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# The Efficiency Wage Hypothesis and Monetary Policy Channels of Transmission: Developments and Progress of Basel III Leverage Ratios


ABSTRACT

It is argued that " the ascendency of the emerging economies changed the relative returns to labor and capital – and that because these economies' global integration has made labor more abundant, workers in developed countries have lost some of their bargaining power – thus putting downward pressure on real wages."

Central bankers' misunderstanding of certain monetary implications have also been highlighted in that by keeping interest rates too low, they allowed a build up of excess liquidity which flowed into the prices of assets such as homes – contributing to the build up leading to the 2007-2009 global Financial Crisis.

The introduction of the 2010 Basel III leverage ratios was intended not only to address shortcomings of the previous Basel capital framework, but also intended to serve as a complement to the risk based capital adequacy framework. However, as with many implementation challenges, other issues which involve calibration between the risk based and leverage based frameworks continue to constitute areas of concern for regulators – and supervisors. So also matters relating to disclosures – as evidenced by ongoing initiatives in respect of Pillar 3.

This paper aims to highlight progress and developments being made since 2010 – as well as accentuate challenges still being encountered by the leverage based framework. Herein lies the importance of continued collaborative efforts aimed at facilitating comparability, consistency, understanding and communication between national and federal regulators and supervisors from different jurisdictions – in efforts aimed at realizing Basel III initiatives and objectives. Herein also lies increasingly greater roles for forensic accountants and computer forensics in an increasingly digital economy.


Key words: monetary policy, leverage ratios, risk based capital adequacy measures**,** disclosures, computer forensics, digital economy, forensic accountants

# The Efficiency Wage Hypothesis and Monetary Policy Channels of Transmission: Developments and Progress of Basel III Leverage Ratios

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## Introduction

In addressing challenges presented by globalization - particularly as a result of the failure of central banking to appreciate fully the consequences and impact – as well as contribution of emerging economies to all time low levels of inflation, as evidenced by repercussions and lessons drawn from the 2008 Financial Crisis, Basel III regulations – and in particular, Basel III leverage ratios were introduced.

- *An underlying feature of the financial crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while maintaining strong risk-based capital ratios. At the height of the crisis, the market forced the banking sector to reduce its leverage in a manner that amplified downward pressure on asset prices. This deleveraging process exacerbated the feedback loop between losses, falling bank capital, and shrinking credit availability* (BCBS, 2013:4).

Whilst further progress continues to be made in respect of the introduction and implementation of Basel III regulations, it is evident that calibration issues and risk weighting factors – coupled with other aspects of Basel III – both in respect of the recently introduced liquidity and leverage ratios, namely maturity transformations and excessive leverages, will also continue to constitute factors which generate risk considerations.

This is evidenced by recent remarks (BIS: 2016)[2]:

*"Monetary policy, by setting the universal price of leverage in a given currency, will influence not only monetary stability but also financial stability. It may therefore be the most effective way to get into "all of the cracks" not reached by regulation and supervision. Moreover, monetary policy also has the potential to increase the risk-taking of investors and financial institutions, thereby affecting economic activity…………. And this idea has gained recognition in recent years. This risk-taking can also involve excessive leverage and maturity transformation, as well*

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[2] In which it is also highlighted that "present monetary policy frameworks do not give enough consideration to the build-up of financial imbalances and that they focus too narrowly on near-term price and output stabilization."

*as imprudent exposures to credit and exchange rate risk. In this respect, the very transmission mechanisms of monetary policy can increase vulnerabilities and reduce resilience. And so, the risk-taking channel generally ties monetary and financial stability together quite closely."*

**Addressing Monetary Policy Mechanisms: Criticisms of the Consultative Document Revised Basel III Leverage Ratio Framework**

It is argued that " the ascendency of the emerging economies changed the relative returns to labor and capital – and that because these economies' global integration has made labor more abundant, workers in developed countries have lost some of their bargaining power – thus putting downward pressure on real wages."[3]

Monetary policy, it is further added, " needs to be revamped." In this regard, it is contended that central bankers have been aided tremendously by emerging economies in addressing inflation through:

- Pushing down the prices of many goods – as well as,
- Through restraining wages in developed countries.

However, two consequences of central bankers' misunderstanding of monetary implications are also accentuated (2006:10):

i) Their misunderstanding of the monetary implications of a positive supply shock: that by keeping interest rates too low, they have allowed a build up of excess liquidity which flowed into the prices of assets such as homes – rather than into traditional inflation – thus encouraging too much borrowing and too little saving. A phenomenon which is also considered to have contributed to contribute to the current account deficit in America.

ii) That central banks' mistake as highlighted under (i), is further compounded by the emerging economies' refusal to allow the exchange rates to rise – piling up foreign exchange reserves instead."

According to a report by the Federal Reserve, the following arguments were provided in support of the need for revisions to the Basel Leverage Ratios (2013:16,17):[4]

[3] The Economist, "Surprise, The Power of the Emerging World" 2006

[4] Federal Reserve, 'Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions' pages 16 and 17

- BCBS's approach for determining the minimum level of the Basel III leverage ratio was different than the calibration approach described above for the risk-based capital ratios.

- The BCBS used the most loss-absorbing measure of capital, common equity tier 1 capital, as the basis for calibration for the risk-based capital ratios, but not for the Basel III leverage ratio. In addition, the BCBS did not calibrate the minimum Basel III leverage ratio to meet explicit loss absorption and market confidence objectives as it did in calibrating the minimum risk-based capital requirements and did not implement a capital conservation buffer level above the minimum leverage ratio. Rather, the BCBS focused on calibrating the Basel III leverage ratio to be a backstop to the risk-based capital ratios and an overall constraint on leverage.

- The agencies believe that while the establishment of the Basel III leverage ratio internationally is an important achievement, further steps could be taken to ensure that the risk-based and leverage capital requirements effectively work together to enhance the safety and soundness of the largest, most systemically important banking organizations.

Other criticisms of the Consultative Document Revised Basel III Leverage Ratio Framework and Disclosure Requirements in June 2013 (the "2013 Consultation"), which according to Shearman and Sterling (2014), is considered to have been met with opposition, particularly from banks involved in the securities and derivatives markets – given the fact that "the 2013 Consultation did not permit the netting of securities finance transactions and did not allow collateral to reduce derivatives exposures – with some banks fearing the need to raise billions in extra capital to meet the proposed leverage limit", are as follows (see pages 2 and 3):

- Measures were over-zealous to the extent that they increased the leverage ratio significantly beyond actual economic exposures. That the imposition of a considerably larger exposure measure as the denominator would result in the leverage ratio, rather than the Basel III risk-based capital measure, becoming effectively the only minimum capital requirement for a significant number of banks.

- Incentives to Hold a Higher Proportion of Riskier Assets

- Tension with the Liquidity Coverage Ratio ("LCR")

- Overstating Actual Economic Exposure ("Double Counting")

**Progress on Adoption of Basel III Standards**

According to the Twelfth Progress Report on adoption of the Basel regulatory framework, the April 2017 BIS REPORT, the following aspects of the risk-based capital standards are still being implemented:

- Countercyclical buffer: The countercyclical buffer is phased in parallel to the capital conservation buffer between 1 January 2016 and year-end 2018, becoming fully effective on 1 January 2019.

- TLAC holdings: The TLAC holdings standard was issued by the Committee in October 2016. It applies to all banks and describes the prudential treatment for holdings of instruments that comprise TLAC for the issuing G-SIB. The standard will take effect from 1 January 2019.

- Minimum capital requirements for market risk: In January, the Committee issued the revised minimum capital requirements for market risk, which will come into effect on 1 January 2019.

- Capital requirements for equity investment in funds: In December 2013, the Committee issued the final standard for the treatment of banks' investments in the equity of funds that are held in the banking book, which took effect from 1 January 2017.

- SA-CCR: In March 2014, the Committee issued the final standard on SA-CCR, which took effect on 1 January 2017. It replaced both the Current Exposure Method (CEM) and the Standardized Method (SM) in the capital adequacy framework, while the IMM (Internal Model Method) shortcut method is eliminated from the framework.

- Securitization framework: The Committee issued revisions to the securitization framework in December 2014 and July 2016 to strengthen the capital standards for securitization exposures held in the banking book, which will come into effect in January 2018.

- Margin requirements for non-centrally cleared derivatives: In September 2013, the Committee issued the final framework for margin requirements for non-centrally cleared derivatives. Subsequently, in March 2015, the Committee published a revised version. Relative to the 2013 framework, the revised version changes the beginning of the phase.

- Capital requirements for bank exposures to central counterparties: In April 2014, the Committee issued the final standard for the capital treatment of bank exposures to central counterparties. These came into effect on 1 January 2017.

The first consultative paper on a new capital adequacy framework, which was issued by the Basel Committee on Banking Supervision, introduced the „three pillar“ model which encompasses the minimum capital requirements, supervisory review and market discipline - „as a lever to strengthen disclosure and encourage safe and sound banking practices.“[5]

In respect of Pillar 3 disclosure requirements and based on the Twelfth Progress Report on adoption of the Basel regulatory framework, the April 2017 BIS REPORT (see page 3), in January 2015, the Basel Committee issued the final standard for revised Pillar 3 disclosure requirements, which took effect from end-2016.[6] The standard supersedes the existing Pillar 3 disclosure requirements first issued as part of the Basel II framework in 2004 and the Basel 2.5 revisions and enhancements introduced in 2009.

## Conclusion

How relevant is the Efficiency Wage Hypothesis - as well as other theories relating to firm performance in addressing monetary policy mechanisms and transmission channels? Inflation persistently constitutes a topic and embodiment of issues which still remain puzzling for many economists. Whilst it is clear that there is no silver bullet in addressing historically low inflation levels, it is also evident that an interdisciplinary perspective – as well as one which embraces empirical, canonical and theoretical models of research, will all be required to address the long standing mysteries of monetary policy dynamics.

The importance and significance of the introduction of the Basel III leverage ratios in the aftermath of the 2007-2009 global financial crisis, coupled with challenges which have been encountered through the implementation of such ratios, also highlights the growing importance of measures and experts – such as accountants, within the context of increasingly digitalized economies. Accurate and reliable measures which account for off balance sheet items and exposures – as well as economic exposures, surely are priceless resources for central bankers, bank regulators and supervisors in their bid, efforts and initiatives to realize Basel III goals and objectives.

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[5] Basel Committee on Banking Supervision, 'Consultative Paper on a New Capital Adequacy Framework' 3rd June 1999 http://www.bis.org/press/p990603.htm>

[6] “Banks are required to publish their first Pillar 3 report under the revised framework concurrently with their year-end 2016 financial report.”

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