The Real and Financial Effects of Basel III

Introduction to a Special Issue of the International Journal of Central Banking

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Following the widespread financial instability of recent years, the Basel Committee on Banking Supervision has put forward reform proposals, commonly referred to as Basel III, to increase the resilience of the banking sector. The reform package is a major overhaul of the current regulatory framework, as it includes a comprehensive set of rules encompassing tighter definitions of capital, improved risk capture, a non-risk-based leverage ratio, a framework for capital conservation and countercyclical buffers, and a novel regime for liquidity risk. In addition, work on the regulatory response to the risks posed by systemically important financial institutions is under way. This issue of the *International Journal of Central Banking* contains papers, discussions, and commentaries that address some of the real and financial effects of Basel III. The papers were presented at the third IJCB Financial Stability Conference hosted by the Bank of England on May 26–27, 2011.

The first paper, "A Pigovian Approach to Liquidity Regulation," deals with liquidity regulation. Enrico Perotti and Javier Suarez use a model in which short-term funding enables credit growth but generates negative systemic risk externalities. They show that a Pigovian tax on short-term funding is optimal when banks differ in credit opportunities. In contrast, when banks differ mostly in gambling incentives, excess credit and liquidity risk are best controlled with a quantity constraint such as a net stable funding requirement. More generally, an optimal policy involves both types of tools. The paper is discussed by Ernst-Ludwig von Thadden.

The second paper—"Macroeconomic Propagation under Different Regulatory Regimes: Evidence from an Estimated DSGE Model for the Euro Area," by Matthieu Darracq Pariès, Christoffer Kok Sørensen and Diego Rodriguez-Palenzuela—examines the economic implications of increasing capital requirements using an estimated euro-area DSGE model with financially constrained households and firms and an oligopolistic banking sector facing capital constraints. The authors show, among other results, that the introduction of more stringent capital requirements (as proposed under Basel III) leads to a transitory negative impact on output, although gradual implementation of the new regulation may smooth out the transitional costs to the economy. The paper is discussed by Andrew Powell.

Some of the implications of capital regulation are also discussed in the third paper, "Capital Regulation and Tail Risk," by Enrico Perotti, Lev Ratnovski, and Razvan Vlahu. These authors analyze how the presence of tail risk affects the relationship between bank capital and bank risk taking. They show that higher capital requirements may have an unintended effect of enabling banks to take more tail risk without the fear of breaching the minimal capital ratio in non-tail risk states. The paper is discussed by Andrew Winton.

The commentary by Richard Herring, "The Capital Conundrum," relates to the paper by Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer entitled "Fallacies, Irrelevant Facts, and Myths in the Discussion on Capital Regulation: Why Bank Equity Is *Not* Expensive," which was presented at the conference but is not published in this issue. He argues that there is a strong case for requiring much higher equity-to-asset ratios and restating these regulatory requirements in terms of proxies for market values rather than relying exclusively on accounting measures.

The last two papers deal with the framework for countercyclical capital buffers. In "Anchoring Countercyclical Capital Buffers: The Role of Credit Aggregates," Mathias Drehmann, Claudio Borio, and Kostas Tsatsaronis investigate the performance of different variables as anchors for setting the level of the countercyclical capital requirements for banks and conclude that a real-time measure of the credit-to-GDP gap is one of the best predictors of the build-up of systemwide vulnerabilities and of the resulting banking crises. In his discussion, Òscar Jordà proposes a formal way of choosing a threshold for this indicator so as to balance the costs and benefits of each alternative.

Finally, in "The Unreliability of Credit-to-GDP Ratio Gaps in Real Time: Implications for Countercyclical Capital Buffers," Rochelle Edge and Ralf Meisenzahl emphasize that ex post revisions of the credit-to-GDP gap in the United States are sizable and often as large as the gap itself and consider the potential costs of this mismeasurement. Simon van Norden discusses the paper and argues that the evidence of ex post revisions is not necessarily relevant for the ex ante use of the indicator.