events, such as fires, are unknown.) Unlike bank liabilities, bank assets can go down, or occasionally up, in value. In particular, bank loans may not be repaid and securities may default or may need to be sold at a time when their market value has declined.

The original, Basel I, rules grouped all assets into a small number of categories and applied a risk-weighting to each category. The total value of each asset is multiplied by its risk weighting and this adjusted amount is added across all assets to produce a total risk-weighted asset (RWA) figure. The percentage weighting for each category ranges from 0%, for extremely safe investments such as cash and US government securities, to 100% for riskier classes of assets. (In a few cases, the weightings now exceed 100% for certain very risky assets, such as loans in default or imminent danger of default and the riskiest tranches of securitizations.) For example, residential mortgage loans often have a 50% risk-weighting, so that a \$1 million mortgage would generate a risk-weighted asset of \$500,000. If a bank were trying to hold capital equal to 10% of its RWA, then it would need \$50,000 of capital to cover this mortgage.

The Basel II revisions made four major changes to the risk-weighted asset calculations:

**Refinement of categories.** Basel II broke the categories down in much greater detail than in Basel I, with more variation in the risk weighting, since it was realized that the crudeness of the original simple categories was encouraging a great deal of “gaming” and misallocation of resources. In addition to the

weaknesses inherent in using a small number of categories, the weightings had been fairly arbitrary and influenced by political considerations. For example, Germany particularly wanted mortgages to carry a lower risk weighting than other bank loans.

**Ratings.** Ratings from the major credit rating agencies became a significant factor in the risk weightings, which had not been true when only broad categories were used.

**Internal risk modeling.** It was agreed that the sophisticated global banks could use their own internal risk rating models to determine the risk weightings for their own particular assets, with some exceptions. The idea was to align regulatory risk calculations with the considerably more sophisticated risk models that were being used by major banks in their own decision-making. This concept counts on the self-interest of the banks to lead them to use the best possible estimates of risk in their own management of assets.

**Trading assets.** Basel II promulgated a different method for calculating the risk of assets that were held in trading accounts, based on the assumption that the risk level of trading assets was principally determined by how far the assets could realistically fall in value before a bank could dispose of the investments. Thus a “value at risk” (VAR) approach was used, utilizing statistical techniques to estimate from historical data how large a loss might be taken in unusually unfavorable circumstances.

Capital adequacy under the Basel Rules is determined by calculating a ratio of the level of capital to the total risk-weighted assets. Basel I defined two tiers of capital, a distinction that has been retained. “Tier 1,” the strongest, consists mainly of common stock and those forms of preferred stock that are most like common. “Tier 2” adds in certain types of preferred stock that are less like common stock and more like debt, as well as certain subordinated debt securities. In addition, Tier 2 includes some accounting reserves that provide a protective function similar to other forms of capital<sup>3</sup>. The two tiers are intended to ensure that there is enough total capital available to handle even extreme occurrences and that the bulk of this capital is the stronger “Tier 1” variety. Generally, banks have plenty of Tier 2 capital, so the practical focus has been on ensuring there is enough of the stronger, Tier 1, form of capital.

The Basel calculations include a number of deductions from the stated balance sheet figures for capital. First, and probably most importantly, the Basel agreements require the deduction of goodwill, (which arises when a company or asset is purchased for more than its book value), effectively treating it as worthless for these purposes. Second, individual national regulators have chosen to fully exclude or to

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<sup>3</sup> Tier 2 capital includes five broad categories. First, some countries, but not the U.S., allow “undisclosed reserves” that are effectively the same as retained earnings, but are separately accounted for. Second, some countries allow certain assets to be held at historical values that can be well below current market values. Some or all of the difference between current and market values would be held as a “revaluation reserve.” Third, general loan loss provisions may be held which are not allocated to specific claims and are therefore available to absorb any unexpected losses. Fourth, certain “hybrid debt capital instruments” are considered to have enough of the aspects of common stock to be considered Tier 2 capital. Fifth, subordinated debt instruments with at least a five year maturity are allowed to count as Tier 2 capital to a limited extent.

limit the amount of certain other accounting assets. For example, U.S. regulators limit the portion of deferred tax assets that may be counted in equity, since the value of those assets would only be realized if a bank makes future taxable profits, which may not occur if it runs into the kind of trouble that makes capital important.

### **What are the proposed changes?**

The financial crisis exposed or underlined a number of areas of weakness in the Basel II rules. These problems led to many proposed changes under Basel III, including the following.

**Higher capital ratios.** The consultative document did not specify figures, but made clear that the minimum acceptable Tier 1 and Tier 2 risk-weighted capital ratios would be raised. This will have major effects, but is difficult to discuss further until the proposed levels are known. Speculation centers on an increase of a couple of points in the minimum ratios, but this is not clear.

**Use of a leverage ratio as a safety net.** Most broadly, the crisis pointed out the problems with using risk-weighted asset calculations that are intrinsically based either directly on historical experience, in the case of the internal ratings used by the large banks, or indirectly, in the case of the risk-weightings that are set by the Basel Committee. The value of many assets fell considerably more sharply and quickly than was suggested by historical experience, in some cases because good quality data did not exist for very many years and therefore had only reflected the favorable market conditions of recent times. In response, there is broad agreement that a straight “leverage ratio” should be given more regulatory weight. In this context, a leverage ratio is simply the ratio of capital to total assets with no risk-weighting of the assets. This has the major disadvantage that as much capital would have to be held to back a U.S. government bond as to back a risky loan, but it does avoid the problems caused by inappropriately low risk weightings. The Basel III rules therefore propose to include a leverage ratio as an additional test of capital adequacy to serve as a “safety net” to protect against problems with risk weightings.

**Tougher risk weightings for trading assets.** A second major problem was that the risk weightings for trading assets were clearly set too low, again reflecting an excessive reliance on favorable recent history. This has already been dealt with in a major set of changes that took effect in what might be considered Basel IIa, through a substantial toughening in the methodology for determining risk weightings of trading assets. It appears that capital requirements in these areas have roughly doubled, on average, compared to the old methodology. These rules changes are retained under Basel III.

**Elimination of softer forms of capital.** The financial crisis demonstrated that some securities that were considered capital instruments were unusable as a practical matter in a severe financial crisis. Capital is only useful if it can be made to absorb losses in order to protect other parties, but regulators were effectively blocked from forcing that loss absorption in the case of subordinated debt, which had counted in certain cases as Tier II capital. Since these were legally debt instruments, the holders could force a bankruptcy or insolvency proceeding if they were to suffer a loss. Putting a major financial institution into insolvency was viewed as a very risky move by policymakers, especially after the insolvency of Lehman Brothers caused severe market turmoil. As a result, subordinated debt will no

longer count as capital even for Tier II purposes and other soft forms of capital are being eliminated or subjected to tighter conditions.

**Exclusion of some balance sheet items from capital.** Following a similar logic, the Basel Committee decided that certain balance sheet items should be excluded from capital because they might not truly be available to absorb losses in a crisis. For example, a bank or bank holding company's ownership stake in an insurance company would no longer count as capital, on the theory that it represented capital at the level of the insurer and should not be required to do double duty. Put another way, an insurer could easily be hit by the same financial crisis as the bank and its own loss of capital would cause problems both at the insurer and then at the bank which was counting on the value of its investment. "Minority interests," which represent partial ownership of a part of the banking group by outside parties, would also cease to count. Yet another category is "deferred tax assets" which represent the value of previous losses which can be used to offset taxes on future profits. Since the value of these assets is dependent on future profits, Basel III moves to effectively exclude them. (They were already limited in some countries, such as the US, where only tax benefits foreseen to be used over the next year were allowed.)

**Higher capital requirements for counterparty credit risks.** The crisis also showed how much counterparty credit risk existed, causing the committee to tighten the rules for when capital must be set aside and how much must be earmarked for these risks. This includes making a distinction on the amount of capital needed to back exchange-traded derivatives, which carry low counterparty risk, and over the counter derivatives, which will now require more capital.

**New liquidity requirements.** The Basel Committee had largely ignored liquidity in the past, leaving it as one of the many items on which national regulators had discretion to regulate as they pleased. Some countries, such as France, had explicit liquidity requirements, but most viewed it only as a subjective item to keep an eye on. However, the financial crisis highlighted the fundamental fact that financial institutions depend for their survival on managing liquidity in order to prevent a fatal run on the bank if confidence in their financial strength evaporated. As a result, Basel III proposed two tough new liquidity tests that would be standardized globally.

First, minimum liquidity levels would be based on a type of stress test using standardized calculations. Effectively, the test mimicked a freezing of the financial markets for a period of [x] months during which it became extremely difficult to raise new funds and existing liabilities, such as short-term debt, would generally roll off at maturity. Core deposits were assumed to be drawn down to some extent, but mostly to remain at the bank. Non-core deposits, such as certificates of deposit, were assumed to roll off completely as soon as they could be withdrawn. Maturing debt was assumed to roll off and not be replaced. Liquid assets could be used to cover cash needs, but haircuts of various sizes were applied to reflect the fire sale in the financial markets caused by the adverse conditions.

Second, a "net stable funding ratio" test was created. This measured the level of liquid assets to the level of liabilities that matured in a year or less. The intention was to force banks to move more of their borrowing to multi-year funding sources or to invest more heavily in fairly liquid assets.

**Contingent capital.** Basel III endorsed the general idea of adding contingent forms of capital, but proposed further study rather than immediate implementation, given the numerous technical issues to be resolved. Contingent forms of capital are basically debt securities which would convert to equity under pre-agreed terms in the event that a bank ran into problems. It can be thought of as a pre-arranged debt-to-equity swap and serves the same purpose of reducing debt to equity ratios and allowing a troubled institution to recapitalize outside of an insolvency proceeding.

**Counter-cyclical capital requirements.** Basel III also endorsed the idea that capital requirements should be higher in good times and somewhat lower in bad times. This would achieve the purpose of “leaning against the wind” and slowing banking activity when it overheats and encouraging lending when times are tough. It is unclear at this point how this might be implemented and the degree of discretion that national regulators would have.

### **What stays the same?**

Regulators, with the concurrence of world leaders, have chosen to keep the essential structure of the Basel II approach intact while trying to improve the mechanisms of the accord. This is not to minimize the extent of the changes described above, which are quite significant, but rather to emphasize that they are consistent with the overall framework of Basel II. The two possible exceptions to this general statement are the leverage ratio, which does not take the risk-based approach that is at the heart of Basel II, and the addition of a liquidity test. In practice, the leverage ratio is likely to be set at levels that leave the risk-based ratios as the key determinants of the capital requirements, muting the effect adding a leverage ratio. For its part, the liquidity test is not truly inconsistent with the capital tests, but should probably be viewed as a supplement that is in the spirit of the original Basel accords.

One aspect that remains the same has come under a great deal of criticism from some academics and market observers. Basel II and III both allow the sophisticated global banks to use internal risk models as key determinants of their capital requirements. The argument in favor of this is that banks devote far more resources than regulators can to developing sophisticated approaches to evaluating the risk they are taking on and they have a strong incentive to get it right, in order to maximize their own profitability over time. Unfortunately, we now know that the risk modeling leading into the crisis was seriously flawed by a combination of excessive reliance on a limited historical record and perverse compensation incentives. There is good reason to believe that the modeling is better now, both because of extensive efforts to fix the problems and because the historical record now includes a much worse set of events, automatically increasing their conservatism. However, many remain skeptical that the basic flaws have been fixed.

A related issue is that capital requirements for trading assets are still calculated with extensive reference to Value at Risk calculations. Basel III adds layers of conservatism that appear to roughly double the capital requirements on average. However, the VAR concept appears to work better for evaluating daily or weekly risks than for somewhat longer holding periods. For this reason, some observers are skeptical that the VAR approach works effectively when applied to less liquid assets.



In both cases, the Basel Committee has chosen to retain the role of standard risk models, despite an awareness of their flaws. The consensus of the committee is that the benefits outweigh the disadvantages and that there is no clearly superior approaches available.

### **What are the major areas of disagreement?**

There is broad agreement within the Basel Committee, at the G-20, and even in the financial markets, that capital requirements need to be raised in light of the financial crisis. However, there are disagreements, particularly between the banking industry and the committee, on the specific approaches being taken to achieve this purpose. As will be discussed further below, the industry argues that the committee is going overboard in many areas and doing so in ways that will significantly, and unnecessarily, raise the cost of providing loans and other banking services. Some of the key areas of discord are:

**Net stable funding ratio.** There seems to be a reasonable degree of acceptance that Basel rules need to cover liquidity, but the industry has pushed back very hard on the net stable funding ratio test. They believe that it would force very substantial and expensive changes to how they fund themselves and invest their assets and that the gain in safety would be marginal. They have more support from disinterested observers on this than they do on their complaints about the higher capital requirements, although opinion is divided in the academic community. Whatever the merits, it appears that the industry has succeeded in giving the regulators great pause on this topic and the test may be dropped from the initial Basel III rules and studied further. The liquidity stress test has generated less opposition, although it is certainly not without controversy either. As a result, it might be included in Basel III or might be put off along with the other liquidity test.

**Higher capital ratios.** This fight will spring up in full fury once specific capital ratios are specified, but the banking industry has already made clear that they believe only moderate changes are necessary, especially given all of the other ways in which capital levels are being increased in the Basel III proposals.

**Use of a leverage ratio.** There is a heated debate on this topic. Virtually all regulators agree that a simple leverage ratio is a useful way of checking to see if the risk-based approach is leading to excessively large balance sheets. Some countries, notably the US, believe that this is such a useful ratio that it ought to be mandatory and binding, so that a bank's minimum required capital would be the greater of the risk-based figure and the one derived from the leverage ratio. Others, notably France, believe it is simply one useful supplemental measure and that how it is used should be up to national discretion. They further point out various technical problems that could make it very difficult to achieve uniformity, such as the differences between US and international accounting standards. Some analyses have suggested that the two different accounting regimes could show total assets on the balance sheet that differed by as much as 100%, so that a fixed leverage ratio could require twice as much capital in one country as another. At a minimum, there will have to be an approach that adjusts the leverage ratio for such differences.

This ratio will probably remain controversial for a long time, if for no other reason than the fact that US banks have been operating under a leverage ratio for some time and are already configured to deal with it, while European banks have not. In a nutshell, many European banks have larger balance sheets than US banks, but focus more on lower-risk assets, since this is what the Basel rules effectively encourage. Adding a leverage ratio would force them to operate more like US banks in their asset allocations.

The most likely result is that the Basel Committee will choose to elevate the importance of the leverage ratio, but do so in a manner that allows the development of greater consensus over time. For example, there has been talk of an “observation period” of several years before it becomes binding, which, in practice, would allow for it to remain non-binding if a true consensus cannot be built. Another possibility is for it to be binding, but set at a low enough level that it would rarely be the determinant of the minimum capital requirements, since the risk-based approach would almost always yield a higher requirement.

**Elimination of softer forms of capital.** Everyone agrees that common stock provides the strongest form of capital protection. The problem is that common stock is also by far the most expensive form of capital for a bank to raise. Therefore, banks have availed themselves of substantial amounts of softer, and cheaper, forms of capital. Therefore, the industry has been fighting back against the elimination of some of these forms and has also been pushing for transition periods in which some or all of these forms of capital would continue to count as capital. The European and Japanese banks feel particularly strongly about this, as they have relied somewhat more on these forms than have the American banks.

**Exclusion of some balance sheet items from capital.** Banks in every country gain considerable benefit from at least one of the balance sheet items that will no longer count as capital and therefore put forth arguments as to why they should continue to count. The Europeans are particularly concerned, because many of their corporate structures include investments in insurers and minority interests in their banks to a much greater extent than is true in the US. On the other hand, the US banks are concerned about deferred tax assets and about mortgage servicing rights, which are of lesser concern to the Europeans. There are legitimate arguments in almost all cases, which is why these items had been counted as capital in the past, but the committee strongly wants to ensure that common stock, and not softer forms of capital, really does constitute the core of capital. This difficult balancing act will be resolved by classic horse trading among the different countries on the committee, balanced by a desire to maintain the overall integrity of the Basel III proposals.

Virtually every part of the Basel III proposals has been objected to by someone, so the above should not be viewed as a complete list, but merely the most important and controversial items.

### **Will the originally proposed changes or timetable be modified?**

Despite the various controversies, it appears unlikely that the core Basel III proposals will be dropped, with the exception of the liquidity provisions. Nor does it appear likely that the timetable for initial implementation will be altered significantly. The G-20 heads of government show a strong desire to finish this at their Seoul meeting in November and it appears that there is sufficient consensus to

achieve this. It is possible, of course, that some disagreements will effectively be declared to be implementation details that can be delayed modestly, even if an objective observer might consider them to be more fundamental concepts rather than just details. That said, it would be a surprise if there were a major delay in a core part of the Basel III proposals, with the exception of the liquidity requirements. The one thing that might create a postponement would be the onset of a new recession or severe financial crisis, such as the Euro crisis was threatening to become. Leaders are not going to want to risk slowing their economies further under those circumstances.

As noted earlier, it is highly likely that there will be a number of arrangements to ease the transition once the initial implementation date is reached, such as phasing out various forms of soft capital over a period of years and perhaps phasing in the new higher Tier 1 capital ratios.

### **What are the likely effects of Basel III?**

There is very considerable disagreement about the effects of Basel III. Virtually everyone accepts that banks and the financial system would be safer as a result of these changes, but that this would come at the cost of slower economic growth in most years due to higher credit costs and reduced availability. However, the magnitude of these effects is at issue and very much affects one's view of the trade-off. As noted earlier, the IIF, an industry group, calculated that the economies of the major economies would be about 3% smaller as a result of Basel III than they otherwise would be five years on<sup>4</sup>. This is a very large impact and the G-20 leaders would probably reject Basel III if they believed these figures. Nor is the IIF's analysis even the most pessimistic. For example, the French banking association offered calculations that suggested a 6% hit to the French economy.

On the other hand, various disinterested observers have concluded that the effects would be much smaller. My own calculations, for example, suggested that a large increase in capital requirements in the US might only increase average loan pricing about 0.2 percentage points, with little effect on availability<sup>5</sup>. (I did not analyze the effects of the liquidity rules, which could be larger, and I assumed a long enough transition effect to avoid abrupt changes.) An increase in loan pricing of this magnitude would likely have quite minimal effects on economic growth. (Consider how small an effect there is on the economy of a 0.25% rate move by the Fed, which is the smallest change they normally make.)

My discussions with European and US policymakers and regulators strongly suggest that the key decision-makers are heavily discounting the industry's analyses, instead buying into the Basel Committee's own apparent view that the drag on the economy would be relatively small and more than offset by the benefits of greater systemic safety. This thinking may either be confirmed or altered on the basis of the committee's Quantitative Impact Study which should be publicly available in September.

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<sup>4</sup> Please see [www.iif.com](http://www.iif.com) for the full interim report.

<sup>5</sup> Please see [http://www.brookings.edu/papers/2009/0924\\_capital\\_elliott.aspx](http://www.brookings.edu/papers/2009/0924_capital_elliott.aspx) and [http://www.brookings.edu/~media/Files/rc/papers/2010/0129\\_capital\\_elliott/0129\\_capital\\_requirements\\_elliott.pdf](http://www.brookings.edu/~media/Files/rc/papers/2010/0129_capital_elliott/0129_capital_requirements_elliott.pdf)

If the Basel Committee is right, the lowered growth rate during non-crisis years may be more than offset by the avoidance of truly severe recessions brought on every few decades by widespread, severe financial crises. A recession as rough as the one we recently went through causes permanent losses to the economy in addition to the awful transitory effects. The long-term unemployed may find they are never able to return to work and some plant and equipment is junked or deteriorates after being out of service for long periods. There are also very long-lasting effects of the sharp increase in national debt that tends to accompany such severe recessions. It is difficult to pin down the permanent shrinkage in the economy, but most observers would agree that it is quite significant. In addition, of course, the temporary shrinkage of the economy adds up to a considerable loss before the economy recovers to more normal levels.

### **Conclusion**

Basel III will happen, roughly on schedule, and will make a major difference to the operation of the financial system. Banking will be safer, but more expensive, with extensive ramifications throughout the economy. Despite the dry nature of discussions of financial regulation, the Basel III process bears watching closely.