The political economy of post-crisis regulatory response: why does compliance with Basel vary?

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Growing international coordination of post-crisis regulatory response

• Contrast with regulatory unilateralism in 1930s

• Core Basel problem: agreeing minimum international standards, with growing focus on implementation

• “Over-compliance” (OC) seen as unlikely & unsustainable
But regulatory OC is common *and* persistent (Basel CARs)

<table>
<thead>
<tr>
<th>year</th>
<th>Count of minimum compliers (min. total CARs)</th>
<th>Count of overcompliers (min. total CARs)</th>
<th>Total countries</th>
<th>% Overcompliers (min. total CARs)</th>
<th>MEMO: % Overcompliers (min. Tier 1 CARs)</th>
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<tbody>
<tr>
<td>1999</td>
<td>66</td>
<td>32</td>
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<td>2004</td>
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<td>2005</td>
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Source: IMF, World Bank, national regulators.
Levels of OC have been substantial (2005)

Minimum regulatory Tier 1 ratios, 2005

De facto average Tier 1 ratios, 2005

N.b. minimum Tier 1 ratios were 4%.
This is surprising

• Assumption of strong RTB in equity capital
  – Key UK-US motivation for minimum standards in Basel I (key targets: Japanese, European banks)
  – Domestic political bargains based on raising bank capital only to similar level of main competitors (Kapstein, Simmons, Singer)

• Financial sector enjoys growing political leverage, even after 2008 (Johnson, Hacker & Pierson)

• Would expect more under-compliance (cheating) than we seem to see

• But since Basel III, we see more OC announcements (US, UK, Sweden, Austria, China, India, etc)
“Mock OC” – headline OC with compensation?

Regulatory & de facto OC, by income per capita

- E.g. Mongolian regulators: OC as compensation for weak governance
When will states prefer safer banks?

- In circumstances of low state fiscal capacity (banks may prefer more capital too)
- With TBTF banks & high financialization (but banks may be in a stronger position to resist)
- When governments/agencies prefer more stringent regulation than they can achieve in Basel
- Much depends on institutional strength/autonomy
Bank interests & lobbying incentives

• Implicit funding subsidies, oligopoly pricing for large banks might offset headline OC in higher rule of law jurisdictions
  – But why give these up?; large banks still lobby against OC in US, UK, etc

• Financial structure
  – Capital markets vs. bank-based systems (Henning: finance-industry coordination in latter)
  – Some market segments may benefit from OC? (e.g. wealth management?)
Strength of anti-bank political coalitions

• Public anger after crises & demands for more stringent regulation
  – But why go beyond Basel?
  – Might expect populist/symbolic regulatory responses than more technical, onerous forms of OC

• Political institutions can channel or block such activism
  – Party organization & discipline
  – Citizens’ referenda
The “Swiss finish”

- **10% CET1 capital ratio, 19% total CAR for UBS & CS on a group & national subsidiary basis**
  - Looks costly, though Swiss Bankers Association is generally “positive” about this approach – why?

- **Costs of OC limited in various ways**
  - Keeps 3% Basel III leverage ratio: could UBS & CS “manage” RWAs? (SNB disclosure requirement since 2012, but less stringent than US)
  - Wealth management business benefits from OC? (but why no support for a higher leverage rule?)
  - Smallest banks exempted from OC

- **Direct democracy seems unimportant**
  - No financial sector referenda; Swiss industry & govt have effectively opposed populist measures to restrict bonuses
The United States – emerging OC?

• No capital OC, but in 2013 Regulators propose 5% leverage rule for BHCs & more stringent liquidity rules than Basel
  – 2012 Collins Amendment: A-IRB banks must also meet 100% of standardized floors for RWAs
  – Major banks strongly oppose; potentially more constraining than Swiss finish

• Regulatory politics of divide & rule
  – Focus OC on the big 8 & make concessions to small banks, garnering strong small bank support
  – Traditional anti-big bank politics reinforced by Tea Party constraint on Republicans (Brown-Vitter May 2013)
  – Role of “the whale”
China – retreating OC

• Modest OC proposed in 2011 (extra 0.5% CET1 capital, 1.5% for 5 majors) by end-2013, & a 4% leverage ratio
  – But uncertainties given governance weaknesses in financial sector, LGFP lending
  – Slowing economy prompted relaxation of implementation to 2019 despite already high CET1 levels

• What drove the initial strategy?
  – Use of Basel standards as internal reform tool
  – International aspect: “good citizen”, and giving no excuses to US & EU
  – Latter less important now implementation is less uncertain
Implications

• OC, like other forms of Basel implementation, is adapted to domestic political circumstances
  – Can be more symbolic than real, with adjustment for bank & industry interests
• But moves to modest extra stringency in US suggests “capture” there is incomplete
• Indicates rising dissatisfaction with Basel outcomes in key countries, dilution of a focal point for post-crisis regulatory convergence