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Financial Regulatory Reform – Where Do Things Stand?

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Ten years have passed since the onset of the global financial crisis and financial regulatory reform has been a key priority at both the national and international levels. While much has been accomplished, there are still improvements that should be made to strengthen banking system operations and reduce the risk of future financial crises. This consideration is particularly important in the United States at the present time in view of initiatives under way to weaken some of the regulatory reforms that have been introduced.

Since the crisis, a major overhaul of the Basel capital accord has been introduced that strengthens the tier-1 common equity base of bank capital requirements while increasing their overall level and introducing new liquidity and funding requirements for banks. In addition, a new macro-prudential dimension of the accord has been added above the basic requirements with the introduction of a counter-cyclical capital surcharge and a special capital surcharge for systemically important financial institutions (SIFIs). A new leverage or minimum capital-asset requirement has also been added. In the United States, these reforms have been supplemented by the introduction of new "stress tests" for SIFIs to assess their viability in the event of major financial disruption and mandatory "living wills'' to assist with their liquidation/restructuring in the event of insolvency.

These are important and welcome changes in bank regulation as they address a number of the defects in the regulatory landscape prior to the crisis. However, it is fair to ask whether the increase in bank capital requirements goes far enough. As of the end of last year, the average Tier-1 (risk-weighted) capital ratio for major banks in the US had increased from around 7 per cent prior to the crisis to around 12 per cent, while the basic leverage ratio had doubled to around 6 per cent. In view of the fact that the average losses experienced by these banks during the crisis amounted to 6-7 per cent of total assets, it is clear that further increases in bank capital requirements are warranted. A number of studies have

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shown that bank capital requirements should be raised to a minimum of around 20 per cent, with one of 15 per cent for the leverage ratio, in order to bring about a major reduction in the risk of future financial crises similar to the one of 2007-09. These are important considerations given the enormous social costs of that crisis in terms of losses in output and employment.

Many critics of these proposals have argued that significant increases in bank capital requirements would stifle the growth of bank credit operations. This claim is not true as a number of analysts have demonstrated that better capitalized banks lend more, not less, and with lower credit risk. These banks also encounter virtually no increase in their overall funding costs or lending spreads.

While a further increase in bank capital requirements is warranted, it is also the case that some simplification of the current regulatory regime could be made. For example, the minimum asset size of banks that qualify as SIFIs could be raised to be more in line with the threshold used at the international level, while the size criterion used to determine if a bank is subject to mandatory "stress tests" could also be raised.

One further simplification that has been proposed in recent financial legislation in the US Congress would be to rely exclusively on a leverage ratio of 10 percent in determining bank capital requirements. While the proposed ratio is higher than the existing one, it would still be too low, as noted earlier. It is also the case that sole reliance on a leverage ratio would lead to more risky bank lending than less and lower liquidity in banks (in the absence of the Basel requirements). These results would be magnified by the fact that the proposed reform would abandon the designation of SIFIs and eliminate the application of "stress tests" to these banks.

The proposed financial reform has also re-opened a policy debate on the appropriate framework for the resolution of SIFIs in the event of insolvency. The new regime that was introduced following the crisis would build on the procedures that have been used for smaller banks and is compatible with the international guidelines for insolvency regimes developed by the Financial Stability Board. By contrast, the recent reform proposal would introduce new bankruptcy procedures within a court-based system that lacks the knowledge of banking institutions developed by financial regulators, as well as access to temporary financing that is likely to be required during a resolution procedure. Resolving this debate is critically important, as clarity on the insolvency procedures for SIFIs is necessary for the maintenance of financial stability, both in normal times and at times of financial stress.