Banking Regulation in the US and Basel III

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Table of Contents

List of Abbreviations 136

1. Introduction 137

2. Banking crises/regulation – some history 137

3. New rules and regulations for US banking 138

4. Basel III/history of Basel accords 145

5. Final thought 150

Appendix 151
References 153

List of Abbreviations

AIG	American International Group, Inc.
BIS	Bank for International Settlements
C-Banker	Commercial Banker
C-banking	Commercial Banking
CDS	Credit Default Swap
CEO	Chief Executive Officer
CFTC	Commodity Futures Trading Commission
Eq. % of Assets	Equity as a percentage of Assets
FDIC	Federal Deposit Insurance Corporation
FDR	Franklin Delano Roosevelt
FHC	Financial Holding Company
GLBA	Graham-Leach-Bliley-Act
GSA	Glass-Steagall-Act
I-Banker	Investment Banker
I-banking	Investment Banking
O & D	Originate & Distribute
OCC	Office of the Controller of the Currency
OTC	Over The Counter
ROE	Return on Equity
r/w	risk-weighted
SEC	Security Exchange Commission
SIFI	Systemically Important Financial Institution
SPE	Special Purpose Enterprise
USA/ U.S.	United States of America
VaR	Value at Risk

1. Introduction

The inclusion of the regulatory elements, which the US-financial industry will have to absorb, will have an impact on the financial world as a whole. Therefore, I think it is appropriate to bring them into the discussion of this workshop on the Euro-crisis.
With this said, I would like to add that I will highlight the key political measurements put in place/ announced/ contemplated after input in form of comments and recommendations offered by bankers, lobbyists, academia and others. I will also make an attempt to put them into a historical perspective. And I will not be shy to be critical about these changes imposed on the US-American banking industry by asking the simple question whether the new rules of the game will:

- Immunize the banking system against a disaster like the one experienced in 2008?
- Even better, avoid banking crashes that require taxpayer money to save the entire economy?

In this context, I have to mention that my research has been focused on the large globally operating banks headquartered in the Western World; primarily the ones now defined as "too-big-to-fail" institutions.

2. Banking crises/regulation – some history

Looking back, the regulatory changes made in 1999 by the US authorities, the abolishment of the Glass-Steagall-Act, led not only the US – but all Western economies into the crisis of 2008, according to not only my research. And it is hard to believe that we all still suffer from it with four years into it. A common opinion has been that the disaster is (almost) as bad as the banking crisis of 1933 was and followed by the Great Depression. Quite a number of similarities of the two "events" can be brought up. However, more importantly, then and now as a consequence of the created disaster the banking laws and regulations were changed.
When contemplating the amendments to the banking regulations made in 1933/34, one has to concur that they were drastic: GSA was signed into law by FDR. It was the end of the "Universal Banking-System" in the USA. All financial institutions had to adjust their business model, better said it had to be radically altered. The subsequent split of investment banking and commercial banking resulted in 65-years of quite stable and sound banking institutions in the U.S.

In 1999, all this was changed back with the Graham-Leach-Bliley-Act disrespecting the "past experiences" of the pre-GSA era in the U.S. And only 10 years later, we are back into deep crisis mode. The impact of GLBA on European Universal banks was a para-

digm shift towards I-banking and away from their stalwart, the lending business. Their objective was to become competitive with the US-C- and I-Banks on an international basis although they "entered the game" with a significant disadvantage. Their balance sheets were much higher leveraged than the competition they desired to take on. Furthermore, the securities markets in the US were better developed, much bigger and more liquid than the European ones. It is an important factor, bearing in mind that the prime role of I-banking has been the trading side of the business equation.

As an example, Deutsche Bank used to be seen as a lending institution for all these years. Today, it calls itself a "GLOBAL INVESTMENT BANK". With it came that management changes were made in favor of I-bankers who introduced a strict trading mentality. Short-term profit focus and with it the publication of ROE-targets were applied as main management tools to justify incentive compensation packages for senior management. And this applies to all Western European banks now playing on this field.
This raises the question whether the present re-shuffle of regulations will have the same "fruitful" impact on the banking industry as the GSA before? And therefore, will it lead to a much more stable banking industry in order to diminish the fallout of such disasters? Or even better, will we avoid banking industry missteps altogether and protect taxpayers' money?

3. New rules and regulations for US banking

According to the Senate Committee on Banking, Housing, and Urban Affairs, the law was written under the Summary headline: *"Create a Sound Economic Foundation to Grow Jobs, Protect Consumers, Rein in Wall Street, End Too Big to Fail, Prevent Another Financial Crisis."*
It is hailed as the most comprehensive financial regulatory reform measures taken since the Great Depression and is called "The Dodd-Frank Wall Street Reform and Consumer Protection ACT".
In the following, I will categorize the key measurements taken in an attempt to highlight strengths and weaknesses of them.[1]

1 See Attachment: Regulatory Measurements taken/to be taken.

Table 1: Restoring American Financial Stability

Key features of legislation	Addressing:
1. Addressing Systemic Risks/ Advanced Warning System	• Organizational issues
2. Bank Supervision/ -Regulation 3. Securitization 4. Transparency & Accountability for Derivatives 5. Hedge Funds/ Insurance 6. Executive Compensation & Corporate Governance	• Idiosyncrasies of last crisis
7. End Too Big to Fail Bailouts/ Bailout by Taxpayers	• The Future of Banking

Organizational Issues, referring to item 1. of Table 1

Members of the newly established Financial Stability Oversight Council will be political appointees. Their duties have been defined as collect information, provide direction, support the work of the council, monitor the financial services market, facilitate information sharing, recommend actions, suggest general supervisory priorities and provide a forum for discussion, among others. From this could be taken that it easily could become a forum with little effectiveness.

Idiosyncrasies, referring to items 2. and 6. of Table 1

When evaluating the key features of legislation, the BIS-working paper +51, titled *"The financial turmoil of 2007-?; a preliminary assessment and some policy considerations"*, written by Claudio Borio, came to mind.[2] In March 2008, Borio obviously did not (yet) foresee the devastating banking crisis that followed with the bankruptcy of Lehman in September of the same year. At that time, he used the word "turmoil", describing what went on in the banking industry: a temporary adjustment to the "new" financial markets". He called the elements of this new market "idiosyncrasies". These bank product innovations were structured credit products; dominantly securitization, credit risk transfer instruments; primarily credit default swaps, a business model switch from B&H to O&D; by extended use of the syndication markets. I would add to the list the "(bad) business behavior" of the Credit Rating Agencies as well as the breathtaking growth of the Hedge Fund Industry and the Private Equity Industry.

Running the idiosyncrasies list against the above stated key measurements to bring back stability of the US banking system, I conclude that the politicians' efforts were motivated by "showing action" against what was new and peculiar in the financial world rather than looking at the US banking industry comprehensively and taking, -in addition thereto-, historical experiences into account. Claudio Borio, already then, ended his paper with the comment: *"... these idiosyncratic elements, prominent as they are, should not blind us to the more fundamental nature of the turmoil and the factors behind it."*[3]

2 Borio, C. (2008).

3 Borio, C. (2008), *op. cit.*

In my words, what has been legislating is an attempt to cure symptoms of the past crisis rather than address the causes!

Overhaul existing Agency Oversight System[4]
At own admission, the legislator has stated that *"Today, we have a convoluted system of bank regulators created by historical accident"*.[5] *"(R)egulation (was) riddled with dangerous loopholes …"*.
I would add due to the fact that GSA was abolished without alignment of the supervisory regulations. The objective is to put in place *"…clear lines of responsibility, reduce arbitrage, and improve consistency and accountability"*.[6]
Fact is that Fed, FDIC, OCC and SEC remain unchanged in place as independent agencies.

Capital Standards
The capital standards presently in place *(5.5 % of assets)* constitute the floor of capital required. Furthermore, a *15 to 1 leverage* can be imposed on US banks to mitigate great threat to the financial system. My remarks on Basel III will complement this US-specific rule.

Securitization Reform
The key features of the reform have been the amendment of registration, disclosure, and reporting requirements for asset-backed securities and other structured finance products as well as the amendment of safe harbor rule; requiring financial institutions to retain more of the credit risk from securitization. Furthermore, revision of accounting rules relating to sales of financial assets and consolidation of certain off-balance sheet entities were included.

Together with the ever-increasing importance of the loan syndication market, securitization transactions involving different asset classes have become the financial institutions' tool to execute on the O&D business model, that I-banks invented. Again, regulatory authorities did not have the foresightedness upon abolishment of GSA to anticipate that the market entrance of large C-banks securitization volume will result in increased deal flow attracting unsophisticated investors lacking the knowledge of and the experience with these risky instruments. The Credit Rating Agencies with their misguided business model have to be seen as major culprit in the matter.

4 See Table 1.
5 Senate Committee on Bank and Urban Affairs; Chairman Chris Dodd (D-CT); Summary: Restoring American Financial Stability; p. 5; Contact: Kirstin Brost; 2010.
6 Chris Dodd 2010, *op. cit.*

Derivatives Issue

Again, credit risk transfer as core business concept has been adopted by C-banks when entering into the competition with I-banks. Furthermore, the Basel II risk weighting schemata opened the door for regulatory arbitrage. The tools used, like for instance individual and index CDS, were private and unregulated without exchange trading and central clearing; i.e. over-the-counter. The introduction of *"Higher Standard of Conduct"* for swap market participants clearly indicates what the market's features used to be, i.e. freewheeling without transparency.

Hedge Funds / Insurance / Credit Rating Agencies

When citing the committee's reason for regulating now the Hedge Fund Industry: *"Hedge funds are responsible for huge transfers of capital and risk, but (some) operate outside the framework of the financial regulatory system, even as they have become increasingly interwoven with the rest of the country's financial markets"*, it demonstrates how leisurely the financial business post GSA was approached by the supervisory authorities.[7] The rules are meant to "end the shadow financial system" that was allowed to create itself over the period of time.

Concerning the Insurance Industry, the regulators were blindsided by the insurers when they became some of the largest CDS-writers (AIG), expanding their product portfolio to the credit markets.

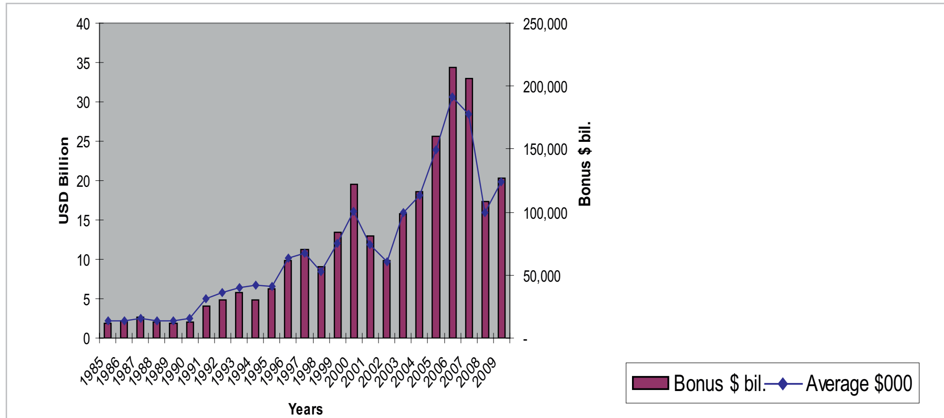
The Credit Rating Agencies, in the eyes of the Government, were meant to *"… (to) warn people about risks hidden throughout layers of complex structures"*.[8] However, it was ignored that the parties for which they rated the securities also paid the rating agencies. In my eyes, it is the incarnation of a moral hazard-case.

7 Chris Dodd 2010, *op. cit.*

8 Chris Dodd 2010, *op. cit.*

Executive Compensation & Corporate Governance

Table 3: Wall Street Bonuses



Source: based on data from http://www.scribd.com/doc/30789728/Wall-Street-Bonus-Chart-2009, New York City Securities Industry Bonus Pools

Post GSA, the compensation packages in the financial industry have grown significantly. The bonus pools of the banks grew from USD 9.8 billion in 2002 to USD 33 billion in 2006. These amounts compare to an average of approx. USD 5 to 6 billion for the 10 years from 1989 to 1999. These amounts and the fact that bankers were held responsible for the financial crisis of 2008 that caused job losses and business closings resulted in an outcry of disgust among the broad population. Like Robert Skidelsky, referring to John Maynard Keynes in his recent book, stated that: *"Popular anger is largely directed against rewarding what is seen as doing harm: bankers who bankrupt their institutions....".*[9]
Thus the politicians reacted by accusing Wall Street that it *"...has developed an out of control system of out of this world bonuses that rewards short term profits over the long term health and security of their firms."*[10]
As consequence, the Government introduced new "rules".
The first question I would want to raise is, whether in a "free enterprise economic system" the Government's involvement in individual stockholder-owned companies should be extended to decisions on the pay of the firms' executives. Thereafter, I would ask what the respective Boards of Directors' function is when allowing the payout of such sums of compensation and doing so by jeopardizing the existence of the company; they are on a fiduciary basis responsible for. They cannot act in the best interest of the owners of the company, which is what I conclude. Against this background, the new rules give shareholders a non-binding vote on executive pay that can be ignored by the Board!

9 See Robert Skidelsky; Keynes – The Return of the Master -; pp. 147 ff.; 2009.
10 Chris Dodd 2010, *op. cit.*

I suggest, with the rethinking of the "Agency Theory", as rekindled by Roger L. Martin's recent book, titled: *"Fixing the Game",* there is an opportunity for academia to address the executive pay issue.[11] Incentive compensation of the Board does NOT align the principals' interest with the agents' (=Boards) interest. For me, it looks like a case of "Moral Hazard".

Concluding Remarks to "Idiosyncrasies":

In all cases, I view the regulatory measurements now implemented as just coming clean with the past. And therefore, I would add that they are not the path-breaking regulatory tools to avoid potentially future mishaps in banking.

The Future of Banking, referring to item 7. of Table 1

Now, let me please turn to the key measurement of the new US regulation package which I like to address today. According to the Government, the objective of this part of the legislation has been:

> *"Preventing another crisis where American taxpayers are forced to bail out financial firms requires strengthening big financial companies to better withstand stress, putting a price on excessive growth or complexity that poses risks to the financial system, and creating a way to shutdown big financial firms that fail without threatening the economy".*[12]

There is the attempt to limit the size of firms in order to avoid that they get "too big to fail" by way of strict rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity, with significant requirements on companies that pose risks to the financial system. Furthermore, "The Volcker Rule" has been created; prohibiting proprietary trading, investment in and sponsoring of hedge funds and private equity funds, and limiting relationships with hedge funds and private equity funds. To protect the American taxpayer from a bailout in case of a financial institution's demise, a so-called "Funeral Plan" requirement was introduced by the Federal Reserve and the FDIC. The plan assumes the case that a single, large and adverse event occurs that is idiosyncratic to the group at a time when the U.S. and global financial systems are not experiencing a system-wide financial panic or crisis. The U.S. Resolution Plan orders the existence of orderly shutdown-rules, liquidation and bankruptcy procedures, with the result that equity and bondholders absorb any losses, not he taxpayers.

When contemplating this part of the new legislation and looking forward, one has to take into account that a number of financial institutions considered "too big to fail" have only grown bigger by acquiring failing institutions during and after the recent crisis. So, the mountain to climb got even higher.

11 Roger L. Martin; Fixing the Game, 2011.

12 Chris Dodd 2010, *op. cit.*

Also, concerning the funeral plan, one has to assume the case that the occurrence of a single large and adverse event that is idiosyncratic to “a” group causes a system-wide financial panic or crisis due to the strong inter-connectedness the financial sector has built up. Such configuration is not at all addressed in the new legislation. Under these circumstances, we would be back to square one.

4. Basel III/history of Basel accords

Table 4: Basel Commitee on Banking Supervision Reforms – Basel III

	Capital					Liquidity
	Pillar 1			Pillar 2	Pillar 3	
	Capital	Risk coverage	Containing leverage	Risk management and supervision	Market discipline	Global liquidity standard and supervisory monitoring
All Banks	**Quality and level of capital** Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions. **Capital loss absorption at the point of non-viability** Contractual terms of capital instruments will include a clause that allows – at the discretion of the relevant authority – write-off or conversion to common shares if the bank is judged to be non-viable. This principle increases the contribution of the private sector to resolving future banking crises and thereby reduces moral hazard. **Capital conservation buffer** Comprising common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Constraint on a bank's discretionary distributions will be imposed when banks fall into the buffer range. **Countercyclical buffer** Imposed within a range of 0-2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.	**Securitisations** Strengthens the capital treatment for certain complex securitisations. Requires banks to conduct more rigorous credit analyses of externally rated securitisation exposures. **Trading book** Significantly higher capital for trading and derivatives activities, as well as complex securitisations held in the trading book. Introduction of a stressed value-at-risk framework to help mitigate procyclicality. A capital charge for incremental risk that estimates the default and migration risks of unsecuritised credit products and takes liquidity into account. **Counterparty credit risk** Substantial strengthening of the counterparty credit risk framework. Includes: more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivatives; and higher capital for inter-financial sector exposures. **Bank exposures to central counterparties (CCPs)** The Committee has proposed that trade exposures to a qualifying CCP will receive a 2% risk weight and default fund exposures to a qualifying CCP will be capitalised according to a risk-based method that consistently and simply estimates risk arising from such default fund.	**Leverage ratio** A non-risk-based leverage ratio that includes off-balance sheet exposures will serve as a backstop to the risk-based capital requirement. Also helps contain system wide build up of leverage.	**Supplemental Pillar 2 requirements.** Address firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges.	**Revised Pillar 3 disclosures requirements** The requirements introduced relate to securitisation exposures and sponsorship of off-balance sheet vehicles. Enhanced disclosures on the detail of the components of regulatory capital and their reconciliation to the reported accounts will be required, including a comprehensive explanation of how a bank calculates its regulatory capital ratios.	**Liquidity coverage ratio** The liquidity coverage ratio (LCR) will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors. **Net stable funding ratio** The net stable funding ratio (NSFR) is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding. **Principles for Sound Liquidity Risk Management and Supervision** The Committee's 2008 guidance *Principles for Sound Liquidity Risk Management and Supervision* takes account of lessons learned during the crisis and is based on a fundamental review of sound practices for managing liquidity risk in banking organisations. **Supervisory monitoring** The liquidity framework includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank and system-wide level.
SIFIs	In addition to meeting the Basel III requirements, global systemically important financial institutions (SIFIs) must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methodology that includes both quantitative indicators and qualitative elements to identify global systemically important banks (SIBs). The additional loss absorbency requirements are to be met with a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. For banks facing the highest SIB surcharge, an additional loss absorbency of 1% could be applied as a disincentive to increase materially their global systemic importance in the future. A consultative document was published in cooperation with the Financial Stability Board, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIFIs.					

Source: BIS, Basel Committee on Banking Supervision Reform – Basel III, June 6, 2011

The BIS-chart, I think is a comprehensive rule setting with two distinct requirements on banks going forward, a minimum capital and liquidity structure and an ultimate inception date in 2019.[13] (Certain parts have an earlier inception date.)
Concerning the subject, I reflected on papers issued by the "Group of Thirty", titled "Regulatory Reforms and Remaining Challenges" and the "Testimony of Professor Richard J. Herring, Wharton School, University of Pennsylvania before the U.S. Senate Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance and Investment", among other materials.[14] [15]
I will split my contribution in two parts, the history of the Basel-Regulations and its design flaws and what are the defects in Basel II. I will also comment on the Basel III-rules, its key features and comments made as well as critical issues.
Basel I, (and I quote Professor Herring):

> *"...(C)reated strong incentives for the banks to engage in regulatory arbitrage by shifting assets off its balance sheets and into SPEs that were often largely outside the scrutiny of creditors, regulators and analysts... and back the assets with a line of credit with a maturity of less than one year."*[16]

The creation of SPEs, holding assets acquired by the banks instead of holding them on-balance sheet, and the rule that 364-day credit-lines backing such SPEs would not be subject to a capital charge, gave the banks more efficient use of their regulatory capital resulting in more revenue generation by way of increasing their lending volume and servicing the SPEs (also called: oversupply of assets). At the same time, shadow banks like SPEs used securitization transactions to sell the risk into the capital markets, resulting in ever more transaction volume with ever more complex structures.
Another shortcoming was the capital regime for the trading book, ignoring liquidity premia when trading in stressed conditions.
Also, the calculation of regulatory capital was deficient as instruments were included that could not absorb losses in a going concern; intangible assets were not deducted from capital and the 4 % Tier 1 capital requirement was weakened as only half of it was mandated to be common equity.
Basel II introduced the concept of risk-weighted assets against which regulatory capital must be held.

To calculate the so-called Tier 1 capital, the rules introduced two options:

- The Standardized Approach based on external ratings. According to Herring, looking back, it led to *"...unintended, regulatory-induced, pressures for institutions to press for innovations that will yield highly rated credit with higher returns"*.[17]

13 See Table 4.

14 Group Of Thirty; Regulatory Reforms and Remaining Challenges; diff. Authors, 2011.

15 Richard J. Herring; "Risk Management and Its Implications for Systemic Risk"; Testimony before U.S. Senate Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance and Investment; June 19, 2008.

16 Richard J. Herring 2008, *op. cit.*

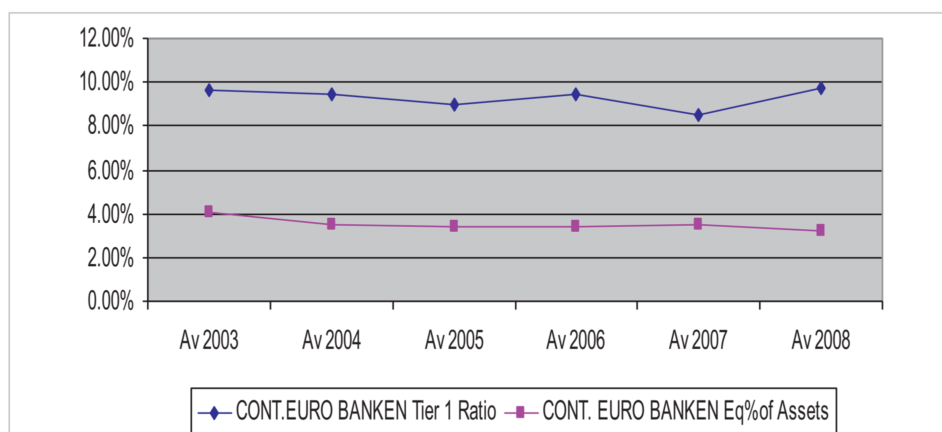
17 Richard J. Herring 2008, *op. cit.*

As a swipe against the regulation, just think of the *moral hazard* issue, the Credit Rating Agencies were under.

- The Internal Ratings Base Approach. It gave institutions that in the judgment of supervisors have operated sophisticated risk management systems a free hand to calculate their Tier 1 capital requirements. It is each bank's individual "black box" that lacks transparency and opens the possibility for different capital charges for the same asset (bank by bank, and country by country).

It is fair to say, with the experience of the crisis under the belt, that the risk models run by these institutions were terribly flawed. They could not cope with the complexity of many instruments and appropriate data was lacking to allow the models to make correct estimates. Just think of VaR- calculations for the trading book and the re-thinking of the method happening right now after the "London whale"-event at JPMorgan.
In summary, risk was undervalued. A FDIC study in 2005 already forecast this result, stating "Basel II appears to represent a fundamentally lower standard of capital adequacy that sharply conflicts with the PCA framework. Indeed, in terms of overall capital requirements, a 5 % leverage ration essentially makes the Basel II framework inoperative."[18]
It was one of the reasons that the US-authorities delayed the Basel II implementation until 2013.
In my opinion, the charts below display the motivation of the European banks to report their Tier 1 Capital ratio rather than being compared with the leverage ratio, as Equity at a percentage of Assets, published by their strong competitors, the large US-banks.[19]

Table 5: C-Banks: Tier 1 Ratio vs. Eq. % of Assets – Europe

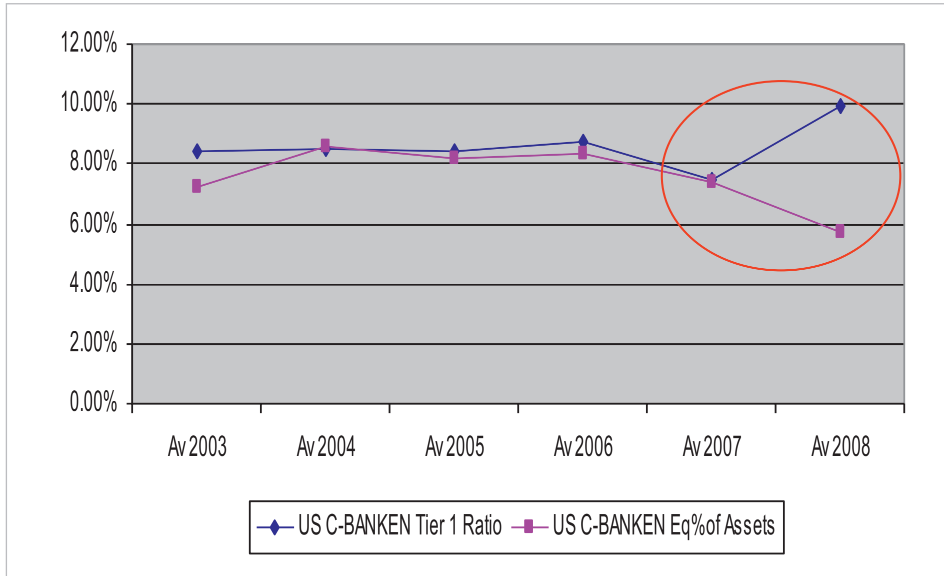


Source: Mikolayczyk; Veränderungen des US-Bankensystems als Wurzel der Bankenkrise von 2008; page 162ff.

18 See Statement of Donald E. Powell, Chairman FDIC: "The Development of the New Basel Capital Accords"; Committee on Banking, Housing, and Urban Affairs; November 10, 2005, pp. 25 ff.

19 See Table 5 & 6.

Table 6: C-Banks: Tier 1 Ratio vs. Eq. % of Assets – USA



Source: Mikolayczyk; Veränderungen des US-Bankensystems als Wurzel der Bankenkrise von 2008; page 162ff.

I would conclude that the Tier1 capital calculation "produced" competitiveness for the European banks for the outer world; i.e. stock markets, clients, etc.; that U.S.-banks have been better capitalized and that post 2007; the worsening leverage ratio versus improving Tier1 capital ratio, at least for me is difficult to reconcile. In particular, taking into account that only one year later, the riskiness of bank assets increased dramatically.

Concluding Remarks on Basel III:

Basel III addresses quite a number of critical issues creating a global standard for liquidity and introducing the leverage ratio –as shown before- in addition to the Tier1 capital ratio. It substantially raises the quantity, quality consistency, and transparency of the Tier1 capital base as follows:

- New minimum of 6 % of risk-weighted assets,
- Introduction of SIFIs with 1 to 2.5 % higher Tier 1 capital requirements,
- At least 75 % must be tangible common equity with the balance of true-absorbing capital,
- New capital conservation buffer of 2.5 % of r/w assets (for "stress periods"),
- New countercyclical buffer of up to 2.5 %, whereas the setting of triggers is a subject of contention.

However, and this leads me directly to the subject of the Euro-crisis as centerpiece of the workshop, these measurements will claim a high toll on the banking sector which in Europe "*...play(s) a fundamental role in the financing of the economy...the European*

economy is overwhelmingly dependent on banks…this explains that the European banks' balance sheets are, on the whole three times larger than in the United States".[20] Jacques de Larosiere makes reference to the much larger and more developed capital markets in the US when expressing his concern about the new ratio requirements.

A McKinsey study estimates the shortfalls on Tier 1 capital and liquidity, assuming 50 % retained earnings payout ratio and nominal p. a. balance sheet growth of 3 % through 2019, primarily due the sheer size of these universal-banking institutions as follows; the European banking sector will need about Euro 1.2 trillion Tier 1 additional capital, Euro 1.7 trillion short-term liquidity and Euro 3.4 trillion long-term funding.[21] The US banking sector, based on 2010 balance sheet data, would have to cover a shortfall of Euro 600 billion in Tier 1 capital, Euro 570 billion short-term and Euro 2.2 trillion long-term funding. McKinsey estimates that Basel III will reduce the banks' ROE by about 4 % in Europe and 3 % in the US. When asking the question how the banks will provide these necessary sums of money, the solution appears to be reduced to earnings retention and divestitures. Besides the shareholders of the banks who will have to accept lower returns, borrowers and trading partners will potentially see exposure reductions, certain client groups might become under-serviced and all bank customers will experience significantly more expensive banking services. Investment Banking, i.e. trading activities in OTC derivatives, cash trading and securitization will be impacted most, while Corporate Banking products like long-term corporate and asset-based lending, credit lines to financial institutions, structured finance, trade finance call for higher capital cover and thus will be curtailed. It leaves the Retail Banking business as least vulnerable to cuts due to fee income generation and higher lending margins at acceptable risk architecture.

Employment and staff compensation will shrink. Furthermore, looking at the present Sovereign Crisis in Europe, a risk weighting of zero for these sovereign borrowers will be very difficult to justify by the authorities going forward in order to bring back the European banking sector on proper footing. It will impact the asset composition of the banks' liquidity holdings.

All in all, the above outlined issues as well as the complexity of the large universal institutions definitely calls for business model-adjustments of the major banks. They appear to have become unmanageable, evidenced by recent bad news coming out of enterprises like JPMorgan, Barclays, and Goldman, to mention some recent ones. And, I am certain, these are only a few issues with which the European economies will be confronted.

20 Group of Thirty; Jacques de Larosiere; Remaining European and Global Challenges; p. 31; 2011.

21 McKinsey; Basel III and European banking: Its impact, how banks might respond, and the challenges of implementation; November 2010.

5. Final thought

All of it raises the question, whether we should rely on the hope that the new rules and regulations as highlighted here, will make it a safer banking industry and the next crisis a milder one? Or, should there be a reform that forces a business model – change, just like under FDR?

One statement comes to mind when thinking about the financial world we have created:

> *"We shall never go far toward restoring soundness to banking until we again fully recognize the sacred division between RISK and SAFETY, which in banking is of necessity marked by the separation between commercial banks, security companies, and savings banks. The financiers who have confused these three functions have been destroying the bases of SOUND finance."*[22]

A statement made by *Supreme Court Justice Louis Brandeis* in the year 1915.

22 See Norman Hapgood; A Foreword to Other People's Money: And How The Bankers Use It; National Home Library Foundation; 1932; Page xxxvi.

Appendix

These are the conceptual highlights and key features of legislation, according to the summary issued by the committee:

Addressing Systemic Risks/Advanced Warning System
- Financial Stability Oversight Council
- Regulation of Nonbank Financial Companies
- Break Up Large, Complex Companies

Bank Supervision/ -Regulation
- Overhaul existing agency oversight system
- Establishment of Capital Standards

Securitization
- “Skin in the Game”
- Better Disclosure

Transparency & Accountability for Derivatives
- Close Regulatory Gap of over-the-counter derivatives
- Central Clearing and Exchange Trading
- Higher Standard of Conduct

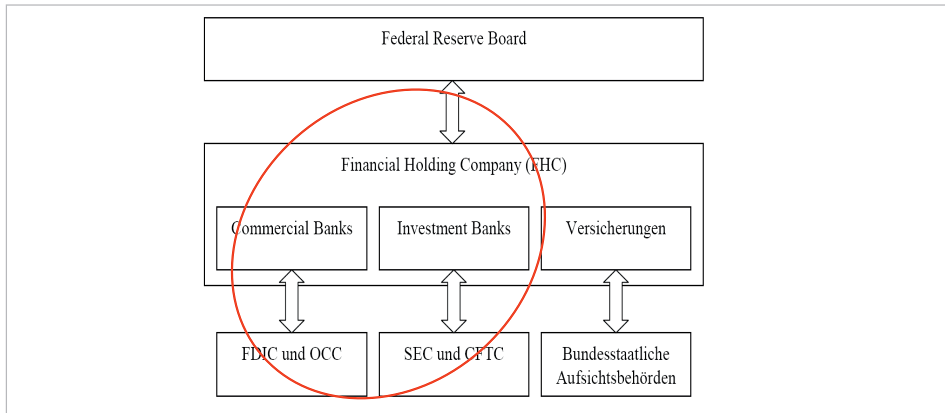
Hedge Funds/ Insurance/ Credit Rating Agencies
- Fill regulatory gaps
- Greater supervision of “shadow financial system”
- Conflict of Interest

Executive Compensation & Corporate Governance
- Shareholder empowerment by way of non-binding vote
- Nomination of Directors
- Claw back of executive compensation

End Too Big to Fail Bailouts/ Bailout by Taxpayers
- Discourage Excessive Growth & Complexity
- “Volcker Rule”
- Extension of Regulation
- “Funeral Plans”
- Liquidation Procedure & Bankruptcy

Furthermore (for completion only):
- Enforcement of Regulations on the Books
- Consumer Protection
- Investor Protection
- Reform of The Federal Reserve
- Requirements and Oversight of Credit Rating Agencies

Table 2: US Banking Supervision



Source: Hartmann-Wendels, etc.; Bankbetriebslehre, p. 74 (incl. own input)

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