

## **BASEL RISK-WEIGHTED CAPITAL STANDARDS: HISTORY OF POOR OUTCOMES**

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House Subcommittee on Financial Institutions and Monetary Policy  
The Tangled Web of Global Governance: How the Biden Administration is Ceding Authority  
Over American Financial Regulation

October 24, 2023

Thank you, Chairman Barr, and members of the Subcommittee, for this opportunity to share my views regarding risk weighted capital standards and their role in assuring bank resilience through the business cycle.

In my comments, I will briefly discuss what capital is and its purpose, and will compare the two principal methods—the leverage ratio (LR) versus the RWC ratio—used to judge the relative capital strength of a bank. I will argue that of two methods, the LR is the clearer, better measure.

### **EQUITY CAPITAL AND ALTERNATIVE MEASURES OF BANK SOUNDNESS**

Equity capital, funded by investors who seek a return on their money and accept the risk of loss, is the most stable funding source for the banking industry. Equity cannot run in crisis and unlike debt is not in default if dividends cease; also, equity absorbs losses before depositors and other creditors.

Historically, the LR—the ratio of equity to total assets—has been the market’s first means to judge a bank’s balance sheet strength. It is a simple, understandable, and efficient way to measure ownership’s stake in a bank and the degree to which the bank can absorb losses and remain solvent.

However, starting in the 1980s, with the goal of raising capital levels globally, bank supervisors from the major industrial countries, led by the US,<sup>1</sup> agreed to develop a more risk sensitive international capital

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<sup>1</sup> Ethan Kapstein, “Supervising International Banks: Origins and Implications of the Basel Accord,” in *Essays in International Finance*, No. 185 (Princeton, NJ: International Finance Section Department of Economics, Princeton University, 1991). Kapstein notes that with the banking turbulence of the 1980s, central bankers increasingly used a set of regulatory safety nets the purpose of which was to maintain the soundness of banks and, when necessary, “to keep financial systems functioning in the face of economic shocks.” The pattern of central bank and supervisory intervention and bailouts to achieve these goals had the effect of expanding the moral hazard issue within banking. As a result, Congress instructed US regulators to develop recommendations to address this issue. The Congress subsequently

framework. Rather than rely on the LR, they would assign risk-weights to assets, adjusting the size of the balance sheet around their estimate and judgement of relative risks. A loan, for example, would receive a weight of 1 while government debt would receive a weight well less than 1. A risk weighted capital (RWC) ratio is then calculated as equity relative to risk-weighted assets (RWAs).

## MISALLOCATING RESOURCES AND CREATING ASSET IMBALANCES

I have long criticized the use of the Basel RWC standard. From the start, the RWC framework was politicized and gamed. To get acceptance among nations, risk weights were adjusted for sovereign debt, mortgages, and securitized assets. Models were, and are, arcane, sometimes manipulated, and often implemented differently among countries.

In contrast to the LR, the RWC ratio is complex, difficult to understand, and costly to construct. For example, the recently proposed Basel III Endgame required over a thousand pages to explain, adding to the thousands of Basel instructions already in place. The Endgame's purpose is to tweak the risk-weighted standards to better capture only two sources of risk, market, and operational risks. I wager there are few bank directors who understand its content.

An inherent problem with a RWC standard is that the weights are static, reflect past events, and too often are adjusted by supervisory judgement. This introduces political and special interests into the process misdirects capital and may incorrectly favor one group of assets over another. For example, in the past, low weights were assigned to high-risk sovereign debt, collateralized debt obligations (CDOs), and derivatives, encouraging growth in these assets while discouraging loans on assets assigned higher risk-weights such as commercial and industrial loans.<sup>2</sup>

## RISK-WEIGHTED CAPITAL STANDARD CAN MISLEAD AND CONFUSE

Risk-weighted capital can misinform its user. For example, as of December 2022, the largest US globally systemic banks showed an average RWC ratio of 14 percent, suggesting a highly capitalized industry. However, judging these banks through the prism of their LR of 7 percent suggests greater vulnerability to shocks. In truth, losses can spring from all asset classes. The losses at Silicon Valley Bank came from its government and government-guaranteed bonds, which had low risk-weights, thus requiring relatively little funding using ownership capital. This is an example of why when the industry experiences problems, investors, the public and the regulators turn to the leverage ratio to judge a bank's resilience.

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passed the International Lending Supervision Act (ILSA) of 1983, instructing regulators to require greater capital at US banks, and it encouraged "governments, central banks, and regulatory authorities of other major banking countries to work toward . . . strengthening the capital base of banking institutions involved in international lending." Kapstein noted that Congress had concluded that if US banks were going to be required to raise capital, it should be done on a multilateral rather than a unilateral basis. As US regulators began international capital adequacy discussions, it modeled the proposed framework after the risk-weighted system already in place at the Bank of England. It is unclear whether any side-by-side comparison was made between the risk weighted approach and the leverage ratio.

<sup>2</sup> For instance, Stephen Matteo Miller and Blake Hoarty show that increasing risk-based capital requirements creates incentives for banks to hold more low risk-weight assets, such as Treasury securities and reserves, instead of high risk-weight assets, such as loans, whereas increasing the leverage ratio affects primarily bank funding decisions rather than bank asset allocations. See Stephen Matteo Miller and Blake Hoarty, "On Regulation and Excess Reserves: The Case of Basel III," *Journal of Financial Research* 44, no. 2 (2021): 215–47. Therefore, apparent reductions in lending may be due to risk-based capital, rather than to the leverage ratio, given that risk-based capital requirements tend to have higher risk weights for loans than many other classes of securities, whereas the leverage ratio does not.

The leverage ratio will not end bank failures. However, it will enhance market discipline as it reveals ownership's stake in the success of a bank, and how much loss a bank can absorb and remain solvent.

## **EMPIRICAL EVIDENCE IN FAVOR OF THE LEVERAGE RATIO AND HIGHER EQUITY CAPITAL FOR BANKS**

Finally, there is a good amount of research indicating that leverage ratio performs better than the RWC ratio in judging a bank's soundness.<sup>3,4</sup> For example, Andrew Haldane, formerly at the Bank of England, provided an analysis comparing the performance of the LR to the RWC ratio in judging bank financial strength around the time of the 2008 crises. He noted two conclusions: first, the leverage ratio was more informative about bank resilience; and second, banks with higher equity capital performed consistently better through the business cycle.<sup>5</sup>

## **SUMMARY**

In summary, US bank supervisors should abandon the risk-weighted capital framework. The leverage ratio, while imperfect, is a more useful tool.

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<sup>3</sup> Jonathan Pogach, "Literature Review on the Macroeconomic Impacts of Capital Requirements," FDIC Division of Insurance and Research, 2026, <https://www.fdic.gov/about/learn/board/hoenig/2016-05-12-lr.pdf>.

<sup>4</sup> See, for example, James Barth and Stephen Matteo Miller, "Benefits and Costs of a Higher Bank Leverage ratio," *Journal of Financial Stability* 38 (October 2018): 37–52.

<sup>5</sup> Andrew G. Haldane, "The Dog and the Frisbee" (address at Federal Reserve Bank of Kansas City's 366th economic policy symposium, "The Changing Policy Landscape," Jackson Hole, Wyoming, 31 August 2012), <http://www.bis.org/review/r120905a.pdf>.