Basel II vs. Prompt Corrective Action: Which Is Best for Public Policy?

BY GEORGE KAUFMAN

This paper evaluates Basel II as a tool for achieving public policy objectives relative to structured early intervention and resolution (SEIR) and prompt corrective action (PCA) in the U.S. It concludes that Basel II compares poorly in terms of maintaining a safe and sound banking system. Rather, Basel II resembles a "best practices" guide for banks in managing their credit risk. However, it may do damage through encouraging some large banks in the U.S. to successfully pressure their regulators to lower the capital trigger ratio for "adequately-capitalized" status in order to benefit from any lower regulatory capital requirement that Basel II may give them.

I. INTRODUCTION

To evaluate Basel II objectively, it needs to be compared to an alternative. As argued below, because Basel is relied upon by many outside the United States to enhance bank safety and soundness, an appropriate alternative is the system of structured early intervention and resolution (SEIR), including both prompt corrective action (PCA) and a legal closure rule at positive capital, which was introduced in the U.S. in 1991 to enhance bank stability.

Basel and PCA have different histories. Each should be evaluated on the basis of what it was initially intended to do and not necessarily as a substitute for the other. Unfortunately, the different underlying histories often appear to be forgotten and each tends to be evaluated on the basis for which it may not have been primarily designed. Currently, in the U.S., this confusion may be setting up a battle that may have serious adverse consequences for financial stability. For the rest of the world, the proposed reliance on Basel may be taking attention away from developing more effective means of enhancing financial stability.

II. BASEL I

Basel (the Basel Committee on Banking Supervision, which meets at the facilities of the Bank for International Settlements in Basel, Switzerland) developed

in the 1970s from a need to facilitate the sharing of information among bank regulators and supervisors in different countries about internationally active banks operating in their countries, which were expanding rapidly (Herring and Litan, 1995). In large measure, this need was motivated by the large international costs of the collapse of the medium-sized Herstatt Bank in Germany, which operated heavily in the foreign exchange market and lost. The bank was legally closed by the German authorities at the end of the business day in Germany, after it was paid by its foreign counterparties, many of whose business day closed later, for foreign exchange transactions, but before it paid these counterparties at the end of their business day. Ironically, the international implications reflected primarily a regulatory and not a market failure. The timing of the closure effectively shifted losses from German depositors and the German deposit insurance agency to banks outside Germany. Basel's objectives were expanded in the 1980s to developing international capital standards to promote both safety among large internationally active banks in light of large losses from LDC lending and competitive equality across countries with respect to capital ratios. The latter was aimed particularly at Japanese banks, which were expanding their foreign market share rapidly on very low capital bases. This was viewed as giving them a competitive advantage.

The capital standards constructed in Basel I (1988) effectively resembled guidelines at the time for "best practices" in large bank capital management, in particular with respect to incorporating credit risk exposures. Individual assets were weighted by one of four risk classification weights, summed, and divided into capital to obtain risk-based capital ratios. The minimum suggested overall capital ratio for a bank was set at 8%, which most banks were then able to satisfy. But the scheme provided no provisions for enforcing this capital standard, replenishing shortfalls, or resolving an insolvent institution at least or even low cost. Thus, the usefulness of the structure for public policy was limited, although it did increase the sensitivity and knowledge of bank managers and bank regulators to measuring and managing risk.

III. SEIR AND PCA

In contrast, in the U.S. at the same time, emphasis was not on developing best practices schemes for banks but on preventing a reoccurrence of the large-scale failure of thrift institutions and commercial banks in the 1980s at high cost to their insurance agencies and, for thrift institutions, also the taxpayers (Benston and Kaufman, 1994). The structure designed was intended to turn troubled institutions around before insolvency, primarily through recapitalization or merger with a healthier institution, and, failing that, as a last resort to legally close and resolve them at lowest cost to the insurance agency and potentially taxpayers. This is to be achieved through increasing both market discipline and regulatory/supervisory discipline.

Market discipline was enhanced by increasing the number of *de facto* at-risk claimants through severely curtailing the use of the misnamed "too-big-to-fail" (TBTF) policy—which, in reality, dealt not with failure but with protecting *de jure* uninsured claimants (Kaufman, 2004a). TBTF was transformed into a harder to invoke "systemic risk exemption" (SRE). Supervisory discipline was enhanced by establishing structured early intervention and resolution with PCA, a legal closure rule at positive capital at which point the bank is put into receivership, and least cost resolution with enforcement provisions that affect both the regulators and the banks.

Capital is the primary, but not the only, measure to trigger regulatory sanctions, which are structured both to resemble the sanctions typically imposed by the market on floundering firms in nonregulated industries and to become progressively harsher and more mandatory as the condition of the bank deteriorates, culminating in legal closure and receivership. These provisions make it more difficult for regulators to forebear and force speedier actions to replenish capital if it declines below minimum target levels. Capital is viewed as the owners' funds that they "have to play with." The less capital, the more restrictive the game becomes and as capital approaches zero, the legal closure rule is invoked, the game is declared over, and least cost resolution is commenced.

The usefulness of capital to absorb losses in this framework is related to the size of the bank. The usual measure of firm size is its total assets. Capital divided by the bank's total assets is the so-called leverage ratio. Under FDICIA PCA specifies three capital ratios—Tier 1 (basically equity) leverage ratio, Tier 1 Basel risk-based ratio, and total capital Basel risk-based ratio—and five capital tranches or zones ranging down from "well capitalized" to "critically undercapitalized." (The major provisions are summarized in Table 1.) The minimum capital levels necessary to be classified "adequately capitalized" are set at 4%, 4%, and 8% for the three capital measures, respectively.

IV. BASEL II

The development of a three-pillar Basel II was primarily motivated by a desire to correct two perceived weaknesses in Basel I. The recommended changes are intended to:

1. Enhance the accuracy of risk-based capital (Pillar I), and
2. Introduce means for enforcing minimum regulatory capital ratios (new Pillars II and III).

But both improvements are relatively weak.

Risk-based capital determined by market weights and forces is necessary for managing banks efficiently, but it is difficult for regulators to replicate accurately. The revised capital requirement in Pillar I attempts to do so for credit risk. But, by increasing its complexity, Pillar I does not necessarily make the

Table 1: Summary of Prompt Corrective Action Provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991

Zone	Mandatory Provisions	Discretionary Provisions	Capital Ratios (percent) Risk Based Total	Risk Based Tier 1	Leverage Tier 1
1. Well capitalized			>10	>6	>5
2. Adequately capitalized	1. No brokered deposits, except with FDIC approval		>8	>4	>4
3. Undercapitalized	1. Suspend dividends and management fees 2. Require capital restoration plan 3. Restrict asset growth 4. Approval required for acquisitions, branching, and new activities 5. No brokered deposits	1. Order recapitalization 2. Restrict inter-affiliate transactions 3. Restrict deposit interest rates 4. Restrict certain other activities 5. Any other action that would better carry out prompt corrective action	<8	<4	<4
4. Significantly undercapitalized	1. Same as for Zone 3 2. Order recapitalization* 3. Restrict inter-affiliate transactions* 4. Restrict deposit interest rates* 5. Pay of officers restricted	1. Any Zone 3 discretionary actions 2. Conservatorship or receivership if fails to submit or implement plan or recapitalize pursuant to order 3. Any other Zone 5 provision, if such action is necessary to carry out prompt corrective action	<6	<3	<3
5. Critically undercapitalized	1. Same as for Zone 4 2. Receiver/conservator within 90 days* 3. Receiver if still in Zone 5 four quarters after becoming critically undercapitalized 4. Suspend payments on subordinated debt* 5. Restrict certain other activities				<2

*Not required if primary supervisor determines action would not serve purpose of prompt corrective action or if certain other conditions are met.
SOURCE: Board of Governors of the Federal Reserve System

regulation more accurate. Increased complexity does, however, both increase compliance costs and reduce understanding, particularly both by the bank CEO, board of directors, and possibly even CFO and by bank supervisors, and, if the and weights are incorrectly selected, increases the opportunity for gaming by the banks.[1] The revision also introduces capital charges for a bank's operational risk for the first time.

Basel II introduces two new pillars—Pillar II: Supervisory Review and Pillar III: Market Discipline—to increase the public policy usefulness of the structure (Kaufman, 2004a). However, Pillar II contains few specifics. It is intended to supplement Pillar I and expand regulatory concern to interest risk. But it focuses primarily on general principles and does not consider the wide variation in supervisory competence across countries. Most importantly, Pillar II contains neither PCA type measures to turn troubled institutions around before insolvency nor a legal closure rule and least-cost resolution provisions to guide the supervisors' actions. Pillar III is not really about market discipline, but rather about creating transparency and disclosure. The latter would not be as necessary to require if there were more truly at-risk claimants exerting more market discipline. Indeed, Pillar III would be far more useful in enhancing market discipline if it focused on increasing *de facto* at-risk claimants by reducing the likelihood of invoking TBTF/SRE through making it more difficult to do, as in the U.S. since FDICIA, and by encouraging or requiring truly at-risk subordinated debt (U.S. Shadow Financial Regulatory Committee, 2000). Nor does Pillar II introduce any cost-benefit criteria to test whether the benefits of each additional item disclosed exceed its costs of collection and processing.

As a result, Basel II provides only partial and flawed improvements over Basel I as a tool for public policy to achieve the goal of enhanced financial stability. Pillar I remains basically a "best practices" guide for bank management.[2] While there is substantial empirical evidence of a negative relationship between leverage ratios and bank insolvency, there is no such evidence between risk-based capital ratios and bank insolvency (Evanoff and Wall, 2001). In no other industry do analysts compute risk-based capital ratios for individual firms. But they do compute and investors use leverage ratios. Risk-weighted assets are an inferior scaler to total assets to gauge how much capital is available to a bank before insolvency. Pillars II and III are vastly inferior to PCA/SEIR with a

[1] In the U.S., the increased complexity is also likely to make it more difficult for banks to comply with both the internal controls provisions of FDICIA and, more recently, sections of the Sarbanes-Oxley Act of 2002, which require quarterly evaluations of the internal control systems and attesting to their effectiveness by the CEO and CFO. In addition, the increased emphasis on improved corporate governances requires greater disclosure to and understanding of the risk management procedures by bank directors, most of whom may reasonably be expected not to be financial experts.

[2] Indeed, a recent article argues that the internal ratings model underlying the regulation is outdated even as it is being proposed (Thomas and Wang, 2005).

strong legal closure rule at positive capital to minimize both the number and cost of bank failures.[3]

Basel II may also be on the verge of causing major mischief in the U.S. that could weaken financial stability for large banks intending to use the advanced internal ratings approach. The 4% risk-based Tier I capital target ratio can be achieved with lower capital than both is required under Basel I and is currently required to be classified as an "adequately capitalized" bank according to the leverage ratio.[4] That is, the leverage ratio is likely to become more binding for these banks and prevent a reduction in required regulatory capital. The FDIC has recently concluded that "U.S. policy-makers will be confronted with a choice between ignoring the results of Basel II or substantially weakening the PCA requirements" (FDIC, 2004). Although almost all U.S. banks currently maintain capital ratios well above the regulatory requirements, some banks appear to be lobbying U.S. regulators to lower the numerical threshold capital leverage ratio to qualify as "adequately capitalized" to below 4%, say to 3½% or lower. FDICIA delegates to the regulators the setting of the numerical thresholds for all tranches but the minimum "critically undercapitalized" closure trigger of 2% equity capital. Some large banks are also arguing that the current leverage ratio requirements put them at a disadvantage with their competitors in the rest of the world, who are not subject to these ratios.

For U.S. regulators to cave in to such pressure in order to have Basel II adopted would be a big and costly mistake both for the macroeconomy and for the banks themselves. Considerable evidence suggests that even a 4% equity leverage ratio is lower than that maintained by almost all domestic nonbank competitors of banks, who are not similarly regulated nor covered by a safety net (Kaufman, 1992 and Kwast and Passmore, 1999). When industry leverage ratios decline below 6%, bank failures increase. Indeed, on the whole, there is a negative relationship between leverage ratios and defaults in all industries (Molina, 2005). With respect to individual large banks, there is no evidence that equity capital increases the bank's overall cost of funds and that there is an inverse relationship between bank capital ratios and bank return on either assets or equity.

Indeed, a time series analysis for U.S. banks shows a weak positive relationship (Berger, 1995). A cursory cross-section analysis across the world's largest banks also shows a positive relationship between capital funds and profitability since the 1980s. Recently, U.S., U.K. Australian, and Spanish banks have high capital ratios and high profitability, while German, Swiss, and Japanese banks have low capital ratios and low profitability, although some adjustment may need to be made for the possibility of simultaneity in the direction of causation (Table 2). This helps to explain why capital ratios actually maintained by U.S. banks are considerably higher than the regulatory requirements. They are signaling strength. Among the largest 1,000 banks in the world in 2003, U.S.

[3] A similar conclusion appears to have been reached by Goodhart (2004).

[4] This occurs because 4% × risk-weighted assets yields a Tier 1 capital number which, when divided by the bank's total assets, is less than 4%.

Table 2: Large Bank Capital Ratios and Profitability by Country

Country	Equity Capital ÷ Total Assets *2002*	Pre-tax Profits ÷ Total Assets *2002*	*2000–02*
		(Percent)	
United States	6.34	1.66	1.67
Spain	5.07	0.93	1.15
Australia	4.91	1.49	1.61
Italy	4.68	0.48	0.81
United Kingdom	4.49	1.11	1.34
Canada	7.32	0.61	0.93
France	3.94	0.58	0.72
Japan	3.15	0.04	−0.25
Germany	2.63	0.05	0.29
Switzerland	2.18	0.08	0.49

Source: Federal Deposit Insurance Corporation, *FYI: An Update on Emerging Issues in Banking*, p. 1 and Bank for International Settlements, *Annual Reports, 2001–2003*.

banks accounted for 15% of aggregate assets, 22% of aggregate Tier 1 capital and fully 37% of aggregate pretax profits. For Japan and the EU countries, capital accounted for a lower percentage of total capital than did their assets as a percent of aggregate assets and profitability even less. For the remaining countries, capital was at least as high a percentage of the aggregate as were assets and was about the same percentage as profitability (Table 3).

Table 3: Top 1,000 Capitalized Banks in the World, 2003 by Geographic Region and Share of Total Assets, Tier 1 Capital, and Pretax Profits

Region	Total Asset	Tier 1 Capital	Pretax Profits
		(Percent of total)	
United States	15	22	37
European Union	48	41	37
Japan	15	12	4
Rest of Asia	11	12	8
Rest of Europe	5	5	6
Middle East	2	3	2
Latin America	1	2	2
Rest of World	3	3	4
Total	**100**	**100**	**100**

Source: *Banker Magazine*, July 2004.

V. CONCLUSION

For most countries, adoption of Basel II by itself could undermine adoption of better public policy structures and thereby increase both the likelihood and costs of financial instability. It is time, therefore, to reconsider the benefit-cost trade-off of Basel versus a U.S. type of structure resembling SEIR and PCA. But the Basel process has not been totally negative. It has greatly improved the measurement and management of risk by both bankers and regulators and thus enhanced financial stability worldwide. Basel should be maintained as an ongoing process to develop ever better bank best practices schemes, but it should never be halted and put in place. It is the process, not the end result, that will provide the major benefits. The integrity of PCA in the U.S. should not be compromised for the sake of hormonizing bank capital standards across countries.

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George Kaufman is the John F. Smith Professor of Finance and Economics and Director of the Center for Financial and Policy Studies, School of Business Administration, Loyola University Chicago. He has taught at Loyola University since 1981. Before teaching at Loyola, he was a research fellow, economist and research officer at the Federal Reserve Bank of Chicago from 1959 to 1970 and has been a consultant to the Bank since 1981. From 1970 to 1980, he was the John Rogers Professor of Banking and Finance and Director of the Center for Capital Market Research in the College of Business Administration at the University of Oregon. He has been a visiting professor at the University of Southern California (1970), Stanford University (1975–76), and the University of California at Berkeley (1979), and a visiting scholar at the Federal Reserve Bank of San Francisco (1976) and the Office of the Comptroller of Currency (1978). He also served as Deputy to the Assistant Secretary for Economic Policy of the U.S. Treasury in 1976. Kaufman received his B.A. from Oberlin College (1954), M.A. from the University of Michigan (1955), and Ph.D. in economics from the University of Iowa (1962).