

## Get Basel III Right and Avoid Basel IV

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We must insist on strong capital for all banks

As the world struggles to address the urgent need to have stronger capital standards for banks, I am reminded of a Midwestern saying I heard often as a young man: “You never seem to have time to do it right the first time, but you always seem to have time to do it over.” It is a maxim we should keep in mind when we hear chief executives and regulators around the globe say that Basel III needs to be accepted and implemented quickly to assure a better capitalised and safer financial system. Rather than pushing through a flawed Basel III, we need to take the time to do it right so we do not have to do it over.

Each new Basel standard attempts to correct the errors and unintended consequences of earlier versions. But instead of resulting in better outcomes, each do-over has been more complicated and less effective than the last. Most disturbingly, each fails to provide enough real capital to absorb unexpected shocks to the economy.

The many Basel iterations all rely heavily on econometric models and probability estimates that are precise to a decimal point. They attempt to estimate the riskiness of assets on a scale of very high to none. Using this system of risk-weighted assets, the 10 largest US banking groups had total Basel capital to risk-weighted assets averaging 11 per cent in 2007 at the start of the financial crisis. The chief executives of these banks were confident, even boastful, of being well capitalised.

But using tangible equity capital and total assets – a more conservative, more credible method of assessing capital adequacy – the average leverage ratio of those same US banks was only 2.8 per cent prior to the crisis, or less than three cents for every dollar of assets on the balance sheet. This more conservative calculation reflects what good analysts do: it excludes items that do not absorb losses in a crisis, such as goodwill, deferred tax assets and other intangibles. And it includes all assets, including those thought to be risk-free.

Once again, in an effort to remedy the flaws of earlier versions, Basel III is meant to increase the quantity and quality of capital on the balance sheet. Some remain confident that Basel III accurately assigns risk weights to numerous categories of assets. Unfortunately, the weightings are more arcane than ever and, therefore, even less useful. Despite the promise of higher capital levels and better quality capital, Basel’s new minimum leverage ratio requirement is only 3 per cent, about the same as that of the largest US banks when the global crisis erupted. Basel III offers more complexity and, therefore, new opportunities to circumvent the system. But it does not offer any more certainty that banks will be well capitalised when the next crisis hits.

In considering the issue of stronger capital, the following comparison is useful. Using the mid-year 2012 regulatory reports for the 10 largest bank holding companies in the US, the average

tangible equity capital ratio is only 6.1 per cent and the highest is 7.9 per cent. Importantly also, few of the largest banks outside the US have tangible equity capital ratios greater than those of the largest US banks, even after adjusting for differences between US and international accounting standards. [Two global megabanks even have ratios of less than 2 per cent.](#)

These are not sufficient levels of capital by any measure, particularly given what we know from the global financial crisis. Some countries are pushing hard to embrace Basel III while claiming it will result in better and higher capital, but it will not. Many of the largest internationally active banks will not sufficiently increase their tangible equity capital under Basel III.

So what level would be sufficient? Before deposit insurance was introduced, the tangible equity capital ratios for US banks of all sizes averaged above 10 per cent. Depositors insisted on these levels if they were to trust the bank with their money. Now, instead of capital, the public relies on deposit insurance for protection, leaving other banks and taxpayers to backstop a failed financial institution. To protect well-run banks, to protect the taxpayer and to ensure that an economy has access to reliable credit, we should insist on strong capital for all banks.

We can establish a simple but stronger capital base by replacing the unmanageably complex Basel risk-weighted standards with a tangible equity capital ratio of around 10 per cent, and use a simplified risk-weighted measure as a check against excessive off-balance sheet assets or other factors that might influence banks' safety.

If the financial industry had had tangible equity capital approaching this level in 2008, we might still have had a crisis. But it would have been far less severe and far less costly to the public. Basel III's implementation has been postponed, and that offers a real chance to get it right. If we do, we won't need Basel IV.

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