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The Regulator is Thinking to Reform Capital Requirements for Financial Institutions

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Recently, the report of the US President's Working Group (PWG) on Financial Markets has addressed the weaknesses in the global financial markets. Also, in recent months, the Federal Reserve has been intensely focused on the continuing strains in financial markets. Healthy, well- functioning financial markets are essential to sustainable growth. In particular, much experience shows that economies cannot perform at their full potential when financial conditions are such as to restrict the supply of credit to sound borrowers.

Given the critical role that these markets play in our financial system, we need to proceed in a prudent manner in making changes, especially as long as the broader financial markets are experiencing stress. The Fed should be more formally accountable for promoting financial stability since the institution's powers are consistent with its responsibilities. The Fed could fully meet these objectives without the authority to directly examine banks and other financial institutions that are subject to prudential regulation.

During the recent financial turmoil, the ability of the Fed to obtain information directly from key institutions and from supervisory reviews has been invaluable for understanding financial developments and their implications for the economy. To fulfill its responsibilities, the Fed would also need to have the ability to look at financial firms as a whole. Finally, to identify financial vulnerabilities, the Fed would need general authority to collect information on the structure and workings of financial markets.

When a bank's capital is found to be inadequate, the bank might be expected to make

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up some of the equity deficiency by raising new capital or restricting current and subsequent dividend payments. If capital requirement is higher then the deposit insurance premium charged by the insurer can be lowered, because given the relevant risks the present value of the insurer's liability can be reduced by increasing the value of assets by an infusion of new capital. In the absence of moral hazard and the regulator is well informed, it is equally well with either risk-based deposit insurance premium or risk-based capital standard. But, if the regulator is not perfectly informed, the two regulatory mechanisms are no longer equivalent.

The Squam Lake Working Group argues that regulators consider systemic effects when setting bank capital requirements. Everything else the same, capital requirements should be proportionately higher for larger banks, banks that hold more illiquid assets, and banks that finance more of their operations with short-term debt. But capital requirements are not free. When designing capital requirements that address systemic concerns, regulators must weigh the costs such requirements impose on banks during good times against the benefit of having more capital in the financial system when a crisis strikes.

The Squam Lake Working Group on Financial Regulation is a nonpartisan, nonaffiliated group of fifteen academics who have come together to offer guidance on the reform of financial regulation. The group first convened in fall 2008, amid the deepening capital markets crisis. The group is intentionally focused on longer-term issues although informed by this crisis—its events and the ongoing policy responses. It aspires to help guide reform of capital markets—their structure, function, and regulation. This guidance is based on the group's collective academic, private sector, and public policy experience.

To achieve its goal, the Squam Lake Working Group is developing a set of principles and their implications that are aimed at different parts of the financial system: at individual firms, at financial firms collectively, and at the linkages that connect financial firms to the broader economy. Banks play a critical role in the allocation of society's limited savings among the most productive investments, and they facilitate the efficient allocation of the risks of those investments. As the current crisis forcefully reminds us, a breakdown in this process can disrupt economies around the world. Because other financial institutions can step in to fill the gap, failure of an isolated bank is unlikely to cause serious economy -wide problems. Large banks, however, are rarely so isolated. Many are linked through tight webs of complex trading relationships, so the failure of one large bank can inflict significant losses on others.

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To achieve its goal, the group is developing a set of principles that are aimed at different parts of the financial system: at individual firms, at financial firms collectively, and at the linkages that connect financial firms to the broader economy. Since the contamination across institutions is not limited to defaults. A bank that simply suffers large losses may be forced to reduce its risk by selling assets at distressed or fire sale prices. If other banks must revalue their assets at these temporarily low market values, the first sale can set off a cascade of fire sales that inflict losses on many institutions. Thus, whether through default or fire sales, one troubled bank can damage many others, reducing the financial system's capacity to bear risk and make loans.

Banks in the United States and many other countries must satisfy regulatory capital requirements that are intended to ensure they can sustain reasonable losses. These requirements are generally specified as a ratio of some measure of capital to some measure of assets, such as total assets or risk-adjusted assets. Capital requirements are typically designed as if each bank is an isolated entity, with little concern for the effect losses or default at one bank can have on other financial institutions.