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Let's Be Frank: Are the Proposed US Rules Based on Basel III an Adequate Response to the Financial Debacle?

Eugene Goyfman*

*Fordham University School of Law

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COMMENT

LET'S BE FRANK: ARE THE PROPOSED US RULES BASED ON BASEL III AN ADEQUATE RESPONSE TO THE FINANCIAL DEBACLE?

*Eugene Goyfman**

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INTRODUCTION

On Saturday, September 13, 2008, Jamie Dimon, then CEO of JP Morgan Chase, declared, “We just hit the iceberg. The

boat is filling with water, and the music is still playing. There aren't enough lifeboats. Someone is going to die.”¹ On September 15, 2008, Lehman Brothers filed the largest US bankruptcy filing ever.² The financial ramifications were quick and merciless—two weeks later, Washington Mutual failed and became the largest bank in US history to collapse from a bank run.³ The panic causing the bank run was not solely a US problem.⁴ Just a year earlier, Northern Rock Plc, a UK bank, suffered from the country's first bank run in 140 years.⁵ The

* J.D. Candidate, 2014, Fordham University School of Law. B.B.A. in Finance, 2011, The City University of New York, Baruch College. The Author would like to thank Professor Richard S. Carnell for his insight and guidance. The Author would also like to thank Tonya Rodgers and the Editorial Board of the *Fordham International Law Journal* for their valuable input. Gratitude is also owed to Edgar Chakarian for his helpful feedback. Most of all, the Author wishes to thank his loving family for their endless support and encouragement. All errors are the Author's own.

1. SIMON JOHNSON & JAMES KWAK, *13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN* 162 (2012).

2. See Sam Mamudi, *Lehman Folds with Record \$613 Billion Debt*, MARKETWATCH (Sept. 15 2008), <http://www.marketwatch.com/Story/story/print?guid=2FE5AC05-597A-4E71-A2D5-9B9FCC29052> (noting that the Lehman bankruptcy was the largest one ever filed in United States' history); Jonathan Stempel, *Factbox: Largest US Bankruptcies*, REUTERS (Oct. 31, 2011), <http://www.reuters.com/article/2011/10/31/us-mfglobal-bankruptcies-idUSTRE79U4J520111031> (listing the largest US bankruptcies, starting with Lehman Brothers).

3. See Cyrus Sanati, *Behind the Downfall of Washington Mutual*, N.Y. TIMES, Oct. 29, 2009, <http://dealbook.nytimes.com/2009/10/29/behind-the-downfall-of-washington-mutual> (explaining how a series of bank runs led to the bank's failure); Robin Sidcl, David Enrich & Dan Fitzpatrick, *Wamu is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, <http://online.wsj.com/article/SB122238415586576687.html> (discussing the failure of the bank). Depositors have a right to withdraw their money on demand. Banks only keep a small amount of the cash for deposits on demand. Therefore, if the bank's depositors all withdraw at the same time, the bank will have no cash to meet its immediate expenses and pay its depositors. The bank thus becomes insolvent due to a bank run. See RICHARD CARNELL, JONATHAN MACEY & GEOFFREY MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 58–59 (4th ed. 2009) (explaining how bank runs can cause bank failure and emphasizing that “[w]ithout emergency assistance . . . no bank . . . can withstand a persistent run”).

4. See Brooke Masters, *Northern Rock Exposed Regulatory Failings*, FIN. TIMES, Sept. 12, 2012, <http://www.ft.com/intl/cms/s/0/7bb1ab1a-fc00-11e1-af33-00144feabdc0.html> (explaining how Northern Rock failed due to a bank run and in part because the bank had “very little equity to absorb unexpected losses”); *Northern Rock, Lessons of the Fall*, ECONOMIST, Oct. 18, 2007, <http://www.economist.com/node/9988865> (noting that this was “Britain's first bank run in 140 years”).

5. See Masters, *supra* note 4 (explaining that Northern Rock was the first bank run in 140 years); Daniel Bentley, *Northern Rock Bank Run Could Have Been Avoided, Says Hector Sants*, INDEPENDENT, June 13, 2012, <http://www.independent.co.uk/news/>

failure of Northern Rock, Washington Mutual and the hundreds of banks that failed after them illustrate the importance of safeguarding depositors from the adverse effects of losses.⁶ Imposing minimum capital regulations is one such way regulators protect their depositors.⁷

Capital has many meanings.⁸ For the purposes of this Comment, “regulatory capital” is the most relevant.⁹ As long as banks have capital that is equivalent to, or more than the value of incurred losses, the depositors will be protected.¹⁰ For example, if a bank has US\$1,000 of loans funded by US\$800 in deposits and US\$200 in common stock, the US\$200 common

business/news/northern-rock-bank-run-could-have-been-avoided-says-hector-sants-7847503.html (reporting on ways the bank could have avoided a run).

6. See *Bank Failures in Brief 2009*, FED. DEPOSIT INS. CORP. (2013), <http://www.fdic.gov/bank/historical/bank/2009/> [hereinafter *Bank Failure Report 2009*] (listing the bank which failed in 2009). For example in 2009 alone, bank failures ranged from large banks such as Colonial Bank in Alabama, with about US\$25 billion in assets, to small banks such as the Dwelling House Savings and Loan Association, in Pennsylvania, with about US\$13 million in assets. See *id.*; see also Pallavi Gogoi, *A Year After Lehman's Collapse, Bank Industry is on New Path*, USA TODAY, Sept. 15, 2009 <http://abcnews.go.com/Business/year-lehmans-collapse-bank-industry-path/story?id=8564287#.UN-SAY4ur> (noting that “92 smaller banks have failed this year [2009], compared with 25 last year [2008]. More failures loom as the government’s list of problem banks tops 400”).

7. See CARNELL, MACEY & MILLER, *supra* note 3, at 277 (explaining that capital helps protect depositors and debt holders because “[a]s long as the institution’s assets can be sold for more than the amount needed to satisfy the institution’s liabilities, the institution’s creditors should incur no loss” and noting that “[d]ebtholders are protected by the ‘equity cushion’ that must be exhausted before the firm’s losses eat into their principal”); John H. Cochrane, *The More Bank Capital, the Safer the Bank*, WALL ST. J., July 15, 2011, <http://online.wsj.com/article/SB10001424052702304911104576444482440753132.html> (discussing how higher levels of bank capital means less chance that a bank be unable to pay its creditors and fail).

8. See RICHARD CARNELL, JONATHAN MACEY & GEOFFREY MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 402–03 (5th ed. forthcoming) [hereinafter CARNELL.] (discussing several meanings in different financial contexts); BLACK’S LAW DICTIONARY 236 (9th ed. 2009) (listing five different meanings of capital).

9. See CARNELL, *supra* note 8, at 402–03 (explaining that capital is the amount the assets exceed liabilities); FED. RESERVE BANK OF KANSAS CITY, *BASICS FOR BANK DIRECTORS* 25 (5th ed. 2010) (explaining that regulatory capital is the specific capital articulated by “[r]egulatory guidelines define capital and spell out the minimum acceptable capital levels for banks. The purpose of these guidelines is to protect depositors and the federal deposit insurance fund”).

10. See CARNELL, *supra* note 8, at 402 (explaining that depositors are protected when bank capital exceeds a bank’s losses); DOUGLAS J. ELLIOT, BROOKINGS INST., *A PRIMER ON BANK CAPITAL* 1 (2010) [hereinafter ELLIOT, CAPITAL PRIMER] (asserting that “there are strong policy reasons to protect depositors”).

stock will protect the depositors should some portion of the loans not get repaid.¹¹ Given the importance of preventing depositors from causing bank runs and consequent bank failure, bank capital regulations aim to reduce risks to depositors through a framework that focuses on minimum bank capital standards.¹²

In the United States, capital standards work in tandem with the prompt corrective action (“PCA”) framework established by the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”).¹³ The FDICIA emphasizes capital supervision as the primary tool for regulation.¹⁴ The FDICIA requires prompt corrective action, including requiring increased capital standards for certain financial institutions, like banks, if a lack of capital adequacy make a financial institution unsafe or unsound.¹⁵

Since the late 1980s, an international body of banking regulators known as the Basel Committee on Banking Supervision (“BCBS”), have developed, inter alia, minimum

11. See ELLIOT, CAPITAL PRIMER, *supra* note 10, at 1 (providing a similar example); Cochrane, *supra* note 7 (explaining same).

12. See CARNELL, *supra* note 8, at 401 (noting that the regulators’ oversight of the “safety and soundness” of banks “center[s]” on capital); ELLIOT, CAPITAL PRIMER, *supra* note 10, at 5–6 (explaining that regulations focus on bank capital in order to protect depositors).

13. See 12 U.S.C. § 1831o (2006) (authorizing federal banking agencies to take “prompt corrective action” to ensure that banks maintain the minimum capital requirements mandated by the agencies); CARNELL, *supra* note 8, at 403 (discussing the statutory origin for regulatory authority).

14. See 12 C.F.R. § 325.101 (2012) (“Section 38 of the [Federal Deposit Insurance Act] FDI Act establishes a framework of supervisory actions for insured depository institutions that are not adequately capitalized. The principal purpose of this subpart is to define, for [Federal Deposit Insurance Corporation] FDIC-insured state-chartered nonmember banks, the capital measures and capital levels, and for insured branches of foreign banks, comparable asset-based measures and levels, that are used for determining the supervisory actions authorized under section 38 of the FDI Act.”); MICHAEL P. MALLOY, REGULATION BY THE BANKING REGULATORY AGENCIES, BANKING LAW & REG. § 7.03 [C][4](b) (2012) (explaining that the Basel Accords focus on capital requirements).

15. See 12 U.S.C. § 1831o (g) (2006) (“If the appropriate Federal banking agency determines . . . [that] the institution is undercapitalized, [it may] take any 1 or more actions authorized under subsection (f)(2) of this section . . . [including requiring an institution to] specify the steps that the insured depository institution will take to correct the unsafe or unsound condition or practice.”).

global bank capital standards.¹⁶ The international agreements, known as the Basel Accords, are non-binding on committee member committee members, which currently represent twenty-seven countries.¹⁷ Since 1998 the Basel Committee has published three accords: Basel I, finalized in 1988, Basel II finalized in 2004, and Basel III finalized in 2010.¹⁸ The Basel agreements' focus on capital requirements is founded on the idea that mandating banks to have high quality capital will protect the depositors from losses.¹⁹

The three current main federal bank regulators in the United States, the Federal Reserve Board ("Federal Reserve"), the Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("OCC") (collectively, "US agencies"), all hold seats on the BCBS and are responsible for implementing the agreements reached by the

16. *See About the Basel Committee*, BANK FOR INT'L SETTLEMENTS (Jan. 23 2013), <http://www.bis.org/bcbs/about.htm> (discussing the main functions of the Basel committee); Jim Brunsten, *Basel Bank Group Attacks EU, US for Capital Rules Lapses*, BLOOMBERG BUSINESSWEEK (Oct. 1, 2012), <http://www.businessweek.com/news/2012-10-01/basel-bank-group-attacks-eu-u-dot-s-dot-for-capital-rules-lapses> (noting the BCBS's role in establishing international capital requirements).

17. *See* BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS ¶ 2 (1988) [hereinafter BASEL I], available at <http://www.bis.org/publ/bcbs04a.pdf> (explaining that the respective regulatory authority of each nation is responsible for implementing the Basel standards); CARNELL, *supra* note 8, at 404 (discussing the development of Basel I); *History of the Basel Committee and its Membership*, BANK FOR INT'L SETTLEMENTS, <http://www.bis.org/bcbs/history.htm> ("The Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.") (last visited May 31, 2013).

18. *See generally* BASEL I, *supra* note 17; BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2004) [hereinafter BASEL II], available at <http://www.bis.org/publ/bcbs128.pdf>; BANK FOR INT'L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION; BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS, (2010) [hereinafter BASEL III], available at <http://www.bis.org/publ/bcbs189.pdf>.

19. *See* CARNELL, *supra* note 8, at 402 ("[W]ell capitalized banks are less likely to falter or fail than poorly capitalized banks. Thus capital requirements help protect depositors, other creditors, the FDIC, and the financial system."); ELLIOT, CAPITAL PRIMER, *supra* note 10, at 2 ("[C]apital is intended to protect certain parties from losses, including depositors, bank customers, and bank counterparties.").

committee in the US.²⁰ The regulators decide how to implement the capital standards promulgated by the Basel Accords.²¹ Specifically, the US agencies draft bank regulations they deem necessary pursuant to authority granted by Congress.²²

Part I of this Comment briefly reviews the most crucial aspects of the three international banking standards and discusses some of their perceived flaws. Part II reviews the US proposed rules and compares them to the newest accord (Basel III). Part III analyzes the proposed rules in the context of the previous accords and current bank capital ratios. It argues that the newest Accord suffers from some of the same historical flaws as the previous accords and that the proposed rules should require much higher capital ratios, as evidenced by empirical studies measuring current bank capital levels showing that bank capital levels currently surpass the mandatory requirements.

20. See 12 U.S.C. § 3911(a) (2012) (“[T]he Federal Deposit Insurance Corporation shall be given equal representation with the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency on the Committee on Banking Regulations and Supervisory Practices of the Group of Ten Countries and Switzerland.”); Brunsden, *supra* note 16 (“U.S. regulators represented on the Basel committee include the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corp.”).

21. See 12 U.S.C. § 3907(a)(2) (2012) (“Each appropriate Federal banking agency shall have the authority to establish such minimum level of capital for a banking institution as the appropriate Federal banking agency, in its *discretion*, deems to be necessary or appropriate in light of the particular circumstances of the banking institution.”) (emphasis added); Jerome Walker et al., *Reconciling the Dodd-Frank and Basel Committee Capital Requirements*, 129 *BANKING L.J.* 627, 642–43 (2012) (“The Basel Committee essentially makes recommendations that each country is free to adopt or not adopt. While the Basel capital requirements are intended to assure international consistency, different countries have adopted different versions of the Basel capital requirements and, thus, different Basel requirements apply to different financial institutions.”). The Office of Thrift Supervision, a fourth banking agency, was abolished by the Dodd-Frank Act and places its regulatory authority in the other regulators. See 12 U.S.C. § 5412(b)(1)(B) (2012) (transferring and vesting the powers of the OTS to the remaining agencies, the Federal Reserve and the OCC).

22. See 12 U.S.C. § 3907(a)(2), *supra* note 21 (granting statutory discretion to regulators to establish minimum capital requirements); see, e.g., Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework, 73 *Fed. Reg.* 43982, 43984 (proposed July 29, 2008) (noting that parts of Basel I were implemented into US regulations).

I. THE DEVELOPMENT OF THE THREE BASEL ACCORDS

This Part reviews the historical development of the first two Basel Accords, and discusses the main new provisions the newest Accord (Basel III). It also details how the United States has implemented the first two international agreements. The part also lays out the main criticisms of each Accord.

A. *Basel I*

The First Basel Agreement introduced risk based capital standards and took effect at the end of 1992.²³ The innovation of the agreement was that it established minimum capital standards across banks on an international level.²⁴ It provided that the minimum bank capital ratio for regulatory purposes should be calculated by dividing the bank's regulatory capital (numerator) by the bank's risk-weighted assets (denominator).²⁵ The risk weighing system was based on Basel I's focus on credit risk—the risk that a counterparty might default on his obligation to repay.²⁶ The agreement introduced five risk-weight categories for the assets denominator of the capital assets ratio, ranging from 0% for assets such as cash or bonds from the central banks of the Organization for Economic Cooperation and

23. See BASEL I, *supra* note 17, ¶¶ 44–46 (stating that banks had until the end of 1992 to reach the target ratio); Malloy, *supra* note 14, at [4](b) (2013) (discussing the historical background regarding the introduction of capital standards via Basel I).

24. See BASEL I, *supra* note 17, ¶¶ 1, 7, 10 (noting that the Committee wishes “to ensure that the integrity of the capital of banks is maintained”); *Id.* ¶ 12 (noting the importance “the Committee attaches to securing a progressive enhancement in the quality, as well as the level, of the total capital resources maintained by major banks”); Heath Price Tarbert, *Rethinking Capital Adequacy: The Basel Accord and the New Framework*, 56 *BUS. L.* 767, 779–80 (2001) (noting that the Basel Committee introduced the concept of “regulatory” capital); *Basel Accord*, *FIN. TIMES LEXICON*, <http://lexicon.ft.com/Term?term=Basel-Accord> (noting that the first accord on “banking supervision rules . . . agreed upon by the G10 major western economies . . . was reached in 1988”).

25. See 12 U.S.C. § 5371(a)(2)(b) (defining the capital ratio as “regulatory capital components in the numerator . . . the risk-weighted assets in the denominator . . . and the required ratio of the numerator to the denominator”); CARNELL, *supra* note 8, at 413 (explaining how to calculate the total capital ratio). The United States has adopted this ratio.

26. See BASEL I, *supra* note 17, ¶ 8 (“The framework in this document is mainly directed towards assessing capital in relation to credit risk (the risk of counterparty failure)”); *Id.* ¶ 31 (“For most banks the major risk is *credit risk*, . . . the risk of counterparty failure.”).

Development (“OECD”), to 100% for assets obtained from private transactions.²⁷ By standardizing the relative risk weights of assets across nations, banks, which carry different types of assets, would be able to rely on uniform general rules to calculate their capital requirements.²⁸

For example, assume Bank A has US\$50 each in bonds from the German and French central banks. Further assume that the yield on the bonds was substantially different, such as 3.5% and 4.5% for the German and French bonds, respectively. Without an international standard, the local bank may place more weight on the riskier French bonds. Under Basel I, however, both assets are claims on OECD central banks, and get weighed equally (*i.e.*, 0%).²⁹ No additional capital is necessary to act as a buffer for unexpected losses because the expected loss is a loss of zero.³⁰ Basel I assumed that the OECD banks are relatively safe and have a low risk of counterparty default.³¹ Consequently, it simplified the way banks calculated their required capital, permitting them to ignore idiosyncratic market

27. See *id.* ¶ 29 (listing the risk weights); *id.* Annex 2 (delineating the risk weights for different types of assets). The Organization for Economic Cooperation and Development (“OECD”) is a group of countries, mostly including European and North American countries, committed to increasing economic progress and world trade. See *About the OECD*, ORG. FOR ECON. COOPERATION & DEV., <http://www.OECD.org/about> (last visited May 31, 2013).

28. See BASEL I, *supra* note 17, ¶ 28(i) (stating that the risk weights “provides a fairer basis for making international comparisons between banking systems whose structures may differ”).

29. See *id.* ¶ 36 (assigning a zero percent risk weight to claims on OECD “central governments and central banks outside the OECD”).

30. See *id.* ¶ 33 (explaining that the Committee chose to implement a risk weighing system that involved defining a “grouping of countries considered to be of high credit standing”). Basel I defines credit risk, and thus assigns risk weights, based on the risk that a counterparty fails to fulfill his obligation; a risk weight of zero necessarily implies that the Basel Committee expects a counter party will not fail to pay his obligations. See *supra* note 26 and accompanying text (explaining that Basel I focuses on counterparty risk).

31. See *supra* note 29 (explaining that Basel thought the OECD countries were of high credit standing); see also BASEL I, *supra* note 17, ¶ 36 (explaining that claims on OECD government will “attract a zero weight” and that even claims on certain central banks outside the OECD will “also attract a zero weight . . . [because this] reflects the absence of risks relating to the availability and transfer of foreign exchange on such claims”); Tarbert, *supra* note 24, at 793 (explaining that under Basel I, “loans to OECD national governments are uniformly assessed as presenting no risk of default”).

differences such as yields on similarly risky French and German bonds.³²

Basel I divided the regulatory capital (numerator) into two tiers: core capital, or Tier 1 Capital, and supplementary, or Tier 2 Capital.³³ Like all the Basel agreements, it provided that Tier 1 Capital should be composed of high quality capital like common stock, while Tier 2 Capital should include less absorbent capital, such as subordinated term debt.³⁴ The numerator of the ratio included Tier 1 Capital and Tier 2 Capital.³⁵ The first agreement required an overall minimum capital ratio of 8%, including a minimum 4% Tier 1 ratio.³⁶

Before discussing the details of Basel I's distinction between tiers of capital, a numerical example may elucidate how capital absorption works. Figure 1 illustrates that on any balance sheet, assets must be equal to liabilities plus equity.³⁷ Assume that Bank A has US\$1000 in loans, US\$900 in deposits, and US\$100 in common equity. As Figure 2 illustrates, if US\$150 worth of loans default, Bank A now has the following balance sheet structure: US\$850 (assets) = US\$900 (liabilities) + (-US\$50) (equity).³⁸ The bank's equity failed to cover the losses it incurred. Therefore it has US\$850 in assets to meet its US\$900 obligation, and the ability of depositors to recover is at risk.³⁹

32. See BASEL I, *supra* note 17, ¶ 36 (assigning the same risk weight based on membership to the OECD).

33. See *id.* ¶ 14 (defining and separating capital into two tiers).

34. See *id.* ¶ 12 n.2 (using the term equity capital to elaborate on Tier 1 Capital). The agreement defines equity capital as "ordinary shares/common stock and non-cumulative preferred stock." *Id.*; BASEL I, *supra* note 17, ¶ 23 (elaborating on Tier 2 Capital by explaining that subordinated term debt has "deficiencies" in its ability "to absorb losses[,] except in a liquidation").

35. See *id.* Annex IA ("The sum of tier 1 and tier 2 elements will be eligible for inclusion in the capital base . . .").

36. See *id.* ¶ 44 (establishing that "the target standard ratio of capital to weighted risk assets should be set at 8% (of which the core capital element will be at least 4%)").

37. Figures 1–2 and the following example are heavily based on the award-winning essay, "Rethinking Capital Adequacy: The Basel Accord and the New Framework." See Tarbert, *supra* note 24, at 785 (explaining how capital losses are reflected on a bank's balance sheet); CARNELL, *supra* note 8, at 402–03 (explaining that capital is the amount the assets exceed liabilities).

38. See Tarbert, *supra* note 24, at 771 (providing a similar example).

39. See *id.* at 772 ("[T]he bank now has the possibility of recovering only [US]\$85,000,000, but its obligations remain [US]\$90,000,000."); CARNELL, *supra* note 8, at 402 (explaining that a bank with more capital is more likely to protect depositors from losses).

Figure 1 – Before a Loss of 15%

ASSETS =	LIABILITIES +	SHAREHOLDER EQUITY
\$1000 (Loans)	\$900 (Deposits)	\$100 (Common Stock)
		CAPITAL RATIO = 100/1000 = 10% Tier 1 Equity.

Figure 2 – After a Loss of 15%

ASSETS =	LIABILITIES +	SHAREHOLDER EQUITY
\$850 (Loans)	\$900 (Deposits)	(\$50) (Common Stock)
		CAPITAL RATIO = 0

Accordingly, the distinction between Tier 1 and Tier 2 Capital reflects the Basel Accords' fundamental theory of depositor protection.⁴⁰ Tier 1 Capital is supposed to be the most loss absorbing capital.⁴¹ This means that, as a bank incurs losses, it can deplete common equity to cover the losses it incurs by selling or issuing more shares.⁴² Because a bank's own common

40. See *supra* notes 26–27 and accompanying text (discussing how Basel I focuses on capital requirements); *supra* notes 7–10 and accompanying text (explaining how increased levels of capital protects depositors).

41. See Thomas Huertas, Dir., Banking Sector, Address at the Fin. Serv. Auth. City & Fin. Bank Capital Seminar (June 26, 2008), *transcript available at* http://www.fsa.gov.uk/library/communication/speeches/2008/0626_th.shtml (explaining that “[s]hareholder’s equity certainly absorbs losses; indeed it bears first loss”); see also BASEL I, *supra* note 17, ¶¶ 12, 23 (explaining that “the key element of capital on which the main emphasis should be placed is equity capital,” while subordinated debt offers less protection due to its “inability to absorb losses”).

42. See CARNELL *supra* note 8, at 407 (explaining that common equity shares have “no special rights[,]” bear the risk of loss, and have the lowest claim in a liquidation); Huertas, *supra* note 41 (“Tier I capital should be capital that is available to absorb losses on a “going-concern” basis, or capital that can be depleted without placing the bank into insolvency, administration or liquidation.”).

equity (*i.e.*, its shareholder's equity) imposes no payment obligation on a bank, its outstanding equity can cover the loss.⁴³

Conversely, Tier 2 Capital does impose some obligations on banks.⁴⁴ For example, banks must make interest payments on their subordinated debt.⁴⁵ Tier 2 Capital can only include debt that is "subordinated," or junior, to claims by depositors.⁴⁶ This means that if a bank loses all its Tier 1 Capital and is forced to liquidate its assets, depositor claimants get paid before subordinated debt holders.⁴⁷ Therefore, Tier 2 Capital provides protection for depositors once a bank is unable to make payments to creditors, while Tier 1 Capital provides protection for depositors and ensures banks can pay their creditors.⁴⁸

Basel I established a target ratio requirement of 8% between capital and risk weighted assets.⁴⁹ This means that the ratio between the numerator (Tier 1 plus Tier 2 Capital) divided by the denominator (risk-weighted adjusted assets) must equal

43. See CARNELL *supra* note 8, at 407 (asserting that common equity is the "purest form of equity" because it does not mature, has no attendant dividend obligations and "[i]n any liquidation of the bank, it gets paid only after *all* other claims have been paid in full[,] " including those of depositors) (emphasis added); Huertas, *supra* note 41 ("[Common equity is flexible because] . . . there is no obligation to pay dividends or to effect distributions to shareholders. The failure to pay a dividend is not an event of default and cannot give rise to insolvency or bankruptcy proceedings . . .").

44. See Tarbert, *supra* note 24, at 785 (explaining that Tier 2 Capital debt imposes obligations); Huertas, *supra* note 41 (noting that banks need to make interest payments on their debts).

45. See Tarbert, *supra* note 24, at 785 (explaining that although debt is an obligation for banks, it can constitute Tier 2 Capital); Huertas, *supra* note 41 ("[T]he failure to make an interest payment could be an event of default and ultimately be grounds for a bankruptcy proceeding.").

46. See CARNELL *supra* note 8, at 408 ("In any liquidation, [Tier 2 Capital] can get paid only after deposits . . . have been paid in full."); Huertas, *supra* note 41 ("Tier II capital should be capital that can absorb losses on a 'gone-concern' basis, or capital that absorbs losses in insolvency prior to depositors' losing any money.").

47. See CARNELL, *supra* note 8, at 405 (explaining that creditors have rights to obtain the value of certain assets based on the priority of their claim); see also Huertas, *supra* note 41 (explaining that depositors have priority in a liquidation).

48. See Huertas, *supra* note 41 (explaining that Tier 1 Capital is meant to ensure that the bank can meet its operating expenses as a "going-concern," while Tier 2 Capital is meant to ensure depositors are protected during a liquidation when the banks is a "gone concern"); see also BASEL III, *supra* note 18, ¶ 58 (stating that the criteria for inclusion in Tier 2 Capital requires that the instrument be "subordinated to depositors and general creditors of the bank").

49. See BASEL I, *supra* note 17, ¶ 44 (establishing that the risk-weighted capital ratio should be 8%).

8%.⁵⁰ As an example of how the requirement works, imagine a bank with US\$200 in assets. If the US\$200 included US\$100 in low-risk OECD government bonds, Basel I weighs this asset at 0%, and weighs US\$100 in corporate loans at 100%, and Basel I requires an 8% ratio of capital to the bank's portfolio of assets.⁵¹ Therefore the bank must hold a minimum of US\$8 total in Tier 1 and Tier 2 capital.⁵²

The effectiveness of Basel I's attempt to enhance bank soundness has been debated.⁵³ Some scholars praised the agreement as an ideal example of international cooperation.⁵⁴ Other scholars have noted that the non-binding nature of the agreement could mean that banks in the countries that chose to implement the new regulations would be burdened with new compliance costs, while banks in countries choosing to forego Basel I would bear no such burden.⁵⁵

Commentators also criticized Basel I for failing its mission of making capital requirements standard across jurisdictions because the "soft" nature of the law leads to regulatory arbitrage.⁵⁶ In other words, a bank could benefit by complying

50. *See id.*

51. *See* CARNELL, *supra* note 8, at 414–15 (providing a more realistic example that involves a nine-step calculation). The example provided above is simply for illustrative purposes and is calculated $(.08 \times [(100 \times 0) + (100 \times 1)])$.

52. *See supra* note 51 and accompanying text.

53. *See* CARNELL, *supra* note 8, at 404 (discussing how banks could take advantage of the simple risk weighing system); *see also* Narissa Lyngen, *Basel III: Dynamics of State Implementation*, 53 HARV. INT'L L.J. 519, 524–25 (2012) (noting that Basel I initially seemed like a success but was also criticized because of its simple risk weighing system).

54. *See* Tarbert, *supra* note 24, at 783 ("Some scholars have emphasized the importance of the Basel Committee as a model for future regulatory reform."); *see also* Lyngen, *supra* note 53, at 519 ("Basel III . . . along with the Basel Committee and its negotiation process, have been hailed as an exemplar of international regulation and law-making . . .").

55. *See* Lyngen, *supra* note 53, at 522 ("Critics also argue that the regulatory solutions that TRNs create are often not uniformly beneficial. Instead, regulatory coordination at the international level often has a distributive effect, with some states gaining at the expense of others. Variations among states' domestic regulated sectors . . . [can lead to] distinct costs of implementation for each state . . ."); *see also* *Fed Approves New Bank Capital Rules*, DALLAS MORNING NEWS, Aug. 4, 1988 ("Following the adoption of the Basel Accord, bank analysts say many big US banks would have to limit growth, control costs more aggressively and sell assets to meet the standards.").

56. *See* CARNELL, *supra* note 8, at 404 (discussing how banks could "game the system"); *see also* John Holman, *A Flawed Solution: The Difficulties of Mandating A Leverage Ratio In the United States*, 84 S. CAL. L. REV. 713, 725–26 (2011) ("Regulatory arbitrage occurs when a bank exploits the difference between its actual risk level and that

with Basel I's capital mandates, even though the actual risk it assumes would call for even more capital coverage than required by Basel I.⁵⁷ For example, all OECD debt was weighted at zero percent.⁵⁸ But if one OECD country was substantially more risky, and thus had higher interest bearing debt, a bank could receive this high-risk, high-return interest rate without having to allocate any additional capital to account for the increased risk.⁵⁹ Similarly, scholars have argued that because Basel I does not mandate the members to adopt it, such an agreement is not "truly law".⁶⁰ Others Scholars have responded to the "soft" law argument by noting that that despite its non-binding nature, Basel I has been historically treated as mandatory.⁶¹ The United States' adoption of Basel I into law further suggests the agreement carries substantial weight.⁶² The United States

implied by its regulatory position. . . . [B]anks could engage in regulatory arbitrage under Basel I by manipulating their holdings so as to include the riskiest assets within each risk category. Given that Basel I's risk weightings were fairly blunt, banks' tendency to manage their holdings in this way could allow banks to carry less capital than their risk profiles warranted.").

57. See *supra* note 56 (explaining how banks could achieve this through regulatory arbitrage).

58. See *supra* note 30 and accompanying text (explaining that OECD government bonds were weighted at zero percent).

59. See Tarbert, *supra* note 24, at 793 ("Moreover, if the risk weight assigned to one loan is far below its inherent risk, the bank will replace this asset with a higher yielding loan requiring the same or less regulatory capital. Thus, a 'bank may engage in costly 'regulatory arbitrage' to effectively evade the regulatory capital requirement."); see generally Holman, *supra* note 56 (explaining how regulatory arbitrage occurs).

60. See, e.g., Aric C. Ecnisse, *Banking on Cooperation: The Role of the G-20 In Improving The International Financial Architecture*, 22 *DUKE J. COMP. & INT'L L.* 239, 250 (2012) ("Scholars have proposed various conceptions of soft law, with some even denying that non-binding soft law is truly law . . . but financial institutions quickly recognize the *indirect* (or practically binding) legal effect of financial standards and start to comply with those standards soon after they are officially adopted by international regulators."); see Gregory C. Shaffer & Mark A. Pollack, *Hard vs. Soft Law: Alternatives, Complements and Antagonists in International Governance*, 94 *MINN. L. REV.* 706, 712-17 (2010) (describing the debate over the force of soft law).

61. See Lyngen, *supra* note 53, at 530 (quoting how scholars note that the agreement has practical binding effect); Tarbert, *supra* note 24, at 782 ("Thus, '[w]ithout in any way approaching the legal status of a treaty, . . . [the] agreement is considered to be binding on its members' . . . Committee pronouncements, despite their lack of formal force, exert in practice a very powerful influence in the generation of national and regional legal rules and formal institutional structures.").

62. See Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework, 73 *Fed. Reg.* 43982, 42984 (Jul. 29, 2008) (noting that parts of Basel I were implemented into US regulations); CARNELL, *supra* note 8 at 404 ("This accord [Basel

implemented Basel I, including the minimum capital ratio, through various regulations issued from the 1990s to early 2000s.⁶³

But as global finance transactions became more complex during this time, the BCBS felt that a new agreement was necessary to improve on the simple five risk weight approach espoused by Basel I.⁶⁴ In June 2004, the Basel Committee approved a new agreement which sought to increase the risk sensitivity of the capital defined in Basel I, provide for more disclosure requirements for regulatory capital, and overall, provide a better framework for determining minimum capital standards.⁶⁵

B. *Basel II*

The new Basel II accords established a new global standard for minimum capital requirements by instituting a three-pillar approach: “minimum capital requirements, supervisory review, and market discipline”.⁶⁶ Like the first accord, Basel II sought to

I] established a basic framework for risk-based capital standards, and U.S. and other regulators then adopted risk-based standards conforming to that framework.”).

63. See Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework, 73 Fed. Reg. 43982, 43984 (July 29, 2008) (“In 1989 the agencies implemented a risk-based capital framework for U.S. banking organizations (general risk-based capital rules). The agencies based the framework on . . . [Basel I], released by the Basel Committee on Banking Supervision (Basel Committee) in 1988”); see also CARNELL, *supra* note 8 at 404 (“This accord [Basel I] established a basic framework for risk-based capital standards, and U.S. and other regulators then adopted risk-based standards conforming to that framework. Although [Basel I] requires the United States to apply those standard only to large, internationally active banks, the federal banking agencies have chose to apply the standards to all FDIC-insured banks.”).

64. See BASEL II, *supra* note 18, ¶ 15 (noting that the framework was meant to ensure that it “keeps pace with market developments and advances in risk management practices.”); see also *id.* ¶ 18 (“Over the last decade, a number of banking organisations have invested resources in modeling the credit risk arising from their significant business operations. Such models are intended to assist banks in quantifying, aggregating and managing credit risk across geographic and product lines.”).

65. See *id.* ¶ 10 (“[T]he revised Framework is more risk sensitive than the 1988 Accord.”); see also *id.* ¶ 11 (“In addition, the disclosures provided under the third pillar of this Framework will be essential in ensuring that market discipline is an effective complement to the other two pillars.”); *id.* ¶ 4 (“The fundamental objective of the Committee’s work to revise the 1988 Accord has been to develop a framework that would further strengthen the soundness and stability of the international banking system”).

66. See *id.* ¶ 4 (noting that the revised accord is based on three pillars: “minimum capital requirements, supervisory review, and market discipline”); Abel Elizalde, *From*

establish standardized international banking capital standards and reduce regulatory arbitrage.⁶⁷ Yet, unlike the other accords, the primary focus was not on capital standards.⁶⁸ Basel II largely maintained the same standards for Tier 1 Capital.⁶⁹ One of its most significant changes, however, was to allow banks to include short term (under two year maturity) unsecured subordinated debt into their capital base (numerator) as Tier 3 Capital, in addition to the already existing long term (over five year maturity) unsecured subordinated debt allowed in Tier 2 Capital.⁷⁰ This is notable because it frustrates the accords' goal of protecting depositors by effectively allowing a bank to introduce an additional illiquid instrument into its capital structure.⁷¹ This is just one example of why, as discussed below, Basel II was criticized as being an ineffective framework for bank soundness.

Basel I to Basel II: An Analysis of the Three Pillars 1 (Feb. 2006), <http://www.abclclizaldc.com/pdf/basel%201%20to%20basel%202.pdf>

67. See BASEL II, *supra* note 18, ¶ 1 (“This report presents the outcome of the Basel Committee on Banking Supervision’s (‘the Committee’) work over recent years to secure international convergence on revisions to supervisory regulations governing the capital adequacy of internationally active banks.”); *Id.* ¶ 4 (“The fundamental objective of the Committee’s work to revise the 1988 Accord has been to . . . [ensure] that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.”).

68. Compare *id.* ¶ 5 (explaining that although the accord is significantly revising the risk sensitivity of the capital requirements, it retains “key elements of the 1988 capital adequacy framework, including the general requirement for banks to hold total capital equivalent to at least 8% of their risk-weighted assets . . . and the definition of eligible capital.”), with BASEL III, *supra* note 18, ¶ 48 (focusing on changes to the definition of eligible capital).

69. See BASEL II, *supra* note 18, ¶ 41 (explaining that “the definition of eligible regulatory capital, as outlined in the 1988 Accord . . . remains in place” except for a few modifications involving risk weighing certain assets).

70. See BASEL II, *supra* note 18, ¶ 44 n.10 (adopting the “definition of Tier 3 capital as set out in the Amendment to the Capital Accord to Incorporate Market Risk . . .”); BANK FOR INT’L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, AMENDMENT TO THE CAPITAL ACCORD TO INCORPORATE MARKET RISKS 5 (2005), <http://www.bis.org/publ/bcbs119.htm> (“[T]he principle form of eligible capital . . . consists of shareholders’ equity and retained earnings (tier 1 capital) and supplementary capital (tier 2 capital) as defined in the 1988 Accord. But banks may also . . . employ a third tier of capital (‘tier 3’), consisting of short-term subordinated debt . . .”); see also BASEL I, *supra* note 17, ¶ 23 (“Subordinated term debt instruments with a minimum original term to maturity of over five years may be included within the supplementary elements of capital.”).

71. See *supra* notes 38–48 and accompanying text (explaining how subordinated term debt is a less absorbent form of capital than Tier 1 equity).

The new provisions of Basel II focused primarily on the calculation of the denominator of the risk-based capital ratio.⁷² It devised two alternative approaches for measuring capital adequacy.⁷³ The first approach, the standardized approach, assigns risk weights to assets based on external credit ratings, instead of basing the risk weight on the type of asset.⁷⁴ The second approach, the Internal Ratings Based Approach, introduces an “internal ratings based” (“IRB”) computer modeling scheme that allowed banks to use their internal risk management to weigh the riskiness of bank assets.⁷⁵ The Accord also demanded more disclosures about how institutions calculate their minimum capital requirements.⁷⁶ The new rules were to be effective by the end of 2006.⁷⁷

These new proposals, particularly those that allowed the banks to use the calculations of their own risk models to weigh

72. See BASEL II, *supra* note 18, ¶ 52 (keeping the numerator the same while emphasizing “revisions to the 1988 Accord for risk weighting” purposes); *Id.* ¶ 44 (“Total risk-weighted assets are determined by multiplying the capital requirements for market risk and operational risk by 12.5 (*i.e.*, the reciprocal of the minimum capital ratio of 8%) and adding the resulting figures to the sum of risk-weighted assets for credit risk.”). This is more complicated than the “simple” risk weights provided by Basel I. See BASEL I, *supra* note 17, ¶ 29 (discussing the simpler risk weights establishing by Basel I).

73. See BASEL II, *supra* note 18, ¶ 50 (“The Committee proposes to permit banks a choice between two broad methodologies for calculating their capital requirements for credit risk. One alternative will be to measure credit risk in a standardized manner supported by external credit assessment.”); *Id.* ¶ 51 (“The alternative methodology . . . would allow banks to use their internal ratings systems for credit risk.”).

74. See *id.* ¶ 50 (“One alternative will be to measure credit risk in a standardized manner, supported by external credit assessment.”); *id.* ¶ 53 (articulating that claims on central banks that have an “AAA” rating are risk weighed at zero percent); *supra* notes 27–32 and accompanying text (explaining Basel I’s risk weighing system).

75. See BASEL II, *supra* note 18, ¶ 211 (“[Banks using the] IRB approach may rely on their own internal estimates of risk components in determining the capital requirement for a given exposure.”); BANK FOR INT’L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, AN EXPLANATORY NOTE ON BASEL II IRB RISK WEIGHT FUNCTIONS I (2005), available at <http://www.bis.org/bcbs/irbriskweight.pdf>.

76. See BASEL II, *supra* note 18, ¶ 753 (“In particular, banks will be required to disclose features of their internal methodologies used in calculating minimum capital requirements.”); *Id.* ¶ 809 (“The Committee aims to [develop] . . . a set of disclosure requirements which will allow market participants to assess key pieces of information on . . . the capital adequacy of the institution. The Committee believes that such disclosures have particular relevance under the Framework, where reliance on internal methodologies gives banks more discretion in assessing capital requirements.”).

77. See *id.* ¶ 2 (“The Committee intends the Framework set out here to be available for implementation as of year-end 2006.”).

assets, were criticized as being “unreliable” by some scholars.⁷⁸ Some commentators have concluded that Basel II was not effective at accurately matching a bank’s credit risk to the capital it had to raise.⁷⁹ Interestingly, the heavy reliance on computer models to calculate credit risk, blamed in part for the 2008 financial crisis, was specifically endorsed by Basel II.⁸⁰

Partly reflecting these concerns, the US agencies limited their implementation of the Basel II standards to a few of the largest internationally active banks at that time.⁸¹ The final rules implementing Basel II were effective April 1, 2008.⁸² At the time, however, most banks were subject to rules that were based on

78. See CARNELL, *supra* note 8, at 405 (asserting that large banks internal models “proved unreliable”); see, e.g., Daniel Hemel, *Regulatory Consolidation and Cross-Border Coordination: Challenging the Conventional Wisdom*, 28 *YALE J. ON REG.* 213, 240 (2011) (noting that an FDIC report had articulated “serious deficiencies in the proposals that regulators use the banks’ own internal risk-management models in setting capital requirements”).

79. See CARNELL, *supra* note 8, at 405 (explaining that “by reducing risk-weights for securities and borrowers with high credit ratings, it facilitated a decline in capital levels,” and the credit ratings later were shown to not accurately reflect the risk of capital); Marianne Ojo, *Basel III: Responses to Consultative Documents, Vital Aspects of the Consultative Processes and the Journey Culminating in the Present Framework (Part 2)*, 30 *NO.10 BANKING & FIN.SERVS. POL.Y REP.* 15 (2011) (“[C]apital requirements for credit risk as a probability of default of an exposure decreases in the economic upswing and increases during the downturn . . . [This] may result in credit institutions raising their capital during periods when its is costly for them . . .”).

80. See BASEL II, *supra* note 18, ¶ 417 (“Credit scoring models and other mechanical procedures are permissible as the primary or partial basis of rating assignments, and may play a role in the estimation of loss characteristics.”); Avinash D. Persaud, *Banking on the Right Path*, 45 *FIN. & DEV. MAGAZINE* 29, 33 (2008) (“Basel II considers the use of computer models . . . sophisticated. But again, this is pseudoscience . . . and will eventually cause systemic collapse.”).

81. See Risk-Based Capital Standards: Advanced Capital Adequacy Framework, 71 *Fed. Reg.* 55830, 52841 (proposed Sept. 25, 2006) (“Outside the United States, countries that are replacing Basel I with the New Accord generally have required all banks to comply with the New Accord, but . . . the United States . . . takes a different approach. [The rule] focuses on only the largest and most internationally active banks.”); Malloy, *supra* note 14, at (4)[b] (“In December 2007, the four regulators jointly published final rules implementing Basel II for the largest, internationally active U.S. banks.”); see also Steven Sloan, *Bankers Maintain Criticism of US Version of Basel II*, 172 *AM. BANKER* 66 (2007) (explaining that “many companies” including Bank of America and Citigroup urged regulators to not apply certain aspects of Basel II to the large banks).

82. See Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 72 *Fed. Reg.* 69288 (Dec. 7, 2007) (noting that the rule is “effective April 1, 2008”); Malloy, *supra* note 14, at [4](b) (noting that the “final rules [implementing Basel II] were effective April 1, 2008”).

Basel I, with some revisions to risk weighing of assets.⁸³ Therefore, unlike Basel I, the US agencies did not adopt Basel II for most banks.⁸⁴

By the end of the financial crisis, some commentators argued that the reliance on the credit ratings was one of the reasons Basel II standards did not establish adequate levels of bank capital during the crisis.⁸⁵ If a bank obtained a triple-A (“AAA”) rated asset from an OECD country, for example, it was required to hold zero additional capital for that asset under Basel II’s standardized risk weight approach.⁸⁶ But, if the AAA asset was incorrectly rated, and was actually as risky as a triple-C (“CCC”) asset, and ultimately failed, the bank would not have enough capital to absorb this loss because it was not previously required to allocate any capital for that risky CCC asset.⁸⁷ Thus the failure to accurately rate debt, as in the previous example, may cause the bank to be unable to absorb its losses, to the detriment of depositors.⁸⁸ As a result of the agreement’s failures to protect banks from the financial crisis, the Basel Committee renewed attempts to enhance banking soundness and allow

83. See Malloy, *supra* note 14, at [4](b) (“The overwhelming majority of U.S. banking institutions would be required either to continue to apply the 1988 Basel I standards, or the new and more risk-sensitive Basel IA.”). This is not entirely surprising, given that of the over 250 page Accord, two pages are devoted to discussing the numerator (Tier 1 and Tier 2 capital) while the rest focuses on the denominator, rules for assessing the proper way to weigh risk. See generally, BASEL II, *supra* note 18.

84. See Risk-Based Capital Standards: Advanced Capital Adequacy Framework, 71 Fed. Reg. 55830, 55832 (proposed Sept. 25, 2006) (noting that the rules apply to “internationally active banking organization” which is defined as having at least US\$250 billion of assets); Malloy, *supra* note 14, at [4](b) (noting that Basel II did not apply to most banks).

85. See, e.g., BASEL II, *supra* note 18, ¶ 53 (using Standard & Poor’s (“S&P”) ratings to weigh central bank debt); Lyngen, *supra* note 53, at 526 (“Basel II also provided several options for risk assessment, including a standardized method that incorporated external credit ratings (later viewed as a primary reason for Basel II’s failure to predict the 2007–09 crisis) . . .”).

86. See BASEL II, *supra* note 18, ¶ 53 (weighing AAA rated claims on a central bank at zero percent).

87. See Tarbert, *supra* note 24, at 794 (noting that banks can give a “loan to central governments by purchasing sovereign debt and hold no capital against such assets”); see also *supra* notes 36–43 and accompanying text (explaining that a failure to hold enough capital to absorb losses may lead the bank to fail).

88. See *supra* notes 37–42 (providing an example that shows how a bank may fail if it does not have enough capital to absorb a loss).

banks to better withstand the effects of a severe economic contraction.⁸⁹

C. Basel III

The Basel Committee issued the new framework in December 2010.⁹⁰ Basel III builds “on the three pillars of the Basel II framework.”⁹¹ The main goal of the new agreement is to strengthen “the international regulatory framework” by focusing on the quality and transparency of banks’ capital structure.⁹² For the first time since Basel I, the agreement enhances the type of regulatory capital (the numerator of the minimum capital ratio) banks are required to maintain.⁹³ Basel III accomplishes this by limiting what can constitute Tier 1 Capital and increasing the overall amount of capital banks must maintain.⁹⁴ It completely eliminates the riskier unsecured Tier 3 Capital allowed under

89. See BANK FOR INT’L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, REVISIONS TO THE BASEL II MARKET RISK FRAMEWORK ¶ 1 (2009), available at <http://www.bis.org/publ/bcbs158.pdf> (“[T]he financial crisis began in mid-2007, an important source of losses and of the build up of leverage occurred in the trading book. A main contributing factor was that the current capital framework for market risk, based on the 1996 Amendment to the Capital Accord to incorporate market risks, does not capture some key risks. In response, the Basel Committee . . . supplements the current value-at-risk-based trading book [to better reflect certain market risks]”) (emphasis added).

90. See BASEL III, *supra* note 18 (including the date on the cover page).

91. *Id.* ¶ 7.

92. See *id.* ¶¶ 2, 6–7 (“[T]he Committee also aims to improve risk management and governance as well as strengthen banks’ transparency and disclosures. . . . To address the market failures revealed by the crisis, the Committee is introducing a number of fundamental reforms to the international regulatory framework The reforms raise both the quality and quantity of the regulatory capital base and enhance the risk coverage of the capital framework.”).

93. See *id.* ¶ 48 (“A key element of the new definition of capital is the greater focus on common equity, the highest quality component of a bank’s capital.”). Technically, the committee published enhancements to the 1996 standards in 2009, but this was an addition to Basel II, while Basel III is an entirely new agreement. See *id.* ¶ 2 n.2 (discussing that the Committee released the enhancements in 2009).

94. See *id.* ¶ 53 (limiting the definition of Tier 1 Capital to either common shares or another instrument that meets 14 requirements that mimics the properties of common shares); *id.* ¶ 129 (introducing the conservation buffer in addition to the regulatory capital minimum requirements).

Basel II.⁹⁵ Like the previous accords, the capital ratio includes a risk-weighted calculation of a bank's assets.⁹⁶

The new agreement goes beyond just reforming the basic capital ratio.⁹⁷ Reflecting on the causes of the financial crisis, it establishes a new countercyclical buffer intended to offset the effects of asset bubbles, or extreme price increases that do not reflect the actual value of an asset.⁹⁸ This buffer is part of the agreement's express attempt to take macro-economic trends into account.⁹⁹ Like Basel II, Basel III increases disclosure requirements regarding how banks calculate their capital ratios, furthering the goal of market transparency.¹⁰⁰ Finally, Basel III also establishes a new liquidity ratio (*i.e.*, whether a bank has enough cash to cover immediate expenses), which is meant to ensure that banks can withstand periods of stress during a financial crisis.¹⁰¹ The increased amount of ratios and associated costs is expected to decrease the profitability of banks in the

95. Compare *id.* ¶ 49 (confining the elements of capital in Tier 1 and Tier 2), with BASEL II, *supra* note 18, ¶ 39 (recognizing Tier 3 capital).

96. See BASEL III, *supra* note 18, ¶ 50 ("Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 8.0% of risk-weighted assets at all times."); *supra* notes 49–51 and accompanying text (discussing how Basel I established minimum capital requirements which were adopted with few modifications by Basel II).

97. See *supra* notes 92–94 and accompanying text (discussing how Basel III increases the quality of Tier 1 Capital but also adds new layers of required capital such as the "conservation buffer").

98. See BASEL III, *supra* note 18, ¶ 2 ("The Committee's comprehensive reform package addresses the lessons of the financial crisis."); *Id.* ¶ 137 ("The countercyclical buffer . . . will be deployed by national jurisdictions when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses."); William C. Dudley, Chief Exec. Officer, Fed. Reserve Bank of N.Y., Asset Bubbles and the Implications for Central Bank Policy, Remarks at The Economic Club of New York (Apr. 7, 2010) ("By an asset bubble, I mean price increases (or declines) that become unmoored from fundamental valuations.").

99. See BASEL III, *supra* note 18, ¶ 137 ("The countercyclical buffer aims to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate.").

100. See *id.* ¶ 91 (requiring increased disclosure requirements regarding how a bank computes its capital requirements in order to "help improve transparency of regulatory capital and improve market discipline"); BASEL II, *supra* note 18, ¶ 809 (requiring increased disclosure requirements).

101. See BASEL III, *supra* note 18, ¶ 40 ("[The liquidity ratio] will help ensure that global banks have sufficient unencumbered, high-quality liquid assets to offset the net cash outflows it could encounter under an acute short-term stress scenario. The specified scenario is built upon circumstances experienced in the global financial crisis that began in 2007 . . .").

short term as they adjust their internal capital composition to meet the new stringent requirements.¹⁰²

In July 2010, shortly before Basel III was finalized, Congress enacted The Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).¹⁰³ It requires that regulators establish new banking capital requirements.¹⁰⁴ In August 2012, the US agencies issued new proposed agency rules intended to implement both Basel III and Dodd-Frank.¹⁰⁵

The proposed rules introduce several changes to the US regulatory scheme.¹⁰⁶ Among other things, the new pending legislation brings savings and loans companies under the capital requirements purview of the Federal Reserve.¹⁰⁷ Thus, unlike the selective treatment the US federal agencies applied to only large internationally active banks while implementing Basel II, the proposed rules apply to almost all banks in the United States and all US savings and loan companies regardless of size.¹⁰⁸ As required by Dodd-Frank, these new standards are the “generally

102. See MACROECONOMIC ASSESSMENT GRP., BANK FOR INT’L SETTLEMENTS, FINAL REPORT: ASSESSING THE MACROECONOMIC IMPACT OF THE TRANSITION TO STRONGER CAPITAL AND LIQUIDITY REQUIREMENTS 2 (2010), available at <http://www.bis.org/publ/othp12.pdf> (concluding that the higher capital equity requirements will cause a short term decrease in growth); *supra* note 55 and accompanying text (explaining that higher capital ratios impose costs on banks).

103. Pub. L. No. 111-203, 124 Stat. 1376 (2010); see *supra* note 90 and accompanying text (noting that Basel III was published in December 2010).

104. See 12 U.S.C. § 5371 (2006) (“The appropriate Federal banking agencies shall establish minimum risk-based capital requirements . . .”).

105. See Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 169, 52793 (proposed Aug. 30, 2012) [hereinafter Regulatory Capital Rules] (“[T]he agencies are proposing to revise their risk-based and leverage capital requirements consistent with agreements reached . . . [in Basel III] . . . [T]he revisions set forth in this [proposed rule] are consistent with section 171 of the . . . [Dodd-Frank Act], which requires the agencies to establish minimum risk based and leverage capital requirements.”).

106. See, e.g., Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52801 (establishing a new common equity tier 1 capital ratio); *Id.* at 169, 52814 (noting a new Tier 2 Capital structure).

107. See *id.* at 169, 52795 (clarifying that the proposed rules are to “apply to all banking organizations currently subject to minimal capital requirements, including . . . state and federal saving associations”); *id.* at 169, 52834 (“Small state member banks and small savings and loan holding companies (covered small banking organizations) would be subject to the [proposed rules] . . .”).

108. See *supra* note 107 and accompanying text (stating which banks are subject under the proposed rules).

applicable” requirements for all US banking organizations.¹⁰⁹ These new rules represent the federal agencies’ comprehensive efforts to reform the entire banking system, and thus protect depositors from the losses incurred during the crisis, by strengthening capital requirements.¹¹⁰

II. BASEL III *v.* US PROPOSED RULES

Part II focuses on the US response to the capital enhancing mechanisms of Basel III. Each subsection of Part II reviews how closely the US proposed rules track the capital enhancing mechanisms introduced by Basel III. Specifically, Part II.A–C discuss the numerator and overall capital ratio, Parts II.D–E explain the new buffers. Part II.F also briefly discusses how the proposed rules update the FDICA’s prompt corrective action (PCA) framework in order to align the capital requirements. Finally, the phase-in schedule for these new requirements is noted in Part II.G.

Furthermore, this Part shows how the US proposed rules essentially implement the Basel III framework for the capital numerator of the ratio. The rules essentially establish the same minimums and requirements for total capital and buffers, but differ in three main ways.¹¹¹ First, the new rules limit the application of the counter-cyclical buffer to only the largest banks.¹¹² Second, the rules are mandated by Dodd-Frank to

109. See 12 U.S.C. § 5371 (2006) (mandating that federal agencies establish “generally applicable risk based capital requirements” to insured depository institutions); Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52792 (“[T]he revisions set forth in this [proposed rule] are consistent with section 171 of [Dodd-Frank], which requires the agencies to establish minimum risk-based and leverage capital requirements.”).

110. See Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52794 (announcing that the OCC, the Fed, and the FDIC “are proposing comprehensive revisions to their regulatory capital framework” and declaring, “[t]hese proposals would revise the agencies’ current general risk-based rules”); *supra* notes 7–12 and accompanying text (explaining how increased capital requirements protect depositors from losses).

111. Compare Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52798 (establishing a total capital ratio of 8% and adopting Basel III’s buffers), with *supra* notes 97–99 and accompanying text (discussing how Basel III adds new layers of required capital including the capital conservation and countercyclical buffers).

112. See Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52805 (explaining how the United States applies the countercyclical buffer). Basel III applies to “internationally active banks” regardless of size. See BASEL III, *supra* note 18, ¶ 47

implement a quicker phase in schedule for certain banks.¹¹³ Finally, the rules align the capital requirements to the PCA framework.¹¹⁴

A. Tier 1 Common Equity

Basel III emphasizes the use of common equity as a way to ensure high-quality capital.¹¹⁵ This emphasis on holding common stock derives from the belief that equity is best able to absorb losses, and thus, protect depositors.¹¹⁶ Accordingly, it establishes a new regulatory requirement known as the Common Equity Tier 1 Capital.¹¹⁷ It raises the minimum equity requirements to 4.5% of all risk-weighted assets.¹¹⁸ This capital must consist of mainly common shares of stock plus retained earnings.¹¹⁹ Basel III does not allow debt-like instruments to be included in Tier 1.¹²⁰

The US federal banking agencies' proposed rules mirror Basel III's establishment of Common Tier 1 Equity.¹²¹ The US regulations would mandate that Tier 1 Common Equity be

(stating that scope of application is the same as Basel II); BASEL II, *supra* note 18, ¶ 20 ("This framework will be applied on a consolidated basis to internationally active banks.").

113. See Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52824 (discussing the transitional requirements).

114. See *id.* at 169, 52807 (noting how the United States proposes to update its PCA framework).

115. See BASEL III, *supra* note 18, ¶ 48 ("A key element of the new definition of capital is the greater focus on common equity, the highest quality component of a bank's capital.").

116. See *supra*, notes 40–48 and accompanying text (discussing why equity capital absorbs the most loss and protects depositors). The Committee equates Common Equity as a "fully loss absorbing capital." BASEL III, *supra* note 18, ¶ 142.

117. See BASEL III, *supra* note 18, ¶ 52 (defining what may constitute "Common Equity Tier 1 capital").

118. Compare BASEL III, *supra* note 18, ¶ 50 ("Common Equity Tier 1 must be at least 4.5% of risk-weighted assets at all times."), with BASEL I, *supra* note 17, ¶ 44 (requiring equity to only be 4% of risk weighted assets).

119. See BASEL III, *supra* note 18, ¶ 52 (declaring that "Common Equity Tier 1 capital consist of the sum of" common shares issued by the bank and retained earnings along with other types of income).

120. See *id.* ¶¶ 52–53 (leaving out debt-like instruments from the definition of Tier 1 Capital and explicitly stating that instruments included in Tier 1 Capital are not "obligatory," and non-payment cannot be an event of default).

121. See Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52801 (establishing a common equity tier 1 capital ratio of 4.5% that is "consistent with Basel III").

comprised of mostly common stock.¹²² The two frameworks use the same definition for what may constitute Tier 1 Equity Capital.¹²³ Under both Basel III and the US rules, Tier 1 Equity Capital may include, among other things, instruments that have the most subordinated claims in a liquidation proceeding and a banking organization must have the ability to not make any distributions on the instrument without triggering default.¹²⁴

B. *Additional Tier 1 Capital*

Basel III introduces “Additional Tier 1 Capital” to the Common Equity Tier 1 to constitute total Tier 1 Capital.¹²⁵ The crucial aspect of this requirement is that the Additional Tier 1 instruments are “subordinated to depositors, general creditors and subordinated debt of the bank”, are perpetual, and allow for complete discretion regarding whether dividends or other distributions must be paid to the owner.¹²⁶ Generally, these instruments include noncumulative perpetual preferred shares and other relatively rare forms of equity.¹²⁷ The minimum Tier 1 Capital Ratio, including Tier 1 Common Equity and Additional Tier 1 Capital, is 6% to total risk-weighted assets.¹²⁸

The proposed rules also establish Basel III’s additional Tier 1 Capital structure.¹²⁹ They greatly restrict what types of preferred shares can be allowed, essentially just allowing

122. *See id.* at 52810-11 (“The agencies continue to expect under the proposal that voting common stockholders’ equity . . . should be the dominant element within common equity tier 1 capital.”).

123. *See id.* (listing the criteria that common equity tier 1 capital instruments must meet); BASEL III, *supra* note 18, ¶¶ 53–54 (same).

124. *See* Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52810-11 (listing these and other criteria); BASEL III, *supra* note 18, ¶ 9 (same).

125. *See* BASEL III, *supra* note 18, ¶ 54 (“Additional Tier 1 capital consists of the sum of the following elements. . .”).

126. *See id.* ¶ 55 (listing the criteria for inclusion in Additional Tier 1 capital).

127. *See* CARNELL, *supra* note 8, at 407 (explaining the such shares may be included in additional Tier 1 Capital and the other forms of equity “are too rarefied to matter for our purposes”); Gregory J. Lyons & Chan E. Casey, *Basel III—An Initial Piece of the Global Puzzle*, 30 NO. 7 BANKING & FIN. SERVS POL’Y REP. 21, 22–23 (2011) (“[N]on-cumulative perpetual preferred is the only type of existing widely distributed security clearly able to qualify under this category.”).

128. *See* BASEL III, *supra* note 188, ¶ 50 (“Tier 1 Capital must be at least 6.0% of risk-weighted assets at all times.”).

129. *See* Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52812 (establishing Additional Tier 1 Capital in a manner “consistent with Basel III”).

common stock-like securities that have higher priority in a bankruptcy proceeding to be included into Tier 1 as “Additional” Tier 1 Capital.¹³⁰ This reflects the overall focus of ensuring that banks have loss-absorbing capital in their Tier 1 Capital.¹³¹ For example, non-cumulative perpetual preferred stock would expressly qualify as additional Tier 1 Capital.¹³² This type of capital is included because it is not cumulative (*i.e.*, the contractual obligations of past dividends do not come due), it has no maturity date and no incentive to be repurchased by the company (*i.e.*, is perpetual or not redeemable), and its holders get paid after depositors in a bankruptcy proceeding.¹³³

C. Total Capital Ratio

Although Basel III eliminates Tier 3 Capital, it still allows banks to hold Tier 2 Capital.¹³⁴ Under Basel III, Tier 2 Capital

130. See CARNELL, *supra* note 8, at 405–06 (explaining the differences between cumulative, noncumulative, and perpetual preferred shares). The chart below compares the two different types of securities.

SECURITY FEATURE	COMMON STOCK	NON-CUMULATIVE PERPETUAL PREFERRED SHARE
DIVIDENDS	No obligation	No obligation (<i>i.e.</i> , non-cumulative)
MATURITY	No obligation to redeem (<i>i.e.</i> , permanent)	No obligation to redeem (<i>i.e.</i> , perpetual)
LIQUIDATION	Lowest ranking	Lowest ranking except for common stock holders (<i>i.e.</i> , preferred)

131. See *supra* notes 40–43 and accompanying text (explaining that Tier 1 Capital is the most able to absorb losses).

132. See Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52812 (“Under the agencies existing capital rules, non-cumulative perpetual preferred stock . . . would continue to qualify as additional tier 1 capital under the proposal.”).

133. See CARNELL, *supra* note 8, at 405–06 (discussing the differences between non-cumulative, cumulative, and perpetual preferred shares); see also BLACK’S LAW DICTIONARY 1552 (9th. ed. 2009) (defining noncumulative preferred shares as “preferred stock that does not have to be paid dividends that are in arrears”); *Id.* at 1553 (9th. ed. 2009) (defining redeemable stock as “preferred stock that can be [bought] by the issuing corporation and retired”) (emphasis added).

134. See *supra* note 95 and accompanying text (detailing that Basel III eliminated the use of Tier 3 Capital established by Basel II).

may include preferred stock and subordinated debt.¹³⁵ Basel III mandates the total capital ratio (*i.e.*, Tier 1 and Tier 2) to be 8% to total risk weighed assets.¹³⁶ Mirroring this framework, the US rules also allow subordinated debt and cumulative preferred stock under Tier 2 Capital.¹³⁷ Thus, the new accords increase the capital ratio potentially by over 50% by requiring a minimum of up to 13% total capital (8% Total Capital plus a potential 5% buffer consisting of equity capital).¹³⁸ If implemented at its maximum, as discussed in Part III, this would represent over a 50% increase in total common equity capital that banks had during the financial crisis (from 6% to 9.5% with the counter cyclical buffer).¹³⁹

D. Conservation Buffer

One of the innovations of Basel III is its greater focus on buffers.¹⁴⁰ This new part of the framework focuses on high

135. See BASEL III, *supra* note 18, ¶ 58 (allowing subordinated debt to be part of Tier 2 Capital); CARNELL, *supra* note 8, at 408 (“Tier 2 Capital encompasses everything else that can count as capital, including cumulative preferred, intermediate- and long-term preferred [shares], and subordinated debt . . .”).

136. See BASEL III, *supra* note 18, ¶ 50 (“Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 8.0% of risk-weighted assets at all times.”).

137. See Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52813 (stating that the allowable Tier 2 Capital is “consistent with Basel III” and noting that “cumulative perpetual preferred securities . . . [C]ould qualify for inclusion in [T]ier 2 capital”); *Id.* at 169, 52815 (“[M]ost existing subordinated debt instruments they [banks currently] include in tier 2 capital would meet the proposed eligibility criteria for additional tier 1 and tier 2 capital instruments, respectively.”).

138. See BASEL III, *supra* note 18, ¶¶ 122, 136 (explaining the buffers). Basel III introduces a 2.5% conservation buffer and a 2.5% counter cyclical buffer. *Id.* ¶¶ 129, 139 (establishing the buffers). Historically, the capital ratio has been 8%. See BASEL I, *supra* note 17, ¶ 44 (establishing the 8% capital to risk weighted assets requirement); *supra* note 69 (discussing that Basel II kept this requirement the same); *supra* note 136 (explaining that Basel III also required the total capital ratio is 8%). In other words, a bank could potentially be required to hold 8% in risk-weighted assets and an additional 5% in common equity to risk weighted assets, or a total capital requirement of 13% (a 62.5% increase over the original 8% requirement).

139. See Bd. of Governors of the Fed'l. Reserve System, DODD-FRANK ACT STRESS TEST 2013: SUPERVISORY STRESS TEST METHODOLOGY AND RESULTS 2 (2013) [hereinafter FEDERAL RESERVE STRESS TEST] (showing a bar chart which indicates that banks had common equity ratios of about 6% in the fourth quarter of 2008).

140. See BASEL III, *supra* note 18, ¶ 26 (“The Committee is *introducing* a framework to promote the conservation of capital and the build-up of adequate buffers above the minimum that can be drawn down in periods of stress.”) (emphasis added);

quality capital such as common equity.¹⁴¹ Basel III requires banks to maintain a conservation buffer of common equity Tier 1 Capital of 2.5% of risk weighted assets in addition to the total capital ratio requirements (*i.e.*, Tier 1 and Tier 2).¹⁴² This means that, in conjunction with the minimum 4.5% common equity requirement, 7% of a bank's capital must be comprised of common equity.¹⁴³ If a bank's capital falls below this buffer, Basel III imposes several regulatory restrictions on executive compensation, including supervisory bonuses, and distributions, such as cash dividends and stock buy-backs.¹⁴⁴ This is distinct part of the framework—banks cannot use Common Equity used in Tier 1 to meet the Conservation buffer.¹⁴⁵

Consistent with their policy of mimicking Basel III, the US rules also require banks to maintain a capital conservation buffer of at least 2.5% common equity.¹⁴⁶ If banks do not maintain these required standards essentially the same limits on

Id. ¶ 122 (“This section outlines the operation of the capital conservation buffer . . .”).

141. *See id.* ¶ 129 (stating that the “capital conservation buffer of 2.5% [is] comprised of Common Equity . . .”); *supra* notes 40–48 and accompanying text (explaining why common equity is a high quality capital).

142. *See* BASEL III, *supra* note 18, ¶ 129 (declaring that the conservation buffer is required “above” or in addition to, the minimum capital requirements).

143. *See supra* notes 117–118 and accompanying text (explaining that Basel III established a 4.5% equity capital requirement); BASEL III, *supra* note 18, ¶ 129 n.47 (“Common Equity Tier 1 must first be used to meet the minimum capital requirements . . . before the remainder can contribute to the capital conservation buffer.”).

144. *See* BASEL III, *supra* note 18, ¶ 131 (explaining that banks with capital levels that fall below certain levels of Tier 1 Common Equity become subject to restriction on capital distributions). “For example, a bank with 8% [Tier 1 Common Equity] and no Additional Tier 1 or Tier 2 capital would meet all minimum capital requirements, but would have a zero conservation buffer and therefore be subject to the 100% constraint on capital distributions.” *Id.*

145. *Id.* ¶ 129 n.47 (“Common Equity Tier 1 must first be used to meet the minimum capital requirements . . . before the remainder can contribute to the capital conservation buffer.”).

146. *See* Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52803. (“The capital conservation buffer would be composed of common equity tier 1 capital and would be separate from the minimum risk-based capital requirements . . . [A] banking organization would need to hold a capital conservation buffer in an amount greater than 2.5 percent of total risk-weighted assets.”); Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52795 (explaining that “revisions incorporate changes” that Basel III articulated and that “this notice (Basel III NPR) proposes the Basel III revisions to international capital standards related to minimum requirements, regulatory capital, and additional capital ‘buffers’”).

capital distributions kick in, including limits on dividends, and discretionary bonus payments to executive officers, such as the CEO.¹⁴⁷ At the lowest range, if the bank maintains a conservation buffer of less than .0625%, a bank may not make any bonus payments to executive officers.¹⁴⁸ This is another example of how the new agreement and its US counterpart directly respond to the financial crisis, reflecting a widely held belief that excessive executive compensation incentivized bank executives to take more risk in the years leading up to the financial crisis.¹⁴⁹ Like most of the framework, however, domestic regulators have discretion in enforcing these restrictions.¹⁵⁰

E. Counter-Cyclical Buffer

Basel III also attempts to remedy pro-cyclicality, another problem thought to have exacerbated the financial crisis.¹⁵¹ Pro-cyclicality can increase the negative impact of booms and bust cycles.¹⁵² This occurs especially during financial booms, where easy access to credit acts as an incentive for firms, including

147. *See id.* at 169, 52803 (explaining that falling below the buffer triggers limits “on capital distributions and discretionary bonus payments to executive officers . . .”).

148. *See id.* at 52804 (“The purpose of limiting restrictions on discretionary bonus payments to executive officers is to focus these measures on the individuals within a banking organization who could expose the organization to the greatest risk.”).

149. *See id.* at 52804 (explaining that the purpose of limiting bonus payments to executives is because they can expose an organization to “the greatest risk.”); *see also* Nassim Nicholas Taleb, *End Bonuses for Bankers*, N.Y. TIMES, Nov. 7, 2011, <http://www.nytimes.com/2011/11/08/opinion/end-bonuses-for-bankers.html> (“Bonuses are particularly dangerous because they invite bankers to game the system by hiding the risks of rare but consequential . . . disasters [such as the financial crisis].”).

150. *See* Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52804 (“[E]ach agency would retain its authority to permit a banking organization supervised by that agency to make a capital distribution or a discretionary bonus payment, if the agency determines that the capital distribution or discretionary bonus payment would not be contrary to the purposes of the capital conservation buffer or the safety and soundness of the banking institution.”).

151. *See* BASEL III, *supra* note 18, ¶ 18 (“One of the most destabilising elements of the crisis has been the procyclical amplification of financial shock throughout the banking system . . .”); Ojo, *supra* note 79, at 15 (“Pro-cyclicality is a term used to denote ‘the self-reinforcing mechanisms within the financial system . . . that can exacerbate boom and bust cycles . . .’”).

152. *See* Ojo, *supra* note 79, at 18 (defining pro-cyclicality); *see also* BASEL III, *supra* note 18, ¶ 4 (explaining that the “crisis was further amplified by a procyclical deleveraging process . . .”).

banks, to take on more risk.¹⁵³ To address this problem, Basel III introduces a mechanism that requires banks to obtain capital, in the form of common equity, when it is readily available.¹⁵⁴ Financial institutions are then required to store it so that it is available to absorb losses during times when access to credit is limited.¹⁵⁵ Thus regulators can mandate a bank to hold up to an additional 2.5% of common equity in addition to minimum capital ratio and conservation buffer.¹⁵⁶

This buffer allows authorities to protect banks from excessive growth by requiring banks to raise common equity during times where credit is readily available and using this equity to absorb any losses that occur when access to credit becomes restricted.¹⁵⁷ Banks that fail to meet the required buffer are subject to the same discretionary capital distribution limits under the conservation buffer scheme.¹⁵⁸ Unlike the other requirements that are proposed as mandatory minimum

153. See BASEL III, *supra* note 18, ¶ 139 (explaining that the countercyclical buffer should be used when “a period of excess credit growth [is judged] to be leading to the buildup of system-wide risk . . .”); Ojo, *supra* note 79, at 16 (asserting that an “example of a ‘fundamental’ source of procyclicality is . . . ‘excessive risk-taking during periods of expansion, which results in the buildup of vulnerabilities’”).

154. See BASEL III, *supra* note 18, ¶ 142 (stating that the, “countercyclical buffer . . . varies between zero and 2.5% of risk weighted assets Banks must meet this buffer with Common Tier 1 Equity or other fully loss absorbing capital . . .”).

155. See *id.* ¶¶ 136–37 (explaining that the buffer is supposed to help alleviate the “vicious circle” that occurs where problems in the “financial system” leads to a downturn in the economy which then negatively impacts the banking sector); see also CARNELL, *supra* note 8, at 418 (explaining that the conservation buffer, which also requires stored capital, is “aimed at keeping bank’s capital well above minimum levels during good times so that banks can better withstand the stress of bad times”).

156. See BASEL III, *supra* note 18, ¶ 139 (explaining that national authorities can implement a countercyclical buffer that “will vary between zero and 2.5% of risk weighted assets”); BASEL III, *supra* note 18, ¶ 138(c) (articulating that the countercyclical buffer “extend[s] the size of the capital conservation buffer”).

157. See *supra* note 143 and accompanying text (discussing how the countercyclical buffer protects banks during downturns); see also Ojo, *supra* note 79, at 19 (“A counter cyclical capital charge, it is contended, ‘would require financial institutions to hold more capital during buoyant periods whilst lowering the regulatory capital levels during periods of stress.’ Through a retention of earnings during buoyant periods, a bank is able to conserve excess capital which can be used to absorb asset write offs during less buoyant periods and periods of financial stress.”).

158. See BASEL III, *supra* note 18, ¶ 147 (explaining that the capital level restrictions are the same between both buffers).

standards, Basel III explicitly leaves the determination of the buffer to each individual regulator.¹⁵⁹

In their approach to counter-cyclical buffers, the US rules take an uncharacteristic departure from adopting Basel III capital requirements for most banking organization.¹⁶⁰ The proposed rules intend to apply the 2.5% Common Equity Tier 1 Capital counter-cyclical buffer *only* to banks that are “interconnected” with other large institutions.¹⁶¹ The rules also enable US regulators to make a determination as to whether this extra buffer is necessary to protect the overall financial system based on several factors, such as the ratio of credit to GDP or other “measures of systemic risk.”¹⁶² The US rules adopt the same restrictive scheme on distributions, although banks subject to the counter-cyclical buffer may have to apply the schemes differently.¹⁶³

159. Compare *id.* ¶ 139 (leaving the implementation of the counter cyclical buffer to the judgment of each national authority), with *id.* ¶ 55 n.16 (“[M]inimum [capital requirements] refers to the regulator’s prescribed minimum requirement, which may be *higher* than the Basel III Pillar 1 minimum requirement.”) (emphasis added).

160. See *supra* notes 109–10 and accompanying text (explaining that the US rules adopt the minimum capital standards to most US banking organizations).

161. See Regulatory Capital Rules, *supra* note 105, at 169, 52805 (elaborating that “[t]he marginal benefits [to] financial stability from a countercyclical buffer function should be greater with respect to [interconnected financial] institutions” whereas the costs of implementation would be too great for smaller firms). Large interconnected banks have been referred to as “advanced approaches” banks by the proposed rules. See, e.g., *id.* (“The agencies propose to apply the countercyclical capital buffer only to advanced approaches banking organizations, because large banking organizations generally are more interconnected with other institutions in the financial system.”).

162. See *id.* (“The agencies expect to consider a range of macroeconomic, financial, and supervisory information indicating an increase in systemic risk including, but not limited to, the ratio of credit to gross domestic product”); *Id.* (“[T]he countercyclical capital buffer amount would be linked to the condition of the overall U.S. financial system and not the characteristics of an individual banking organization”). *Id.*

163. See *id.* at 169, 52804 (establishing the maximum payout ratio scheme for the capital conservation buffer and noting that “capital distributions and bonus restrictions applied to an advanced approaches banking organization could be more or less stringent than if its capital conservation buffer were based on risk-weighted assets as calculated by all banking organizations.”).

F. Prompt Corrective Action

As Figure 3 illustrates, the US rules have aligned the PCA framework to match Basel III’s new capital requirements.¹⁶⁴ The new Common Equity Tier 1 requirements mean that banks must maintain at least 4.5% common equity to be considered “adequately capitalized.”¹⁶⁵ Banks below the Tier 1 common equity requirement of 4.5% would be considered “undercapitalized.”¹⁶⁶

Figure 3.¹⁶⁷

Requirement	Total RBC measure (total RBC ratio—percent)	Tier 1 RBC measure (tier 1 RBC ratio—percent)	Common equity tier 1 RBC measure (common equity tier 1 RBC ratio (percent))	Leverage Measure (leverage ratio—percent)	PCA requirements
Well Capitalized	≥10	≥8	≥6.5	≥5	Unchanged from current rules *
Adequately Capitalized	≥8	≥6	≥4.5	≥4	Do.
Undercapitalized	<8	<6	<4.5	<4	Do.
Significantly undercapitalized	<6	<4	<3	<3	Do.
Critically undercapitalized	Tangible Equity (defined as tier 1 capital plus non-tier 1 perpetual preferred stock) to Total Assets ≤2				Do.

Consider the old framework where undercapitalization meant having a total capital (Tier 1 and Tier 2) ratio of under 8% or having a Tier 1 ratio of less than 4%.¹⁶⁸ The new PCA framework

164. *See id.* at 169, 52807, Table 6 (delineating the new PCA framework, applicable to most banking organizations); *see also supra* notes 13–15 and accompanying text (discussing the purpose of the PCA framework).

165. *See* Regulatory Capital Rules, *supra* note 105, at 169, 52807, Table 6 (showing that banks need at least a 4.5% “common equity tier 1 [Risk Based Capital] ratio” to be “adequately capitalized”).

166. *See id.* (showing that banks with less than a 4.5% “common equity tier 1 [Risk Based Capital] ratio” are “undercapitalized”).

167. *Id.*

168. *See id.* Table 5 (“Current PCA Levels”) (showing that banks with less than a 8% Total Risk Based Capital ratio or less than a 4% [Risk Based Capital] Tier 1 ratio is “undercapitalized”).

is one of the ways in which the US rules are more demanding than Basel III.¹⁶⁹

For example, imagine two different banks: Bank A is regulated by a jurisdiction governed both by Basel III and a PCA framework while Bank B operates in a jurisdiction governed by Basel III without a PCA framework. Assume that both banks' entire capital structure consists solely of a Tier 1 Equity Capital ratio of 4.0%. Both banks have failed to meet their Common Equity Tier 1 requirement of 4.5% and have failed to meet their 2.5% conservation buffer requirement.¹⁷⁰ Accordingly, neither bank can engage in any capital distributions, such as dividend payments to stockholders.¹⁷¹ Bank B has no other duties under Basel III; theoretically, Bank B can simply not comply with the requirements as long as the bank is not concerned with making capital distributions.¹⁷²

The PCA framework, on the other hand, requires regulators to take action against Bank A by treating it as undercapitalized.¹⁷³ Bank A must submit a capital restoration plan to regulators explaining how it plans on meeting the required capital minimum requirements.¹⁷⁴ If Bank A fails to

169. See *supra* notes 164–168 and accompanying text (explaining why the PCA framework is more stringent than Basel III).

170. See BASEL III, *supra* note 18, ¶ 131 (explaining that Basel III established a 4.5% equity capital requirement); Regulatory Capital Rules, *supra* note 105, at Table 6 (same).

171. See *supra* note 143 and accompanying text (noting that Common Equity must first be used to meet the minimum requirements before it can be used for the conservation buffer); see also *supra* notes 151–52 and accompanying text (articulating that having a capital conservation buffer of zero means the bank cannot make any capital distributions).

172. This is an unrealistic assumption in most cases. Restrictions on capital distribution also include preventing bonus payments to executives as well as other constraints that would certainly provide an incentive for Bank B to comply with the requirements. The example is for illustrative purposes only.

173. See 12 U.S.C. § 1831o(b)(1)(C) (“An insured depository institution is ‘undercapitalized’ if it fails to meet the required minimum level for any relevant capital measure.”); 12 U.S.C. § 1831o(f)(2) (“The appropriate Federal Banking agency shall carry out this section by taking 1 or more of the following actions”) (emphasis added); Richard S. Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 329 (1993), reprinted in CARNELL, *supra* note 8 at 423 [hereinafter Carnell, *Perverse Incentives*] (noting that the PCA framework “specifically requires regulators to take timely, effective action to prevent loss to the [FDIC’s] insurance fund.”).

174. See 12 U.S.C. § 1831o (c)(2) (detailing the process for a bank to submit a “capital restoration plan”); Carnell, *Perverse Incentives*, *supra* note 173, at 425 (“An

provide a realistic plan, it may be deemed non-viable, and can be placed in receivership.¹⁷⁵ Therefore, while Bank B under Basel III may simply decide not to comply with the capital requirements and try to withstand its inability to make capital distributions, the PCA requirements act as “a catalyst for restoring” Banks A’s capital, or will lead to Bank A’s demise if it does nothing.¹⁷⁶ Therefore, the PCA framework provides a stronger enforcement mechanism than Basel III for ensuring capital soundness.¹⁷⁷

G. *Transitional Differences in Phasing Requirements*

The proposed rules deviate from certain transition periods established by Basel III that give banks time to adjust their capital structure to meet the new capital standards.¹⁷⁸ Basel III becomes effective January 1, 2013.¹⁷⁹ It requires banks to meet the Capital Tier 1 Ratio by 2015.¹⁸⁰ The Capital Conservation

undercapitalized institution must submit an acceptable capital restoration plan to the appropriate Federal Banking Agency . . . specifying the steps it will take to become adequately capitalized and regulators must decide whether to approve the plan.”).

175. See 12 U.S.C. § 1831o (h)(3)(A) (explaining that the agencies have the power to “appoint a receiver . . . for the institution” if it is “critically undercapitalized”); Carnell, *Perverse Incentives*, *supra* note 173, at 340 (“[T]he agency may approve a plan only upon finding that the plan rests on realistic assumptions . . . [L]ack of an acceptable plan is itself grounds for conservatorship or receivership.”).

176. See Carnell, *Perverse Incentives*, *supra* note 173, at 425 (asserting that the restrictions on capital distributions are a “catalyst for restoring capital”); see also *supra* note 175 and accompanying text (discussing that a bank deemed non-viable will be placed into receivership).

177. See *supra* notes 175–176 and accompanying text (explaining how the PCA framework requires regulators to act). Basel III provides some tools that national regulators can use to ensure compliance with capital requirements (e.g., limitations on capital distributions for failing to meet the conservation buffer); see also *supra* notes 146–150 and accompanying text (explaining the conservation buffer). The US rules go a step beyond this and not only limit a bank’s ability to make distributions, but also forces it to either recapitalize, or fail. See *supra* notes 169–74 and accompanying text (explaining the PCA framework).

178. See Regulatory Capital Rules, *supra* note 108, at 52824 (“The proposed transition provisions have been designed to ensure compliance with the Dodd-Frank Act. As a result, they could, in certain circumstances, be more stringent than the transitional arrangements proposed in Basel III.”).

179. See BASEL III, *supra* note 18, ¶ 94(a) (“National implementation by member countries will begin on 1 January 2013.”).

180. See *id.* ¶ 94(b) (“On 1 January 2015, banks will have to meet the 4.5% Common Equity Tier 1 and 6% Tier 1 requirements.”).

Buffer must be fully implemented by January 2019.¹⁸¹ Instruments that no longer qualify as Tier 1 and Tier 2 Capital will be phased out over a ten-year period beginning in January 2013.¹⁸² The capital conservation buffer requirement takes effect on January 1, 2016 and is gradually phased-in equally over a three year period, increasing by .0625% per year to reach its final level of 2.5% on January 1, 2019.¹⁸³

The US proposed rules, pursuant to Dodd-Frank, detail a stricter schedule for phasing out non-qualifying capital securities than Basel III for certain banks.¹⁸⁴ The proposed rules incorporate the transition period mandated by Dodd-Frank to banks having at least US\$15 billion worth of assets.¹⁸⁵ Thus, capital instruments issued before June 2010 by large banks that no longer meet the requirements would be phased out from 2013–2016 instead of a ten-year period.¹⁸⁶ For example, current Tier 1 and Tier 2 Capital that no longer meets the new Tier 1 and Tier 2 capital requirements by 2013 will begin being phased

181. *See id.* ¶ 133 (“The capital conservation buffer . . . [becomes] fully effective on 1 January 2019.”).

182. *See id.* ¶ 94(g) (“Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased out beginning 1 January 2013 [T]heir recognition will be capped at 90% from 1 January 2013, with the cap reducing by 10 percentage points in each subsequent year.”).

183. *See id.* ¶ 133 (“[The capital conservation buffer] will begin at 0.625% of RWAs [risk weighted assets] on 1 January 2016 and increase each subsequent year by an additional 0.625 percentage points, to reach its final level of 2.5% of RWAs on 1 January 2019.”).

184. *Compare* 12 U.S.C. § 5371(b)(4)(B) (2006) (“For debt or equity instruments issued before May 19, 2010 . . . any regulatory capital deductions required under this section shall be phased in incrementally over a period of 3 years, with the phase-in period to begin on January 1, 2013”), *with* Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52843 (explaining that Basel III requires non-qualifying capital instruments to be phased out over a ten-year “horizon”). *See also* Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52830 (explaining that Dodd-Frank mandates a three-year phase-in schedule for “depository institution holding companies with total consolidated assets greater than or equal to [US]\$15 billion . . .”).

185. *See* Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52830 (noting that Dodd-Frank imposes a three-year phase-in schedule for “depository institution holding companies with total consolidated assets greater than or equal to [US]\$15 billion . . .”); *Id.* at 169, 52831 (explaining that a “depository institution holding company of [US]\$15 billion” would begin phasing out ineligible capital starting January 1, 2013 and would be allowed to include “zero percent as of January 1, 2016 and thereafter”).

186. *See supra*, note 184 and accompanying text (comparing the Basel ten-year phase-in period with the three-year phase-in period in the proposed rules).

out over three years.¹⁸⁷ In 2016, the bank capital must achieve the new standards.¹⁸⁸ Banks that have less than US\$15 billion in assets, however, have until 2022 to meet the new standards.¹⁸⁹

This Part has given a brief overview of how the US proposed rules compare to the standards articulated by Basel III. The US rules mimic the Tier 1 Capital, Tier 2 Capital, conservation buffer, and counter-cyclical buffer requirements set by Basel III. The proposed rules differ, however, in their transitional requirements for large banks. In addition, the rules incorporate the new capital requirements into the existing PCA requirements, which provide an enforcement mechanism not articulated in Basel III. Part III of this Comment analyzes these differences and similarities and makes recommendations.

III. ANALYSIS OF THE NEW REQUIREMENTS AND RECOMMENDATIONS

Part III argues that the rules do not go far enough to enhance banking soundness. Part III.A explains that the US federal agencies do not always enforce the required capital levels of banks. Part III.B argues that even if the agencies were to enforce the minimum capital requirements, there would not be a substantial impact on the safeness and soundness of banks because the requirements are set much too low and have been easily met by the largest banks. Part III.C argues that the minimum capital standards should be set much higher to reflect the actual amounts of capital banks need to bolster market confidence, and the PCA framework should be accordingly revised to require banks to meet the higher levels of capital.

Unquestionably, the newest Accord enhances bank soundness by issuing new capital requirements.¹⁹⁰ The US proposed rules, however, simply copy many of the new

187. *See id.* at 52866, Table 9 (discussing the transition period).

188. *See id.* (discussing the transition period).

189. *See id.* at 52831 (explaining that a bank “under [US]\$15 billion . . . that issued a tier 1 non-qualifying capital instrument in August 2010 would be able to count 90 percent of the . . . instrument as of January 1, 2013 . . . [but] as of January 1, 2022, no tier 1 non-qualifying capital instrument would be recognized as tier 1 capital.”).

190. *See supra* notes 10–12 and accompanying text (explaining that bank regulation focuses on promoting the safety of bank through capital requirements).

requirements.¹⁹¹ The US rules rubber stamp the Basel requirements rather than mandating stricter requirements based on the amount of capital US banks are currently holding.¹⁹² Based on the actual amount of capital banks are currently reporting in the United States, the proposed rules are too lax.¹⁹³ The PCA requirements and overall capital ratio should be increased to reflect the post crisis level of capital that US banks have currently accumulated.

The proposed rules capture many aspects of Basel III and should dampen the impact of future financial crises.¹⁹⁴ Several important measures, such as the counter-cyclical buffer, help to bolster a bank's ability to absorb losses when a financial crisis hits.¹⁹⁵ The restrictions on capital distributions and bonus payments are a direct incentive for management to maintain the required capital levels.¹⁹⁶ Also, Dodd-Frank mandates that banks deduct unqualified instruments more quickly than Basel III, making banks safer quicker.¹⁹⁷

191. See, e.g., *supra* notes 121–24 and accompanying text (explaining how the United States has proposed rules that closely track several parts of Basel III).

192. See, e.g., *supra* note 191 and accompanying text (showing that several parts of Basel III were identical to the proposed rules); BASEL III, *supra* note 18, ¶ 55 n.16 (explaining that each Country *may* implement higher ratios than those articulated by Basel III).

193. Compare *supra* notes 118 and accompanying text (explaining how the Basel III rules mandate a 4.5% common equity requirement), with Peter Eavis, *15 of 19 Big Banks Pass Fed's Latest Stress Test*, N.Y. TIMES, Mar. 13, 2012, http://www.nytimes.com/2012/03/14/business/jpmorgan-passes-stress-test-raises-dividend.html?_r=0 (noting that the current levels of capital are higher than 4.5%). See also Federal Reserve Stress Test, *supra* note 139, at 16 (noting that banks are currently holding over 11% current tier 1 equity capital).

194. See *supra* note 54 and accompanying text (noting how some commentators have “hailed” the agreement as an example of future international lawmaking); *supra* notes 7–12 and accompanying text (explaining that increasing capital requirements decreases potential losses to depositors).

195. See *supra* notes 153–58 and accompanying text (discussing the countercyclical buffer); *supra* notes 34–42 and accompanying text (explaining that increasing capital requirements allows a bank to absorb potential losses).

196. See *supra* notes 147–149 and accompanying text (discussing the distribution restrictions associated with a low conservation buffer).

197. See *supra* notes 184–86 and accompanying text (explaining the transitional differences mandated by Dodd-Frank); *supra* notes 41–43 and accompanying text (explaining that higher quality capital is more likely to help depositors avoid losses). Having less non-qualifying instruments makes banks safer because the new instruments must conform to Basel III's higher quality capital. See *supra* notes 90–97 and accompanying text (explaining how Basel III mandates higher quality capital).

The new PCA framework also bolsters bank safety by focusing on a specific component of capital, common equity.¹⁹⁸ For example, unlike the previous accords, banks cannot keep 4% equity and 4% subordinated debt on their balance sheets and still meet capital requirements because common equity must now always be greater than 4.5%.¹⁹⁹ There is no denying that the new framework is an improvement and is a step in the right direction.²⁰⁰ However, the requirements suffer from some of the same problems as the previous accords and are a pale shadow of what US banks should be mandated to implement.²⁰¹

A. The United States Does Not Always Enforce Its Bank Capital Requirements

Basel III introduces a new conservation buffer and counter-cyclical buffer.²⁰² The buffers, besides requiring more capital than the previous accords, can limit a bank's ability to distribute bonuses or dividend payments.²⁰³ The US proposed rules adopt the buffers and their restrictions, but also go a step further by aligning the common tier 1 equity ratio to the prompt corrective action framework.²⁰⁴ There are several reasons why this framework will not offer much in the way of requiring US banks to comply with capital requirements, which the buffers and realignment are patently meant to do.

First, there is a history of a lack of capital level enforcement in the United States.²⁰⁵ A recent bank capital enforcement study

198. See *supra* notes 169–77 and accompanying text (articulating the benefits of the PCA framework).

199. See *Regulatory Capital Rules*, *supra* note 105, at 169, 52840 (explaining that the PCA framework was updated to require banks to always have at least 4.5% Common Tier 1 Equity).

200. See *supra* note 54 and accompanying text (noting how some commentators have praised the Basel lawmaking process); *supra* notes 7–12 and accompanying text (explaining that increasing capital requirements makes bank less likely to fail).

201. See *supra* note 193 and accompanying text (explaining that the minimum capital requirements are set too low).

202. See *supra* notes 144–54 and accompanying text (discussing the new buffers).

203. See *supra* note 143–50 and accompanying text (discussing the potential restrictions on distributions when banks fail to meet the new buffers).

204. See *supra* notes 164–73 and accompanying text (explaining how the PCA framework has been realigned).

205. See Julie Andersen Hill, *Bank Capital Regulation By Enforcement: An Empirical Study*, 87 *IND. L.J.* 645, 648 (2012).

concluded that “the data show a near-complete absence of capital enforcement action issued to the largest banks.”²⁰⁶ In fact, the Federal Reserve “is less likely than other regulators to bring serious capital enforcement actions and is less likely to increase capital requirements.”²⁰⁷

Therefore, to the extent that the Basel framework gives full discretion to the implementing jurisdiction, the argument that soft law is not “truly law” gains some credence.²⁰⁸ In other words, the new framework, like the other Accords, has an internal weakness because it does not stipulate or decree how its requirements should be enforced.²⁰⁹ In the context of the buffers, which restrict discretionary spending, the proposed rules explicitly state that, “each agency would retain its authority to permit a banking organization supervised by that agency to make a capital distribution or a discretionary bonus payment.”²¹⁰ This means that the agencies can selectively refuse to enforce the buffer imposed restrictions. Although this gives the agencies some leeway in how they enforce potentially costly bank capital requirements, it also exposes depositors to the risk that banks remain inadequately capitalized.²¹¹ Therefore, if the agencies fail to enforce the standards, this would frustrate the Accords’ goal of fostering depositor confidence through the imposition of meaningful bank capital requirements.²¹²

Additionally, Dodd-Frank’s resounding silence gives the US federal regulators a wide breadth of discretion in establishing

206. *Id.*

207. *Id.*

208. *See supra* note 60 and accompanying text (discussing the criticism of “soft law”).

209. *See supra* note 177 and accompanying text (discussing how the PCA framework provides an enforcement mechanism that is not in Basel III); *see also supra* notes 55-57 and accompanying text (explaining that each member is responsible for implementing the Basel agreement).

210. *See supra* notes 147-49 and accompanying text (discussing how failing to meet the buffers can result in limits on discretionary distributions); Regulatory Capital Rules, *supra* note 105, 77 Fed. Reg. at 169, 52804 (same).

211. *See supra* note 57 and accompanying text (explaining how new capital requirements impose certain costs on bank growth); *supra* notes 6-12 (explaining how depositors are at risk when a bank is not adequately capitalized).

212. *See supra* notes 7-12 and accompanying (explaining that capital requirements are imposed in order to protect depositors).

capital levels.²¹³ Dodd-Frank mandates a specific three-year transition plan for non-qualifying instruments.²¹⁴ The agencies have no choice but to adopt this statutory mandate into the proposed regulations.²¹⁵ The Act utterly fails, however, to provide specific guidance on capital standards. Congress did not delve into the minutia of capital requirements, instead requiring only that the “appropriate” agency establish such standards.²¹⁶ Consequently, the historical grant of complete discretion with no method of enforcement is a major way in which the ultimate effectiveness of the Accord can be undermined.

B. Banks Have Accumulated a Key Capital Component in Excess of the Requirements

Furthermore, even if the agencies suddenly became ardent defenders of capital standards and ruthlessly enforce them, there is still reason to doubt that the new agreement’s capital levels do much to mitigate the effects of unexpected losses. Both Basel III and the US proposed rules put a large emphasis on increasing the Tier 1 Common Equity of banks.²¹⁷ Although both frameworks extol the virtues of focusing on common equity as a tool to help depositors, they demand exceedingly little of this component.²¹⁸

The focus on common equity is patently clear under Basel III and the US rules.²¹⁹ The new framework introduces a new Tier 1 Common Equity requirement and two entirely new buffers which are comprised exclusively of common equity.²²⁰ Together, these new standards impose a 7% common equity mandatory requirement on banks (4.5% of Tier 1 Common

213. *See supra* notes 21–22 and accompanying text (noting that Dodd-Frank leaves it to the regulators to establish capital level requirements).

214. *See supra* notes 184–85 and accompanying text (explaining how Dodd-Frank imposes this transition).

215. *See supra* notes 185–89 and accompanying text (discussing how the agencies adopted this transition changes as required by Dodd-Frank).

216. *See supra* note 104 (discussing how Dodd-Frank requires this).

217. *See supra* notes 41, 122–26 (explaining how this is a “key” aspect of regulatory standards); *see supra* notes 126–29 (discussing how the United States focuses on this component).

218. *See id.* (explaining how this is an important aspect of regulatory standards).

219. *See supra* notes 41, 122–26 (noting the importance of common equity).

220. *See supra* notes 120–25 and accompanying text (discussing how Basel III establishes these requirements).

Equity and 2.5% Conservation Buffer).²²¹ Yet, current levels of bank capital show this standard is not particularly imposing.²²²

The results of the Federal Reserve's most recent "stress test," reports that, as of the end of the third quarter of 2012, the largest banks maintain over a 11% ratio of Tier 1 common equity to risk weighted assets.²²³ This easily surpasses the 4.5% Tier 1 Equity requirement and even the overall 7% equity required by Basel III and espoused by the US proposed rules.²²⁴ Therefore, while the new standards emphasize the importance of including common equity into banks' minimum capital levels, they in fact necessitate relatively lax requirements.²²⁵

The Common Tier 1 Equity requirement, unfortunately, is not the only impotent feature of the new standards. Basel III, like Basel II, keeps the overall risk weighted asset ratio at 8%, complex global financial developments notwithstanding.²²⁶ The new agreement and the US proposed rules do, however, include a conservation buffer and a counter-cyclical buffer.²²⁷ This means that a bank may be required to carry at least 13% of capital to risk weighted assets (8% overall capital ratio plus 5% buffers). However, the latest study shows that the largest banks in the United States have already surpassed this capital level.²²⁸ The overall capital ratio for these banks in the third quarter of

221. See *supra* note 143 and accompanying text (explaining how the standards require 7%).

222. See FEDERAL RESERVE STRESS TEST, *supra* note 139, at 16 (displaying a table which notes the levels of bank capital).

223. See *id.* (displaying a table which notes the levels of bank capital); see Eavis, *supra* note 193 ("One measure of capital for the banks, which currently stands at 10.1 percent of assets . . .").

224. See *supra* note 118 and accompanying text (discussing the Basel III common equity tier 1 requirement of 4.5%); Regulatory Capital Rules, *supra* note 108, at 52840 (explaining that the PCA framework was updated to require banks to always have at least 4.5% Common Tier 1 Equity).

225. See *supra* notes 217–24 (explaining that the new standards focus on common equity); *supra* note 223 (noting how banks have already met this requirement).

226. See *supra* note 136 (explaining how Basel III also mandates the same ratio).

227. See *supra* notes 146–56 and accompanying text (discussing these buffers).

228. See *supra* note 223 (noting that the current bank capital levels for the tested banks exceed this requirement).

2012 was over 15%, even higher than all the buffers and minimum capital ratios combined.²²⁹

When evaluated under the new requirements, the latest stress test shows that banks are easily able to meet the new requirements and surpass them.²³⁰ It also means that the new standards, which are supposed to ensure the safety and soundness of banks, are much less rigorous than even what banks currently impose upon themselves.²³¹ In times of easy access to credit, therefore, it is foreseeable that the new requirements may cause the current bank capital levels to decrease to meet the requirements, thus undermining the intent of the heightened ratio.

C. The Minimum Requirements Should Be Set to Those Levels Which Bolster Bank Confidence

The fundamental objective of the capital requirement framework is to protect depositors and avoid bank failure.²³² Bank runs occur when depositors lose confidence in the longevity of a bank.²³³ It would make sense, therefore, to require levels of minimum capital standards that assure depositors that a bank can endure sudden losses. In other words, regulations should require banks to hold enough capital so that the vast majority of depositors will not question the viability of a given bank.

Historically, right after a financial crisis, confidence in banks is at its lowest point.²³⁴ Therefore, banks must remain

229. See FEDERAL RESERVE STRESS TEST, *supra* note 139, at 16 (displaying a table which notes the banks' capital levels). The proposed rules require 13% if all the buffers and ratios are required. See *supra* note 138 and accompanying text.

230. See *supra* note 217–24 (explaining that Basel III introduces new requirements); *supra* note 225 (noting how banks have already met the common equity requirements).

231. Compare *supra* note 143 (explaining that the new requirements requires a 7% common equity ratio), with *supra* note 225 and accompanying text (explaining that banks currently have over a 10% common equity ratio).

232. See *supra* notes 7–12 and accompanying text (explaining the purpose of capital requirements).

233. See *supra* notes 3–6 and accompanying text (explaining bank runs).

234. See Una Okonkwo Osili et al., *Bank Crisis and Investor Confidence*, CTR. FOR ECON. STUDIES, No. 09–02 (2009) (“Decreased confidence in the banking sector can prolong recovery following a crisis and reduce the perceived credibility of post-crisis reforms.”); Felix Rioja et al., *The Long Run Effects of Banking Crisis on Investment*,

adequately capitalized to stay competitive in the market and bolster confidence.²³⁵ That is, even without regulations, the market requires a certain amount of capital.²³⁶ The 2013 Federal Reserve Stress Test study is an indicator of what the market requires when investor confidence is low after a crisis.²³⁷ This can be seen as the real, market-based minimum capital requirement for banks to function in the market place.²³⁸

Therefore, prompt corrective action would be most effective at these levels, where investor confidence is likely to be low enough to threaten the bank's viability. If depositors do not trust the stability of a bank due to its low amounts of capital, the bank may suffer a bank run and fail.²³⁹ The proposed rules mandate that federal agencies enforce the capital requirements when Tier 1 equity falls below 4.5%.²⁴⁰

This is too little too late. By the end of 2008, when many banks were on the brink of failure, banks had Tier 1 Common

ANDREW YOUNG SCHOOL OF POL'Y STUDIES, GA. STATE UNIV., Mar. 2011, at 2 ("Confidence in the banking system can erode with repeated crisis of when the effects are widespread with a country, for example, causing losses on deposits or extensive bank closures."); *see, e.g.*, Gogoi, *supra* note 6 (reporting that a "complete loss of confidence in the financial system" lead the US government to inject "billions of dollars" into the financial system).

235. *See* Elliot, *supra* note 10, at 6 (explaining how the banks had to increase their capital in order to meet investor perceptions of capital adequacy); Tarbert, *supra* note 24, at 773 (explaining that the threat of banks runs encourages "banks to maintain sufficient capital, commensurate with their portfolio risk, to ensure the continued confidence of depositors, thereby avoiding a run on the bank that might put it out of business).

236. *See* Elliot, *supra* note 10, at 6 ("[A]t the turn of 2009 some of the big banks found that investors were deeply concerned about the level of their tangible common equity as a percentage of total assets. Banks could not afford to ignore this perception, even though it was not the primary focus of either regulators or rating agencies, so they took steps to enhance their tangible common equity ratios."); Tarbert, *supra* note 24, at 773 ("Many economists and legal scholars believe that the market alone, not the government, should regulate bank capital.").

237. *See* Elliot, *supra* note 10, at 6 (explaining how the banks had to increase their "tangible common equity as a percentage of total assets" in order to meet investor perceptions of capital adequacy).

238. *See generally* FEDERAL RESERVE STRESS TEST, *supra* note 139 (noting the current amount of capital banks carry); *see also* Tarbert, *supra* note 24, at 773 ("Many economists and legal scholars believe that the market alone, and the government, should regulate bank capital" [insert period]).

239. *See supra* notes 3–6 (explaining how a bank run occurs).

240. *See supra* notes 164–74 and accompanying text (discussing the PCA framework).

equity ratios of just over 5%.²⁴¹ The new PCA framework only *begins* to work when, as the financial crisis has shown, a bank may already be dangerously close to failure.²⁴² Therefore, the PCA framework should be set at levels improve a bank's soundness before depositors have already lost faith. It should require at least 11% of Tier 1 common equity to be "adequately capitalized" because the banks have determined that such levels are what the market requires to bolster confidence after a crisis.²⁴³

Similarly, the minimum overall Basel capital ratio should be raised to at least 14.5%.²⁴⁴ As explained above, the Tier 1 Equity requirement should be increased to the current bank capital levels (*i.e.*, 11% Common Tier 1 Equity).²⁴⁵ If the Tier 1 common equity requirement were raised, this would increase the overall Tier 1 Ratio to 12.5%.²⁴⁶ Tier 2 Capital would still be 2%, meaning that the overall ratio would be 14.5%.²⁴⁷ This requirement would be separate from the conservation buffer of 2.5%.²⁴⁸ In other words, using current bank capital levels as a standard would require a bank to have 11% Tier 1 Common Equity and still maintain its separate 2.5% conservation buffer comprised of common equity, which is an overall total of 13.5%

241. See FEDERAL RESERVE STRESS TEST, *supra* note 139, at 2 (displaying a graph showing these capital levels).

242. See *supra* notes 164–74 (explaining that the agencies only act when a bank is not at least "adequately capitalized").

243. See *supra* note 237–40 (explaining that when investor confidence is low, banks obtain capital levels necessary to bolster investor confidence).

244. See FEDERAL RESERVE STRESS TEST, *supra* note 139, at 16 (noting that the current overall capital levels are approximately 16%).

245. See *supra* notes 234–38 and accompanying text (explaining that bank capital levels should be set to the level apparently required by the market).

246. See *supra* notes 237–43 and accompanying text (explaining that bank levels should be raised to the current capital levels). If the Tier 1 Common equity were to be raised to 11% (instead of 4.5%), this would increase overall Tier 1 Capital to 12.5% (instead of 6%). See *supra* note 118 (explaining that Basel III requires a 4.5% ratio); BASEL III, *supra* note 18, ¶ 50 (explaining that Basel III also allows "Additional Tier 1 capital" for a total ratio of 6%).

247. See *supra* note 246 (explaining how my proposal would result in a Tier 1 Capital ratio of 12.5%); *supra* note 134 and accompanying text (explaining that Basel III allows Tier 2 Capital, bringing the overall (Tier 1 and Tier 2 Capital) to 8% of risk weighted assets).

248. See BASEL III, *supra* note 18, ¶ 129 n.47 (explaining that common equity can only be used for the conservation buffer once it has been used to fully satisfy Tier 1 Common Equity ratio).

common equity. Requiring these amounts would be much more likely to secure financial stability for banks because these levels are more likely to assure depositors that a bank will not fail.²⁴⁹

The requirements this Comment proposes are significantly higher than those contained in the proposed US rules, but given the extended transition period (*i.e.*, the requirements won't be fully in effect until 2019), higher ratios would be a much more meaningful step towards mitigating financial crises.²⁵⁰ Additionally, these ratios would not be the most stringent worldwide. Switzerland's proposed rules, for example, provide for ratios ranging from 19% to 26% for certain banks.²⁵¹ The requirements recommended here are based on what banks have demonstrably been able to obtain in the United States while still achieving growth and fostering a growing economy.²⁵² And these higher levels are keyed to what the market perceives are safe levels after a financial crisis, so they are precisely designed to maintain confidence in the banking system.²⁵³ If the requirements were raised to the levels this Comment suggests, they would meaningfully enhance the US banking regulatory framework and benefit the financial system.

CONCLUSION

The current Basel agreement and proposed rules are a step in the right direction. They increase the total amount of capital banks should carry and are aligned with the US's PCA framework to bolster enforcement. The Basel Agreements suffer, however, from the historical problem of the lack of an international method of enforcement. Similarly, the proposed

249. See *supra* notes 7–12 and accompanying text (explaining how increasing capital requirements benefits depositors).

250. See *id.* and accompanying text (explaining how bank capital helps prevent bank failures).

251. See Katharina Bart, *Swiss Banks Cry Foul Over Capital Rules*, WALL ST. J., May 13, 2011, available at <http://online.wsj.com/article/SB10001424052748703864204576320792058038706.html> (explaining that the legislature is proposing ratios in this range).

252. See FEDERAL RESERVE STRESS TEST, *supra* note 139, at 16 (disclosing the amount of capital banks currently hold); James Politi, *US Economy Grows at Faster Rate of 3.1%*, FIN. TIMES, December 20, 2012, available at <http://www.ft.com/cms/s/0/a1518516-4aac-11e2-968a-00144feab49a.html> (explaining how the United States has grown the most since 2011).

253. See *supra* notes 241–43 and accompanying text (explaining how the market requires a certain amount of capital).

rules are subject to lack of domestic enforcement. Additionally, they actual set capital requirement levels much too low as an empirical matter, as determined by the current level of capital that banks hold. This Comment lays out the Accords and the most crucial parts of the proposed rules, and argues that, although helpful, the new minimums are a pale shadow of what needs to be required in order to have a meaningful impact on depositor safety.

NOTES AND OBSERVATIONS

NOTES AND OBSERVATIONS