

Impact of Higher Capital Adequacy Requirements for Banks: Evidence from BRICS

The global financial crisis (GFC) of 2008 imposed huge costs on the economies which are unwinding to date. After the collapse of Lehman Brothers, the regulators were confronted with difficult questions, which led to the G-20 leaders to agree on a comprehensive set of prudential norms to increase the resilience of the banking systems. The central component of these reforms is raising capital requirements.

Theoretically, the benefits of higher capital adequacy requirements are manifold; it helps in building a strengthened and more resilient financial system which can reduce the frequency of financial crisis and the related cost of such crisis. Given the historical frequency of crises in BRICS, one may think that the benefits would be limited. However, the growing importance of BRICS on the global platform, along with the growing interconnectedness among economies, the exposure to potential shocks will only increase. Thus, it is in the interest of all the five economies to implement the new regulatory norms to build a more resilient financial system.

The literature mostly considers the costs and benefits of the higher capital adequacy norms for the developed economies like the United States, the United Kingdom, and other OECD countries. However, it is equally crucial for BRICS economies to weigh the benefits of these norms on the economy against the potential costs.

This study fills the gap in the literature by estimating the impact of higher capital adequacy requirements for each of the BRICS economies, standalone. The conceptual framework of estimating the costs and benefits for each of the BRICS economies is closely aligned with the Long Term Economic Impact (LEI) study by the Basel Committee on Banking Supervision (BCBS). The impact is estimated as the amount (in percent) of GDP saved by increasing the capital requirements. The findings are then validated by a structured questionnaire,

administered on the banking experts who have been closely involved in the process of Basel implementation at their banks.

This research, delves deeper into the impact of higher capital adequacy requirement on the credit risk (risk in the loan portfolio of banks), which has been termed as the prime contributor to the systemic banking crisis in the past episodes of crises. A further disaggregation on the basis of ownership and accounting for the GFC is also done.

The main findings of this study indicate that the net benefits of higher capital adequacy requirements outweigh the costs for all the BRICS economies; however, the benefits for Brazil and Russia are substantially higher. Also, a strong monetary policy of an economy can play a role in controlling the costs of higher capital for the economy. The survey results also establish that higher capital norms will increase the stability and resilience of the banking sector. The survey also gauges the opinion of experts on the indirect impact of these norms, along with the critical success factors in the process of implementation. Finally, the results of the empirical analysis establish a positive relationship between capital norms and credit risk.

The study has important implications for academia and policymakers. While it enriches the existing body of knowledge with new findings and evidence for the academia, for the policymakers, it suggests that a more conservative approach results in a lower probability of a crisis. It is also suggested that there is enough room to increase the capital requirements above the regulatory ratios as the net impact will still be positive. To the best of the author's knowledge, the study has made a novel attempt to assess the impact of each of the BRICS economies separately along with collecting the invaluable insights from the banking experts about the implementation process.