PROPOSAL FOR CAPITALIZATION
OF BANKS EXTRAORDINARY PROFITS

Author Javier Bolzico

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I. Introduction

Since the 2007-2009 international financial crisis, the community of regulators and analysts has been working on a proposal to change the existing financial regulations in order to prevent such a crisis from happening again. One of the conclusions derived from the analysis of the crisis is the need to strengthen banks' capital position, especially in normal times or in times of rapid economic growth. These measures fall within the framework of what is known as "macroprudential policies."

Among the proposals aimed at strengthening capital, three documents prepared by the Basel Committee on Banking Supervision (BCBS) are worth mentioning:

- *Strengthening the resilience of the banking sector*. Consultative Document. December 2009.
- *Countercyclical capital buffer proposal*. Consultative Document. July 2010.
- *Calibrating regulatory minimum capital requirements and capital buffers: a top-down approach*. October 2010.

The first document sets out, among several proposals tending to improve the calibration of the minimum capital requirements in the three Basel II pillars, the requirement for financial institutions to maintain capital buffers additional to the regulatory minimum, which should be built by retaining part of the earnings. The objective of these capital buffers is to introduce a countercyclical capital measure that will contribute to a more stable financial system. The document sets forth a proposal for a conservation capital consisting in additional capital to be drawn upon in periods of stress. Additional capital is defined as the percentage above the regulatory minimum. The document also provides guidelines for another buffer—a countercyclical buffer consisting in building up capital during periods of excess credit growth.

The second document contains a detailed proposal for creating a countercyclical capital buffer. This buffer is additional and supplementary to the capital conservation buffer. The document proposes the introduction of a buffer additional to the capital conservation buffer during periods of excess credit growth associated with increased risk.

The third document lays down the rationale for calibrating the capital buffers based on historical experience and stress testing.

The two capital buffer proposals represent an improvement towards achieving higher capitalization levels and strengthening financial institutions and systems, over current regulations that only impose minimum capital requirements. These proposals do not mean, however, that once the capital buffers have been built up banks cannot distribute earnings from risky transactions that may result in losses in the following years.

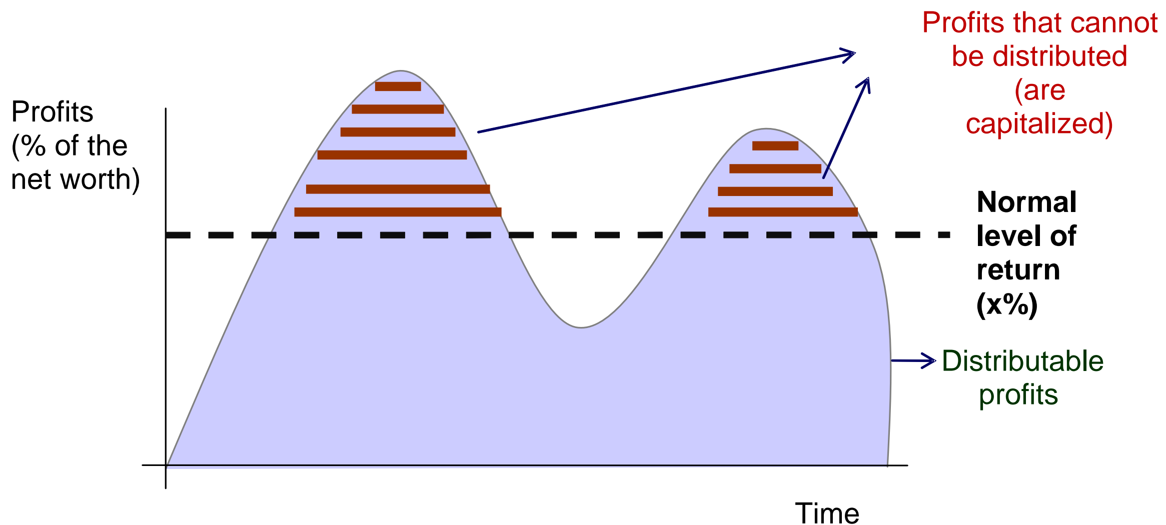
The present proposal aims at preserving the strength of intermediary institutions' balance sheets, restricting the distribution of extraordinary profits from their operations, in the belief that such profit comes from transactions that may result in losses in the following years. It

partially supplements the abovementioned proposals and, at the same time, speeds up compliance with them.

II. The proposal

It is proposed that the regulatory framework require financial intermediaries to capitalize extraordinary profits, where "extraordinary" means profits above normal or ordinary levels. Profits exceeding the level defined as normal by national regulators cannot be distributed to the shareholders and must be booked as capital reserve.[1]

Chart 1: Capitalization of extraordinary profits



III. Rationale of the proposal

The proposal is based on the fact that extraordinary profits are usually associated with extraordinary risks that may materialize in the following years, or with ways of intertemporally allocating income and expenditure in bank balance sheets. Thus, a prudential measure is to **request banks not to distribute profits that exceed the returns considered as "normal," in the belief that such profits may be associated to**

[1] A more flexible alternative would be, instead of requiring profit capitalization, to have institutions retain earnings for a certain period of time (e.g., five years), after which the supervising authority could authorize their distribution should the institution be appropriately capitalized.

future losses. In fact, empirical evidence shows that it is common for banks facing solvency problems to have previously experienced a period of extraordinary profit.

Importantly, this measure does not have a negative impact on ownership rights or the value of shares, since capitalized profits still belong to shareholders (which should be reflected in the value of traded shares).

IV. Advantages of the proposal

The abovementioned proposal offers the following advantages:

- **The capitalization level of banks conducting riskier operations is increased.** Banks making extraordinary profits generally take more risks; this proposal requires those banks to capitalize part of their earnings in addition to the general capital requirements.
- **Bank balance sheet strength is favored.** Mandatory capitalization of extraordinary profits, even for banks meeting the minimum capital requirements, tends to strengthen the balance sheet of institutions making such extraordinary profits. At the same time, it prevents bank balance sheets from weakening due to the distribution of all profits.
- **Excessive risk taking is discouraged.** Unable to distribute extraordinary profits—associated to higher risk—, institutions are discouraged to engage in riskier transactions to obtain such profits.
- **Damage to prudential banks is prevented.** Limiting the distribution of extraordinary profits by riskier and more aggressive banks prevents prudential banks from being competitively affected—through a reduced distribution of earnings.
- **Creative accounting to generate artificial profits and "bonuses" is discouraged.** Incentives to manipulate accounts in order to show extraordinarily high profits are reduced, since such profits cannot be distributed and shareholders are therefore unwilling to approve payment of extraordinary bonuses.
- **Ordinary income distribution is not affected.** This proposal, unlike others dealing with capital strengthening, only affects extraordinary profits—rather than ordinary income—distribution.

V. Definition of "normal" or "ordinary" profits

In order to implement this proposal, regulators have to define the "normal" or "ordinary" level of profitability above which earnings cannot be distributed and must be capitalized. Each regulator would be responsible for setting periodically the "normal" level. The proposal design should take into account incentives for institutions to potentially engage in regulatory arbitrage, reducing extraordinary profits (e.g., anticipating expenditures for the next fiscal year) to effectively distribute earnings.

The methodology for determining the “normal level” is beyond the scope of this document. For illustrative purposes, however, below are some of the methods that could be used to that end:

- To take as point of reference banks’ risk-adjusted borrowing rates on long-term deposits and for amounts exceeding insured deposits, considering that such rates represent market-expected bank returns.
- To take as a floor the return on sovereign bonds of each country (considering that such return is the risk-neutral rate or the best risk-adjusted return in each country) adding a “banking risk premium.”
- To take the average (current or historical) financial system return.
- To calculate an “appropriate” risk level linked to the activity and the return associated to that risk.
- Others as may be defined.

VI. Conclusions

Mandatory capitalization of extraordinary profits is a macroprudential measure that will contribute to higher financial system capitalization and to capital allocation based on the risk run by each institution. This will help to improve risk management and provide greater stability to the financial system.

VII. References

- Basel Committee on Banking Supervision. *Strengthening the resilience of the banking sector.* Consultative Document. December 2009.
- Basel Committee on Banking Supervision*. Countercyclical capital buffer proposal* Consultative Document. July 2010.
- Basel Committee on Banking Supervision *Calibrating regulatory minimum capital requirements and capital buffers: a topdown approach*. October 2010.