**Back to Basics: A Better Alternative to Basel Capital Rules; Thomas M. Hoenig, Director, Federal Deposit Insurance Corporation, delivered to The American Banker Regulatory Symposium; Washington, D.C.**
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## Introduction

I have been involved in central banking and financial supervision my entire career. I understand the importance of having the right market conditions and regulatory framework for an economic system to thrive. And most certainly I know that the foundation of a strong financial system is strong capital. For these reasons I wish to add my perspective on today's discussion regarding Basel III. After reading the entire 1,000-plus page proposal, I would encourage the Basel Committee and the international regulatory community to step back and rethink the Basel capital standards.

It may be helpful here to recall how Basel has evolved. Following the implementation of Basel I, many in economics and finance and many of the world's largest banks wanted a more sophisticated and flexible risk-based capital standard. The U.S. chaired the Basel II Committee then and with others agreed that such change was necessary for the largest firms to remain globally competitive. Basel II and III were also given the task of satisfying various national interests, adding more complexity. As a result, the number of Basel risk weights evolved from five to thousands.

Basel III is intended to be a significant improvement over earlier rules. It does attempt to increase capital, but it does so using highly complex modeling tools that rely on a set of subjective, simplifying assumptions to align a firm's capital and risk profiles. This promises precision far beyond what can be achieved for a system as complex and varied as that of U.S. banking. It relies on central planners' determination of risks, which creates its own adverse incentives for banks making asset choices.

The poor record of Basel I, II and II.5 is that of a system fundamentally flawed. Basel III is a continuation of these efforts, but with more complexity. It also is more prolific since it applies across all banking firms. Directors and managers will have a steep learning curve as they attempt to implement these expanded rules. They will delegate the task of compliance to technical experts, and the most brazen and connected banks with the smartest experts will game the system.  In private discussions I find a good deal of uneasiness about Basel III's ability to be more effective than previous Basel efforts; however, there is a sense that we cannot go back. I suggest that we not only can go back, we must.  In my remarks to follow, I will set out my views on the role of capital and the flaws of Basel III, and then will suggest a simpler alternative that takes us back to the basics.

**Capital, the Safety Net and Markets**

Capital is the foundation on which a bank's balance sheet is built.  There can be no fortress balance sheet without fortress capital.  In a market economy, capital insulates a firm from unexpected shifts in risk and from losses on loans and investments gone bad.  A reliable capital measure facilitates the public's and the market's understanding and judgment of the financial condition of a firm and industry.  And finally, while essential to the health of a firm, capital has its limits.  Even high levels of capital cannot save a firm from bad management or save an industry from the cumulative effects of excessive risk taking.

In judging the role of capital, it is useful to look back at bank capital levels in the U.S before the presence of our modern safety net.  Prior to the founding of the Federal Reserve System in 1913 and the Federal Deposit Insurance Corporation in 1933, bank equity levels were primarily market driven.  In this period the U.S. banking industry's ratio of tangible equity to assets ranged between 13 and 16 percent, regardless of bank size.  Without any internationally dictated standard or any arcane weighting process, markets and the public required what would seem today to be excessively high capital levels.

With the introduction and expansion of the safety net of deposit insurance, central bank loans and ultimately taxpayer support, the market's capital demands changed.  While the safety net protects depositors from loss and promotes stability in the system, its secondary effect has been to erode the market's role in disciplining banks. Depositors and other creditors have come to understand that the safety net protects them far more importantly than does bank capital or good management.

It is important to ask where these changes have taken us. One of the most significant results has been that bank supervisors rather than the market have been left the difficult task of determining adequate capital for the industry. Unfortunately this has led to a systematic decline in bank capital levels. Between 1999 and 2007, for example, the industry's tangible equity to tangible asset ratio declined from 5.2 percent to 3.8 percent, and for the 10 largest banking firms it was only 2.8 percent in 2007. More incredible still is the fact that these 10 largest firms' total risk-based capital ratio remained relatively high at around 11 percent, achieved by shrinking assets using ever more favorable risk weights to adjust the regulatory balance sheet.

It is no coincidence that the financial industry in 2008 was unable to withstand the pressures of a declining market nor bear anywhere near the losses that the taxpayer eventually assumed. It turns out that the Basel capital rules protected no one: not the banks, not the public, and certainly not the FDIC that bore the cost of the failures or the taxpayers who funded the bailouts. The complex Basel rules *hurt*, rather than helped the process of measurement and clarity of information.

Basel III introduces a leverage ratio and raises the minimum risk-weighted capital ratios, but it does so using highly arcane formulas, suggesting more insight and accuracy than can possibly be achieved. Where the markets assess, demand and adjust intrinsic risk weights on a daily basis, regulators using Basel look backwards and never catch up. For example, people knew well in advance of the recent financial crisis that the risk on home mortgages had increased during the period between 2005 and 2007, yet no changes were made to the risk weights. Basel III still looks backward as demonstrated by the few changes made regarding the weights assigned to sovereign debt.

Finally, it is noteworthy to observe how much the industry’s capital level diverges depending on which Basel measure is reported. For the 10 largest U.S. banking organizations as of the second quarter of 2012, total Tier I equity capital was $1.062 trillion. Total adjusted tangible equity capital was $606 billion. In a crisis, which number counts?

Given the questionable performance of past Basel capital standards and the complexities introduced in Basel III, the supervisory authorities need to rethink how capital standards are set. Starting over is difficult when so much has been committed to the current proposal. The FDIC is no different from other U.S. and international regulatory agencies where committed staff has devoted enormous effort to drafting and implementing Basel III. However, starting over offers the best opportunity to produce a better outcome.

**An Alternative to Basel**

How might we better assess capital adequacy? Experience suggests that to be useful, a capital rule must be simple, understandable and enforceable. It should reflect the firm's ability to absorb loss in good times *and* in crisis. It should be one that the public and shareholders can understand, that directors can monitor, that management cannot easily game, and that bank supervisors can enforce. An effective capital rule should result in a bank having capital that approximates what the market would require without the safety net in place.

The measure that best achieves these goals is what I have been calling the tangible equity to tangible assets ratio. Tangible equity is simply equity without add-ons such as good will, minority interests, deferred taxes or other accounting entries that disappear in a crisis. Tangible assets include all assets less the intangibles.[1]

This tangible capital measure does not remove the complexities from the balance sheet. It does not attempt to differentiate risks among assets. It does not tier the measure into any number of refined levels. There is no governmental ex-ante endorsement of risk assets or capital allocations.

Instead, this tangible capital measure is a demanding minimum capital requirement within which management must allocate resources within the overall capital constraint. This simple measure accepts that firms quickly shift their allocation of assets to take advantage of changing risks and rewards. This simpler but fundamentally stronger measure reflects in clear terms the losses that a bank can absorb before it fails and regardless of how risks shift. It provides a consistent and comparable measure across firms.

Since the federal safety net is the current substitute for capital in protecting the depositor, it also is reasonable that the supervisor should expect the same minimum capital as would the market without the safety net. As noted earlier, the equity ratio for the banking industry before the safety net was implemented ran between 13 and 16 percent. Therefore, the starting point for any discussion of an acceptable level of tangible equity for all banking firms should be well above the 3 1/4 percent level now implied by the Basel III proposal.

Finally, under this simpler approach there remains the challenge of more precisely assessing individual institutional risk and judging whether this minimum capital is adequate. That judgment should be determined through the periodic examination process, which for the largest banks has become deemphasized in favor of stress tests. It is the often ignored Pillar II of the Basel standards.

This is no simple task. However, it is through this process, properly conducted, that supervisors can best assess a financial firm's fundamental operations, liquidity, asset quality and risk controls. Some disregard it perhaps because they claim regulatory capture. My own experience is that commissioned examiners as a rule are highly skilled professionals, able to effectively assess bank risk. If the financial supervisors' record needs improvement, we must hold accountable the leadership of the regulatory agencies. The examination process, effectively conducted, holds the best potential to identify firm-specific risks and adjust capital levels as needed.

**Can Simpler be Better?**

Some argue that a simple measure with a relatively stronger minimum capital level would reduce liquidity in the market, constrain loan growth and undermine the economy. I offer a different perspective.

First, experience tells us that economies compete best from a position of strength, and a strong economy will always have banks with strong capital and balance sheets. The recent recession and credit crunch were made worse because banks had too little capital as they entered the crisis. They were forced to sell assets and shrink their balance sheets in the absence of a strong capital cushion to absorb losses. The U.S. economy would have been significantly less harmed had the financial industry been holding adequate capital in 2008.

Second, the term "increased liquidity" is often used when the objective is really "increased leverage." In the growth phase of an economic expansion, borrowing is readily available, and firms and individuals easily borrow funds. Some describe this as a liquid market. A more appropriate description is leveraging up. Liquidity is the ability to convert assets to cash without loss. Leverage is expanding the balance sheet using debt. It is therefore often the case that greater balance-sheet leverage results in less balance-sheet liquidity. This is especially true in a crisis.

Third, a reasonable capital level does not inhibit economic growth. It sustains it. For example, a 10 or higher percent tangible capital to tangible asset ratio, depending on exam findings, allows a dollar of capital to support as much as 10 dollars of loans and other assets. Leverage is permitted, and credit is available and supportive of long-term growth. Sustainable growth is enabled. Excessive growth is impeded.

Finally, a simple, understandable and enforceable capital standard when measured consistently, not subject to manipulation, and enforced uniformly across the industry provides for equitable treatment of all firms within the industry, from smallest to largest.

In contrast, the Basel Accord would permit a commercial bank to be judged as "adequately" capitalized having a Tier I leverage ratio of 4 percent, which implies an even lower tangible equity ratio, so long as the total risk weighted capital ratio is above 8 percent, and the Tier I risk weighted risk capital ratio is above 6 percent, and the common equity Tier I risk weighted capital ratio is above 4.5 percent. This is more complicated than simple, more confusing than clear and more easily gamed than not.

**A Final Observation**

In reading the Basel proposal, I am convinced that much of its complexity derives from the complexities and conflicts embedded in the combination of commercial banking and broker/dealer activities. The safety net's enormous subsidy encourages ever-greater risk taking as firms attempt to achieve a higher return on equity than would otherwise accrue from operating the payments system and serving as a financial intermediary. In other words, from what they would earn from commercial banking. The safety net's subsidy facilitates the use of leverage and provides an incentive toward higher risks that are hidden in opaque instruments, in trading activities and in derivatives. It bestows an advantage to subsidized firms not afforded others. Solving this problem requires a fundamental restructuring that separates banking from trading activities.[2]

Now, in the mistaken belief that the subsidy can be neutralized, and that risks and shifting risks can be captured, measured and properly and quickly capitalized using financial models, we get Basel III. It's time we acknowledge that no Basel model can accomplish this objective. Markets move too quickly, and human nature is too dynamic.

Basel III will not improve outcomes for the largest banks since its complexity reduces rather than enhances capital transparency. Basel III will not improve the condition of small- and medium-sized banks. Applying an international capital standard to a community bank is illogical, particularly when models have not supplanted examinations in these banks. To implement Basel III suggests we have solved measurement problems in the global industry that we have not solved. It continues an experiment that has lasted too long.

We would be wise to acknowledge our limits, to simplify the system, to confine the subsidy, and to reduce the taxpayers' exposure to an enormous future liability. It is time for international capital rules to be simple, understandable and enforceable.

I understand where the proposal stands today and how much has been invested in drafting Basel III, but I believe the Committee should agree to delay implementation and revisit the proposal. Absent that, the United States should not implement Basel III, but reject the Basel approach to capital and go back to the basics. By doing so, we can focus on efforts that will create a well-managed, well-capitalized, well-regulated financial system that actually supports economic growth.

1. The measure of tangible equity and tangible assets used here differs from the GAAP measures, which excludes intangible assets such as goodwill, by also excluding deferred tax assets. Deferred tax assets are excluded because they are not available for paying off creditors when a bank fails, that is, they are "going concern" assets but not "gone concern" assets.
2. My proposal to limit activities supported by the public safety net by restricting commercial banking organizations to traditional banking activities and limited other intermediation activities can be found at http://www.fdic.gov/about/learn/board/Restructuring-the-Banking-System-05-24-11.pdf

The views expressed are those of the author and not necessarily those of the FDIC.