June 12, 2012

Statement by
FDIC Director Thomas Hoenig

Basel Capital
Notices of Proposed Rulemaking

I support moving these Notices of Proposed Rule Making into the public domain for comment. I strongly encourage the industry and, just as importantly, other interested parties to address the questions posed in these notices. I also would encourage any additional comment the public might wish to make on the final rule regarding market risk that is being voted on today.

The proposed risk-based capital and leverage (capital relative to unweighted assets) ratios are improvements over Basel II. They are composed of stronger forms of capital and have higher risk weights. The minimum capital requirements also are higher. The individuals who developed the Basel capital standards and these proposed rules worked tirelessly to improve the definitions of capital and measures of risk, and I very much appreciate their efforts.

Despite these improvements, I remain concerned that as proposed, the minimum capital ratios will not significantly enhance financial stability. The rules continue to focus on risk-based capital ratios, which strike me as overly complex and opaque. Also, experience suggests that the tangible common equity leverage ratio is what investors focus on and is what ultimately determines whether capital is adequate. Because leverage is one of the primary factors that determines financial outcomes, I also am concerned that the minimum leveraged ratios in the proposals are too low to be of real value in moderating future crises.

Currently, the primary focus of the U.S. implementation of the Basel approach is on minimum risk-based capital ratios. These ratios depend critically on -- and are very sensitive to -- the models used to estimate risk and determine risk weights. As the financial system has become more complex, the models too have become more complex, but not necessarily better. For example, in the booming economy leading up to the financial crisis, while total capital ratios showed increases, tangible equity leverage ratios declined systematically. This was particularly the case for the largest banking organizations, despite the build up in risk that was exposed only ex post. In addition, in a recent Barclays Capital international survey of 130 institutional investors, most respondents indicated that they do not trust the internal models used by banks to calculate risk-weighted assets and would prefer simplified risk weighting and less firm-specific discretion.

As a result, I am very interested in hearing public comment on whether consideration should be given to focusing less on risk-based capital and more on minimum leverage ratios, which are independent of models and less subject to manipulation.

I am aware that a minimum leverage ratio in isolation may encourage institutions to gravitate towards riskier assets because all assets must be funded with the same percentage of equity. However, the Basel risk management approach includes three pillars—capital, supervision, and market discipline. It is important not to view the capital requirement in isolation, but instead as part of a system that makes use of all three pillars. And, if managements, supervisors, and the markets' ability to assess risk are undermined because the risk-based measure is overly complex and opaque, then the measure will be ineffective -- or worse, counter productive.

Because of the importance of leverage ratios, I encourage comment regarding their use. For example, should the proposed Tier 1 leverage ratios be higher? Would it be better to use the newly proposed Common Equity Tier I capital to measure leverage? Would higher minimum ratios address concerns about risk incentives associated with greater reliance on a leverage ratio? Should the minimum supplemental leverage ratio for advanced-approach institutions be higher to be considered well capitalized than adequately capitalized? Currently 3 percent is the proposed minimum for both categories. There is ample evidence that without government guarantees the market would require significantly higher levels of capital.

A greater emphasis on leverage ratios would be stricter than what is agreed to in the International Accord. However, there is precedent for stricter requirements. Leverage ratios, at the urging principally of the FDIC, were adopted in the United States even though they were not part of the Basel I or II Accords. More recently the Swiss have implemented higher minimum capital ratios, and the United Kingdom's Vickers Commission has recommended higher requirements than in the Basel III Accord.

While staff have developed detailed measures of risk, it is bankers and bank supervisors, those serving on the boards of banks and those in the field, who must understand them, implement them, and enforce them. Having read these drafts, I suspect that will be no easy task. The measures imply more accuracy than can be realized. Risks migrate from assigned levels, and formulas go stale. The more complicated a rule the more likely it will be "gamed," with the most brazen winning out over the most conscientious participants in the market. Also, the more complicated a rule, the more costly it is to implement. Increasing costs against constant revenues drives consolidation within an industry already heavily concentrated.

There are many issues that deserve attention as these proposals are placed in the public domain for comment. I encourage the industry and the public at large to engage in a vigorous discussion about what capital measures will serve financial stability best.