Proliferating ‘over-compliance’ and its implications

The political economy of post-crisis financial regulation

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Introduction

SINCE THE GLOBAL FINANCIAL CRISIS PEAKED IN SEPTEMBER 2008, A NUMBER OF COUNTRIES HAVE SIGNALED THEIR INTENTION TO ADOPT MORE STRINGENT DOMESTIC RULES THAN THOSE PROPOSED BY THE BASEL COMMITTEE.

In this policy briefing I examine the economic and political implications of the spread of this “over-compliance” with international financial regulatory standards, focusing on the UK and US. Although banks have often argued that these new regulations will significantly raise bank funding costs and reduce economic growth, the effects are more likely to be modest. From a public policy perspective, the levels of bank capitalization envisaged in Basel III are probably well below what would be optimal in the major countries, creating ongoing economic distortions and risks for taxpayers. This leaves national over-compliance as a potential solution, but I argue that the political limits of unilateral regulatory stringency remain substantial. Instead, the main contribution of OC may be mainly to add to already high levels of regulatory complexity and opacity, deepening the problem of ensuring that governments, regulators and the financial sector are accountable to the general public.
A key component of the Basel Committee’s work agenda is to ensure strong regulatory regimes and effective supervisory systems across its member jurisdictions. Public confidence in prudential ratios, resilient banks and a level regulatory playing field for internationally active banks cannot be assured without consistency in the adoption and implementation of the Basel standards. The lessons of the recent financial crisis have underscored the need for full, timely and consistent implementation of the standards. (BCBS 2013: 1).

Since the end of the Bretton Woods era, national regulatory responses to banking crises became increasingly coordinated, primarily through the Basel Committee on Banking Supervision (BCBS), a committee of central bankers and regulators from the major developed countries. The main focus of this coordination was the process of minimum standard setting in banking regulation, the latest iteration of which is referred to as “Basel III,” agreed in 2010 (Kapstein 1994; Oatley & Nabors 1998; Singer 2007; Goodhart 2011).

After the Asian crises of the late 1990s, the global implementation of these standards received growing attention. As the BCBS statement cited above suggests, the focus on implementation has sharpened since 2008, with the G20 – all members of which are also now members of the BCBS – agreeing to harden what have hitherto been “soft law” standards that are in principle voluntary and implemented on a best efforts basis.¹

In 2012 the BCBS established a Basel III Regulatory Consistency Assessment Programme (RCAP) “to monitor the timely adoption of Basel III standards, and to assess the consistency and completeness of the adopted standards and the significance of any deviations in the regulatory framework” (BCBS 2013: 1).

Although implementation failures among the G20 and beyond are a substantive concern, a growing and different challenge has been the mushrooming of “over-compliance”² (OC) announcements by different national jurisdictions.


² I define compliance with international standards as actor behaviour that is consistent with both their formal requirements and their intent. I define OC as national regulations that are more stringent in effect than minimum international standards. Regulators, including BCBS, prefer the term “super-equivalence,” but this seems to elide the fact that such regulations may not be substantively equivalent to international standards. Industry and legal firms often refer to “gold plating,” which may be deployed tactically to suggest that such extra stringency is wasteful and unnecessary.
The so-called “Swiss finish” of significantly higher capital requirements than Basel III minima on major Swiss banks has been prominent among these, but both of the hitherto most important countries in the Basel process have also announced varying forms of over-compliant national regulation: the UK on minimum equity capital requirements for its “ring-fenced” banks, and the US on leverage and liquidity requirements for its major bank holding companies.

Other countries announcing intentions to go beyond Basel III include Austria, China, India, Singapore, Spain and Sweden. Hong Kong, Singapore and Switzerland have long had reputations for relative regulatory stringency, but a number of other countries are now moving in a similar direction, albeit in different ways.\(^3\)

In the next section of this policy brief I summarize the areas of announced regulatory OC with Basel III in the US and UK. Section two discusses the main economic challenges posed by such OC and section three addresses political challenges. A final section concludes.

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3. Many countries are also announcing that they will implement new regulations in advance of the agreed Basel III implementation schedule, so-called “front-running.”

4. CET1 capital is common equity Tier 1 capital. Tier 1 capital can include other near-equity capital.
The ICB also proposed a correspondingly more stringent minimum leverage ratio for RFBs of 4.06%, compared to the 3% minimum of Basel III (ICB 2011, para 4.57).  

In the final draft version of the British government’s financial reform bill, the ICB’s extra 3% CET1 requirement for RFBs was accepted, but the proposal to raise the minimum leverage ratio above 3% was not (UK Treasury 2013: 106). The government also provisionally accepted the ICB’s proposal that the most systemically important RFBs hold primary loss absorbing capital of at least 17%. This looks significantly more stringent than Basel III minima, under which global systemically important banks (G-SIBs) will be required to meet minimum total capital requirements of between 11.5 and 13% of RWAs.

The draft legislation also allows the regulator discretion to apply even higher capital requirements if it has concerns about residual taxpayer risk. This proposal therefore currently leaves the UK with apparently substantive OC for large RFBs regarding the CET1 ratio, but with minimum compliance with the Basel III leverage ratio. These capital requirements are seen as unusually punitive by the UK’s major banks, indicative in the eyes of some that the British government “has no interest in London remaining a global financial centre.”

In contrast to the UK, the US authorities have eschewed OC on capital ratios for its major banks. Instead, they have argued for relatively stringent leverage and liquidity requirements for large banks and in the use of internal risk weightings. On the first, the combined regulators’ proposal of July 2013 envisages a minimum 5% leverage ratio for the largest US bank holding companies (BHCs), with a 6% requirement for their subsidiaries, in order for banks to avoid restrictions on paying dividends to shareholders and discretionary bonuses to executives.

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5 The simple minimum leverage ratio is an innovation in Basel III, a minimum of 3% of Tier 1 capital to total assets, and is intended to act as a non-risk weighted “backstop” to the risk weighted Basel capital ratio. The ICB proposal was aimed at ensuring that this leverage ratio would continue to operate as an effective backstop under its enhanced 11.5% total Tier I requirement for RFBs (compared to Basel III’s 8.5% minimum): i.e. Basel’s 3% leverage ratio should be increased proportionately from 3% to (11.5/8.5) x 3% = 4.06%.


7 ibid., para 5.

8 Author discussion with senior London banker, 8 March 2014.

However, whether this amounts to substantive OC is uncertain. The US GAAP accounting method for calculating total assets is relatively lenient compared to the International Financial Reporting Standards (IFRS) used in Europe, which are more comprehensive in measuring off-balance sheet derivative positions. Some analysts expect that the 5% US leverage rule will still be more stringent than the 3% minimum leverage rule in Basel III (e.g. Bank of England 2013: 69), but others are more doubtful. Admati and Hellwig (2013: ch.6) show that while JPMorgan Chase reported a leverage ratio of 8% at the end of 2011 under US GAAP, the ratio under IFRS rules would only have been 4.5%.

At the same implied discount of 44%, a minimum leverage ratio of 5% under US GAAP might mean an IFRS leverage ratio of only 2.8%, under the Basel minimum standard. Nevertheless, US banks complain that the leverage proposal is relatively onerous and likely to become a “frontstop” for minimum Tier 1 capital requirements, reducing lending, growth, and putting large US banks at a disadvantage vis-à-vis foreign banks (The Clearing House 2013).

In October 2013, US regulators proposed a tighter liquidity coverage ratio (LCR) for major banks than in Basel III, for implementation two years in advance of the international schedule. The Basel III standard was intended to require banks to hold a minimum amount of high quality liquid assets (HQLA) that could be converted easily into cash and allow banks to maintain operations without access to additional funds over a period of 30 days. The US proposal is more restrictive than Basel as it narrows the range of assets qualifying as HQLA and makes more restrictive assumptions about the rate of outflow of some kinds of funding (US Shadow Financial Regulatory Committee 2013).

Although both of these aspects of OC remain at the proposal stage, the US has already moved beyond Basel III in two other important respects. The Collins Amendment to section 171 of the Dodd-Frank Act requires banks adopting the advanced internal approach to risk weighting to meet a 100% risk-weight floor based on the “standardized” approach, which applies externally generated risk weights to the balance sheets of smaller, less sophisticated banks. This may ensure that the largest US banks are unable to obtain a regulatory advantage over small banks by using internal models to “manage” their risk weightings and

10 Dodd-Frank Act, 12 U.S.C., Section 171, § 5371.
11 In July 2009, the BCBS agreed to extend Basel I capital floors beyond 2009, but only at the level of 80%. The Basel assessment team judged the US rule to be more conservative in practice. (BCBS 2012, 19).
thereby to offset the increased capital requirements of Basel III. The Federal Reserve has also been relatively aggressive in subjecting US banks’ balance sheets to annual “stress tests” since 2009 that require banks to hold sufficient capital to withstand a variety of severe market shocks – some argue these now provide a more important regulatory floor than official minimum capital ratios.\textsuperscript{12} Both of these conservative approaches to capital requirements represent a retreat from the approach of allowing major banks to determine their own capital needs that began in the mid-1990s.

These potentially significant divergences in both the UK and US from Basel III mean that comparing the relative stringency of financial regulation across major jurisdictions is becoming more rather than less difficult. Large differences in accounting standards across major jurisdictions, significant variations in the timing of implementation, and continuing uncertainties surrounding some of the key proposals made by national authorities all serve to erode the viability of a level playing field in financial regulation that the BCBS still sees as a major objective of regulatory coordination.

\textsuperscript{12} “Banks strive to weather the Fed’s stress test storms,” FT.com, 24 February 2014.
2. Economic implications

Are regulatory variations of these kinds of any economic significance? Banks often claim that Basel III itself, and even more the “gold-plating” of some aspects by major countries, is very costly and likely counterproductive. The economic literature in this area suggests caution about such claims is warranted. It also suggests that there is likely to be a substantial gap between the net private and public costs of OC, as for financial regulation in general. I first address the impact of regulatory OC on bank funding costs before turning to consider its broader impact on the economy.

2.1 The impact of OC on banks’ funding costs

Banks and industry organizations argue that Basel III, and OC with it, will significantly raise ongoing bank funding costs.13 (This is in addition to the implementation costs of new regulation, which one major UK bank estimated to be up to £1 billion).14 Such industry claims are often strongly disputed in the theoretical and empirical finance literature (e.g. Admati and Hellwig 2013; Miles et al. 2012).

The first reason for skepticism regarding industry objections is that increases in equity capital ratios should lead to an offsetting reduction in the riskiness and thus the cost of equity finance. One aspect of the Modigliani-Miller (MM) theorem in corporate finance is that the overall cost of capital will be invariant to the liability mix of a firm’s balance sheet (a higher proportion of equity and a lower proportion of debt will reduce bankruptcy risk and thus the cost of equity). In practice, higher leverage (greater reliance on debt finance) may be more attractive to banks if depositors do not understand the risk of higher leverage, because there are public deposit guarantees or other implicit public guarantees of banks’ debt (so the cost of equity does not rise as much as it otherwise would), or because there are tax advantages for debt finance.15

13 On the supposed costs of Basel III, see IIF (2011); for bank views on the costs of OC in the UK see UK House of Commons Treasury Committee (2011).

14 Stephen Hester (RBS), testimony in UK House of Commons Treasury Committee (2011).

15 The latter is due to the common practice of allowing firms to deduct interest payments on debt from taxable income, whereas in most countries dividend payments for shareholders are paid from post-tax company income and taxed again as capital income for shareholders (this bias is lower in systems with dividend imputation, such as Australia – I thank Kevin Davis for this point). For summaries of this extensive literature and its application to banking, see Miles et al. 2012 and Admati and Hellwig (2013).
In practice, these market distortions tend only partly to offset the MM effect of lower leverage on the cost of equity. Miles et al. (2012), for example, calculate that the plausible impact on capital costs of requiring banks to meet a CET1 capital ratio double those envisaged in Basel III would only be an extra 10-40 basis points. Thus, it is plausible to expect that the effect of the UK’s much less onerous CET1 requirement for RFBs on their funding costs would be very marginal. Under some conditions, OC might even reduce banks’ funding costs.  

It is also relevant that most major international banks have already managed to meet Basel III minimum capital requirements well ahead of the implementation schedule. The BCBS’s ongoing monitoring exercise shows that as of 30 June 2013, the average CET1 capital ratio under a “fully implemented” Basel III framework was 9.5% for 102 large international banks (BCBS 2014: 2, 10-12).

Only 5% of this sample of banks fell below Basel CET1 minima (including additional surcharges for G-SIBs). The estimated aggregate shortfall of CET1 capital was €57.5 billion, but this shortfall is modest compared to aggregate post-tax profits prior to dividend distributions of €456 billion for the year ending 30 June 2013. Of the 29 G-SIBs monitored, 21 already meet their enhanced CET1 requirements. Most are also now close to meeting in practice the 10% minimum to be required for RFBs in the UK by 2019, suggesting that the negative competitive implications of British OC will also be low.

The weighted average leverage ratio of these monitored banks also already exceeds the envisaged 3% minimum. The BCBS estimates that the CET1 capital requirement is more constraining than this leverage ratio for three quarters of major banks (BCBS 2014: 2-3). Thus, in spite of industry complaints, major banks appear to have more than sufficient income generating capacity to meet and exceed Basel III capital requirements well in advance of the implementation deadlines, and the minimum Basel III leverage ratio seems not to be a major constraint.

It is more difficult to assess the impact of other areas of OC such as liquidity requirements because they have no clear effect on bank leverage.

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16 This might apply for example to wealth management banking, which might benefit from a perception of relative safety. This possibility is analogous to “race to the top” phenomena that some have pointed to in areas like health and environmental standards (Vogel 1995: 97). Swiss banks, interestingly, have said that they are relatively relaxed about capital OC in Switzerland (see “Transcript: View from the Top with Urs Roth of the Swiss Bankers Association,” FT.com, 30 October 2009).
The Basel III liquidity coverage ratio does not affect the liability side of bank balance sheets. The net stable funding ratio (NSFR), further proposals on which were only released in January 2014, will affect the liability side of banks’ balance sheet and is intended to provide incentives for banks to use stable sources of funding, discouraging over-reliance on short term wholesale funding in particular. The NSFR should therefore mainly affect the composition of debt liabilities rather than leverage per se. These requirements may reduce bank profitability somewhat by forcing them to hold a greater proportion of their assets in lower-yielding instruments and by requiring them to rely less on short-term debt finance, but this should be offset by a substantial reduction in balance sheet risk. It is also worth noting that as of 30 June 2013, 72% of 227 banks being monitored by the BCBS already exceeded the minimum LCR of 100% (to be implemented gradually over 2015-19). (BCBS 2014: 3).

2.2 Does over-compliance provide net benefits or costs to the public?

Banks have argued that the main costs of Basel III, and OC with it, will fall on the general public via lower lending, lower employment, incomes and growth (e.g. The Clearing House 2013). Perhaps most notoriously, the Institute for International Finance, a major bank lobby group, estimated in 2011 that the impact of Basel III implementation by 2015 would be a permanent reduction in real global GDP of 3.2% and a reduction in employment of 7.5 million, driven by significantly higher bank funding costs and related pressure on banks to shrink lending (IIF 2011). These costs, they claimed, would be concentrated in the developed world, especially in relatively bank-dependent Europe and Japan. They also argued that the claimed stability benefits of Basel III would be modest at best (IIF 2011: 76-9).

The IIF (2011: 43-8) accepts that their estimates of increased bank funding costs, which are many times those of the BCBS and of academic studies, are the main drivers of this predicted dire macroeconomic impact. Miles et al. (2012) argue that more plausible estimates of the former imply a much smaller impact on growth and employment.
In general, higher levels of equity financing will permit banks sustainably to lend more rather than less to customers (Admati and Hellwig 2013, chs 6, 11). Furthermore, the public benefits of a reduced incidence of costly financial crises are likely to be much larger than any effects of higher equity financing on lending in normal times. Indeed, Miles et al. argue that “optimal” levels of equity capital are probably at least double those agreed in Basel III.

If so, the modest forms of OC envisaged in countries like the UK and Switzerland may be costly from a public policy perspective for the opposite reason commonly given – that is, the public would benefit from even higher levels of OC with Basel III than these countries envisage. Correspondingly, strategies of minimum convergence on Basel III imply that governments and regulators may continue to impose large implicit costs on the general public and to provide large private benefits to bank shareholders, creditors and executives (see also Admati and Hellwig 2013).

This conclusion is often seen as vulnerable to the objection that unilateral OC risks undermining the international competitiveness of the country’s financial sector. The chairman of the British Bankers Association argued in 2010 that “it is vital to ensure that individual markets do not disrupt the international level playing field by adding their own ‘finishes’ or by being super-equivalent.” However, this objection relies on the questionable assumptions that the impact of such OC on (national) bank funding costs is large and that implicit taxpayer subsidies to private interests associated with banks are justified. On the latter point, trade theory suggests that only in exceptional circumstances does it make sense for governments to promote a particular sector with subsidies – high technology of various kinds has often been seen as a classic case (Krugman 1986). Finance is sometimes seen as “strategic” given its crucial role in intermediating processes of saving and investment, but it does not follow from this that it makes economic sense to subsidize this sector to increase its weight in the economy. There is some evidence that very large financial sectors may reduce growth and increase the probability of costly crises.

17 Marcus Agius, quoted in “Divided G20 poses threat to banking reform, Osborne warned.” The Guardian, 23 October, 2010. For an earlier argument against OC, see British Bankers Association et al. (2005).

18 Arcand, Berkes and Panizza (2012) find a positive macroeconomic effect of financial deepening does not apply once private credit exceeds 80-100% of GDP.
Relatively lax jurisdictions may succeed in attracting some internationally oriented financial business, but at the cost of the general public and of other sectors (such as by attracting scarce high skilled labour).

National regulators can apply the same regulatory requirements on the local subsidiaries of international banks as on domestic banks so that there is no unfair advantage for the former. Uneven regulation across countries will impose some additional compliance costs on internationally active banks, but there is no obvious reason why uniform financial regulation is optimal for countries with very different national circumstances and preferences.

The same problem can arise domestically if relatively stringent regulation is applied only to one particular category of financial firm. If this creates competitive advantages for entities such as “shadow banks”, for example, from a public policy perspective this problem would best be tackled through a broader application of regulation rather than socially sub-optimal regulation for all financial firms. As discussed in the next section, there has been a growing tendency since 2008 to apply more stringent regulation to large banks.

This may be justified by the high cost of large bank failures, by the often large implicit public subsidies benefitting “too big to fail” (TBTF) banks, or by other advantages of size (IMF 2014, ch.3).

The CFO of JPMorgan recently noted that as America’s largest bank it faced the highest regulatory capital requirement of any US bank, but that its scale gave it “pricing power” that would nullify the competitive disadvantage this higher capital requirement produced.19

Whether such competitive inequalities are best tackled by differential regulation or by a stricter application of competition policy to large banks is unclear (see Haldane 2012a).

3. The political challenges of over-compliance

The forgoing discussion suggested that the costs of OC have probably been exaggerated by private sector representatives and that there may be strong public interest arguments for much higher equity capital requirements than is currently envisaged in the UK, US, Switzerland and elsewhere, including Australia. This leaves over-compliance with Basel III as a potential solution. However, the practical political constraints on such OC are substantial. The financial sector has substantial resources to obtain political influence in major countries and a strong incentive to lobby against OC because its costs will fall largely on them rather than on the general public. This is analogous to the political economy of regulation in other sectors that produce negative externalities, such as industrial pollution. In this section, I briefly review some of the political challenges posed by OC at the national, global and regional levels.

3.1 National political challenges

The ex ante preference of national regulators for OC is likely to be stronger if they prefer more stringent regulation than they can achieve in international negotiations.

Senior British regulators indicated that their regulatory preferences significantly exceeded in stringency what was achievable in the Basel III negotiations. In the US, the crisis has probably benefitted the FDIC, long inclined to be more conservative and less close to Wall Street than the Federal Reserve, though the Fed itself has shifted towards a more conservative regulatory stance. However, given the sharp divergence between the private costs and public benefits that can apply to more stringent financial regulation, the influence of regulators is likely to depend on the ability of governments to isolate opponents and to build broad coalitions supporting OC.

Some literature in recent years has portrayed the US financial sector, especially the major banks, as having effective veto power over ambitious or threatening regulation (Hacker and Pierson 2011; Johnson and Kwak 2012b; Turner 2011.

20 Haldane 2012b; Turner 2011.
Wall Street clearly does possess substantial political influence on particular issues, influence that may be traced in part to the system of election financing and big finance’s lobbying capacity.\(^{22}\)

Jamie Dimon, CEO of JPMorgan Chase, famously said in 2011 that Basel III was “anti-American” and that the US should consider choosing not to implement it.\(^{23}\) Nevertheless, US authorities are proceeding with the implementation of Basel III, the Volcker rule and some other elements of OC as outlined earlier, suggesting that major banks have not had it all their own way.

Isolating political opponents of greater regulatory stringency may be achieved in part by limiting the scope of application of regulatory OC. In most prominent cases, including the UK, US and Switzerland, OC is targeted on the largest banks. This “divide and rule” strategy is particularly clear in the United States. US politicians and agencies have focused their OC proposals on the (eight) largest bank BHCs. This delivers some competitive benefits to smaller banks and their local customers, serving to mobilize small banks to support these proposals.\(^{24}\) Of 6,263 US banks at end-March 2012, there were only 17 designated core banks that will be required to implement Basel III, of which eight are designated as G-SIBs.

The differential application of regulations in the US is particularly stark in the case of the proposed liquidity rule, which will not apply at all to small banks; larger but less internationally active banks will only need to hold a 21-day liquidity buffer. Nor will smaller US banks be subject to the enhanced leverage ratio proposed by regulators. Regulatory differentiation of the American variety is less easy in the EU given the determination there to apply Basel standards to all depository institutions regardless of size.

Broader political support in the US for implementing the Volcker rule and some other aspects of regulatory OC for large banks was probably also assisted by the “London whale” incident in 2012, in which JPMorgan made a very large and embarrassing loss in proprietary trading. But grass roots political activism may also have been more important here than elsewhere. The Tea Party movement has continued to protest and to monitor Washington’s presumed support of TBTF banks and, importantly, has had more sustained influence over the

\(^{22}\) For one example of this capacity, see “Banks’ Lobbyists Help in Drafting Financial Bills,” New York Times, May 23, 2013.


\(^{24}\) “Finance: Out to Break the Banks,” FT.com, 30 April 2013.
Republican Party than the progressive Occupy movement has had over the Democrats.  

In April 2013, Senators Brown (Dem.) and Vitter (Rep.) introduced a bill (S.798) to the US Senate aimed at addressing the TBTF problem by requiring a minimum leverage ratio of 8-15% for large banks. The bill was passed to the Senate’s Committee on Banking, Housing and Urban Affairs where it has since lingered; Govtrack gives it only a 10% chance of passing. Opposed by major banks, it was backed strongly by the small US bank lobby, the Independent Community Bankers of America. On present indications therefore, large bank lobbies appear to have been able to block a bill aimed at addressing the implicit public subsidies likely to accrue to TBTF banks (IMF 2014, ch.3).  

Some prominent cases of OC such as the UK and Switzerland impose modestly higher minimum capital requirements on large banks, but much less than might be optimal from a public interest perspective. In both cases large banks successfully pushed back against OC on the simple leverage ratio, a potentially more onerous constraint. This may leave large British and Swiss banks (at least) able to reduce the already modest cost of OC on capital requirements by using internal models to manage their RWAs. Meanwhile, American OC on the leverage ratio may be more symbolic than real due to the comparative laxity of US accounting standards. Perhaps unsurprisingly, some major international banks now profess to be comfortable with the key requirements of Basel III.  

3.2 International challenges  

In global terms, the main challenge of apparently proliferating OC is that it could further undermine the level regulatory playing field that has been a key objective of the Basel process since the late 1980s. Until recently, this has not been seen as a major problem due to the presumption among regulators and analysts that there are powerful systemic tendencies for a “race to the bottom” – or at least to the global regulatory minimum – in bank capital in an increasingly globalized financial system (Alessandri and Haldane 2009; Hardy 2012; Oatley and Nabors 1997; Simmons 2001;  

28 The Swiss National Bank (SNB 2013) has argued that its two G-SIBs’ leverage ratios remain too low and below the international peer average at 2.3%, revealing lingering doubts that high reported capital ratios will be sufficient to reduce real leverage.  
Singer 2007). To the extent that there is a growing tendency among major countries to depart significantly from Basel standards, this may undermine them as a focal point for international coordination (cf. Garrett and Weingast 1993).

As noted above, this may be less of a problem than the BCBS professes if the priority of governments since 2008 has shifted towards ensuring financial stability rather than financial sector competitiveness. One could go further to argue that if Basel III is fatally flawed it should be abandoned entirely in favour of more stringent national regulation (e.g. Admati and Hellwig 2013). But despite Basel’s evident flaws, minimum international standards have often provided governments and regulators with domestic political cover to improve financial regulation during times when domestic political support for this is low (Foot and Walter 2011, ch. 6; Singer 2007; Walter 2008). The idea that Basel standards promoted a level regulatory playing field has always been a convenient myth for governments and regulators. Abandonment of Basel would also reduce opportunities for mutual learning and information sharing. At present, there are few signs of any willingness to abandon Basel entirely, particularly in the financial community itself.

Growing unilateralism in financial regulation has also been a major challenge in Europe since 2008. Since 1989, the European Union agreed to coordinate financial regulation as a consequence of the single internal market in financial services (and effectively across the broader European Economic Area, or EEA). In March 2013, the EU agreed a new Capital Requirements Directive (CRD IV) and a Capital Requirements Regulation (CRR) that will implement Basel III.

The CRR is self-enforcing in EU member states, whereas CRD IV must be implemented in national legislation. The EU has historically implemented Basel standards not only for its internationally active banks, but for all depository institutions in the EU, on the grounds that full market integration requires a single regulatory playing field for all European banks. The new EU rules go beyond Basel in some areas, such as the EU cap on bank employee bonuses from 2014, but not on the key components of Basel III.

The UK, along with Austria, Cyprus, Spain, and Sweden have indicated a strong preference that EU rules should not constrain their ability to adopt more stringent national regulation to promote domestic financial stability. This position was opposed by other important member states with large financial sectors and relatively leveraged banks, notably France and Germany, as well as by the European
Commission, which defended a level regulatory playing field on the grounds that regulatory unilateralism would undermine the internal market and create opportunities for regulatory arbitrage (European Commission 2013). Since the internal market allows for cross-border bank branching in the EU and EEA, banks subject to less stringent regulation in one member state could offer services to customers in member states where banks must meet more stringent regulations.

Earlier versions of the CRD in the EU allowed for significant regulatory divergence, including under-compliance, across member states due to varying national interpretations (European Commission 2013: 7-8). CRD IV allows for some national discretion in these areas but under Article 133, member states intending to apply more stringent national capital requirements must notify and justify them to the Commission, the European Banking Agency and the European Systemic Risk Board. The Commission may issue a negative opinion on grounds that the measure(s) distort the internal market, which may in turn be overruled by the European Council. The extent of such additional national regulatory stringency is also restricted: from 2014, an additional systemic risk CET1 capital buffer can be applied to all or a subset of institutions of up to 3% subject to notification to Commission, EBA and ESRB; from 2015, a systemic risk buffer of up to 5% may be applied. Systemic risk buffers may also be applied to bank exposures to other member states, with the requirement that the implementing authority inform their counterparts in these jurisdictions. Where a member state imposes a systemic risk buffer and a G-SII buffer, the higher of the two will apply. The Commission explanation suggests that one possible justification for more stringent national measures could be a national real estate market bubble – though presumably British-style arguments about the risks borne by countries with large international financial centres will also be allowable (European Commission 2013: 5).

Member states will also be able to set their own CET1 counter-cyclical capital buffer, which ranges from 0-2.5% of RWAs, and can impose additional capital requirements on individual banks through the “pillar 2” supervisory review process. They are also permitted to introduce the requirements of CRD IV and the CRR earlier than the final 2019 implementation date. In other areas,

30 If the Commission issues a negative opinion on a buffer of between 3-5%, the member state must comply or explain why it chooses to diverge from the opinion. Only the Commission is permitted to authorize additional measures in excess of 5%.

31 Global systemically important institution. Member states may also apply O-SII buffers (other systemically important institutions) of up to 2%.
the European solution does not permit national discretion. This includes the leverage ratio, liquidity requirements, and capital floors (the EU agreed to extend the 80% Basel I capital floors through end-2017, consistent with the BCBS agreement). Member states are free to adopt national liquidity measures until 2015, when liquidity requirements will be harmonized. This compromise appears broadly to have satisfied the preferences of key member governments such as the UK. It indicates the constraints on national discretion imposed by regional integration agreements facilitating high levels of financial integration (especially in the form of guaranteed market access for bank branches) and with voting rules that necessitate political compromise. It also indicates the way in which the Basel process continues to set the main benchmarks for post-crisis regulatory response in this region.

There are no equivalents to the EU in other regions, where lower levels of market integration are associated with almost no institutional constraint on regulatory unilateralism. In Asia, for example, despite growing market integration in recent years there are no binding agreements on financial regulation. However, most Asian countries have used Basel standards as a benchmark for regulatory reform, especially after the Asian crises of the late 1990s. They have also retained a variety of additional national prudential and quasi-prudential controls, but Basel standards remain at the core of the policy response to the crisis throughout the region.32 The same can be said of financial regulatory policy in Latin America and Africa.

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32 These controls include loan to value ratios in China for residential mortgages, and capital controls in a number of Asian countries. On partial Asian adoption of Basel standards since the 1990s, see Walter (2006, 2008).
4. Conclusion

The apparent proliferation of OC with Basel international financial regulatory standards since 2008 creates a variety of challenges. I have argued that the political challenges are significant even if the economic implications of Basel III, and of modest OC with its standards, have often been exaggerated. Basel standards in fact retain a surprising amount of “compliance pull” – even in those countries where senior regulators have expressed considerable dissatisfaction with Basel III, most of its standards look likely to be adopted, and unilateral OC measures are for the most part very modest departures from these standards.

As a result, levels of bank leverage in the major countries will probably remain excessive from the point of view of promoting a more sustainable and stable financial system. Indeed, rather than being a solution to financial instability, variable OC of the kinds currently envisaged mainly risks adding to rather than reducing the ever-growing complexity and opacity of financial regulation. This raises fundamental questions about how citizens can be expected to hold governments, regulators and the financial sector accountable (Myerson 2014).

So far, national regulators seem to have built domestic political support for only very modest extra stringency relative to international standards and in ways that fail to address this accountability dilemma. There seems to be a tendency whereby regulators gain small victories in some areas (e.g. on extra bank capital for large banks) but lose larger battles in others (e.g. on minimum leverage ratios). Politically, Basel standards provide remarkably sticky benchmarks that national governments in most countries still hesitate to exceed significantly even when there are strong public interest grounds for doing so. This points to the ongoing substantive political influence of the financial sector, though large banks have certainly not been all-powerful in terms of their ability to minimize the costs of new regulation. The danger remains that if Basel III fails to deliver sustainable financial stability in the medium term, a more enduring delegitimation of this crucial aspect of global policy coordination could result.
Bibliography


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The Melbourne School of Government (MSoG) research agenda addresses these kinds of governance and policy dilemmas and MSoG provides training for people who must deal with these in their work.

Research@MSoG aims to provide excellent scholarship which has an impact on governance and public policy. This research underpins our ability to improve the capacity of policy makers to make sound decisions, design and deliver effective policies and programs, and build robust institutions in Australia, the region and beyond.

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