IMPROVING THE BASLE COMMITTEE'S NEW CAPITAL ADEQUACY FRAMEWORK

Joint Statement by a sub-group of the Shadow Financial Regulatory Committees of Europe, Japan, and the U.S.

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The Basle Committee's proposed reforms of international bank capital standards suggest an increasing reliance on commercial credit ratings and internal bank risk ratings. These reforms, although laudable in intent, do not adequately address fundamental weaknesses in the existing system for setting prudential capital standards. We offer criticisms of the proposed reforms and suggest a new direction for improving minimal regulatory standards for capital. Among other things, we recommend supplementing the existing framework with a minimum subordinated debt requirement as a means to bring market discipline to bear on bank risk and capital management.

On June 3, 1999 the Basle Committee on Banking Supervision issued a proposal for a new capital adequacy framework for internationally active banks. The 1999 proposal is particularly intended to replace the 1988 Basle Committee Accord on credit risk.

The reason for this overhaul is that the 1988 Accord has some fundamental drawbacks. As is phrased by the Basle Committee itself: "The current risk weighting of assets results, at best, in a crude measure of economic risk, primarily because degrees of credit risk exposure are not sufficiently calibrated as to adequately differentiate between borrowers' differing default risks. Another related and increasing problem with the existing Accord is the ability of banks to arbitrage their regulatory capital requirement and exploit differences between true economic risk and risk measured under the Accord. Regulatory capital arbitrage can occur in several ways, for example, through some forms of securitization, and can lead to a shift in banks' portfolio concentrations to lower quality assets".

In its June 1999 paper, the Basle Committee proposes replacing the existing system of credit risk weightings by a system that would use commercial agencies' credit assessments for determining risk weights. The Committee is also considering allowing 'sophisticated banks' to use their internal ratings of loans as a basis for setting regulatory capital charges. Moreover, as a potential future successor for the internal ratings, the Committee intends to investigate whether sophisticated banks could be allowed to use credit-risk portfolio models for calculating regulatory capital requirements. With respect to the definition of regulatory capital and the minimum required capital ratio, the Committee maintains at this stage the existing rules of the 1988 Accord.

An analysis of the existing Basle standards, and the proposed reforms, can be usefully divided into four parts:

1. The measurement of bank portfolio risk;
2. The measurement of bank capital;
3. The establishment of minimal standards for capital relative to risk; and
4. The role of market discipline in influencing bank capital and risk choices.

Measuring Bank Portfolio Risk

With respect to the measurement of risk, in constructing the new risk weights, the Basle Committee's proposal places new reliance on the assessments of commercial agencies' credit ratings and internal bank risk ratings. The goal is laudable - to move away from arbitrary, categorical measures of risk, but in practice neither commercial rating agencies, nor internal risk ratings are reliable regulatory tools.

While the use of commercial credit ratings to measure loan risk is a move toward rationalization of risk weights, it still keeps in place the crude additive approach to measuring the risk of a portfolio. Futhermore, the risk weights are not derived from the private ratings in a consistent manner; entities with similar default risks and ratings are given different risk weights. Moreover, increasing the reliance on ratings for setting prudential standards in bank regulation creates an incentive for ratings agencies to serve the interest of the *borrowers* being rated, and thus subverts the original purpose credit ratings were intended to serve.

The move toward greater reliance on self-measurement of risk also could be an improvement, but only if credible penalties could be levied on banks if they consistently underestimate their risk. The problem here is the credibility of such penalties because it may be difficult (politically and economically) to penalize banks when they suffer losses and thereby become undercapitalized, particularly as long as information about bank compliance remains solely in the hands of the regulators. When information about internal risk management is not made public, and when the determination of the reasonableness of bank risk estimates remains in the hands of bank regulators, the possibility of regulatory forbearance must be considered a distinct possibility.

Measuring Bank Capital

Although the Basle Committee does not propose changes in its definition of capital, we believe some significant improvements are possible. Improving bank accounting practices by moving to a market-based method of accounting for assets and liabilities would provide a measure of capital that more meaningfully reflects banks' economic condition.

We also believe that the definition of capital should be revised. The current standards discriminate against the use of subordinated debt in satisfying capital requirements. Subordinated debt can provide a credible buffer against losses to depositors (or deposit insurers) if it is not protected from the risk of loss, and in this sense it can serve as an adequate substitute for equity capital. Indeed, as we argue below, it is desirable to mandate a minimum proportion of credibly unprotected subordinated debt as part of a bank's capital adequacy requirement.

Establishing Minimal Standards for Risk-Based Capital

The Basle Committee does not propose any changes in the ratio of capital to risk-adjusted assets, but again we believe changes are warranted. One question to consider is whether the current level of capital relative to risk-weighted assets is appropriate. Historical evidence on bank capital structure, as well as evidence on how banks and other financial institutions today choose capital ratios when they are subject to market discipline, suggests that minimum capital ratios should be higher than those currently in place.

Another question is whether it might be desirable for a simple leverage ratio to replace a risk-based capital ratio as the regulatory minimum. Insofar as both approaches mismeasure asset risk, both create potential distortions. Distortions in bank decision making occur when regulatory constraints determine a bank's choice of capital (that is, when bank capital ratios reflect regulatory requirements rather than market requirements). Inaccurate risk weights offer opportunities to arbitrage risk standards. It is not obvious whether it is more distortionary to set uniform (and, therefore, necessarily inaccurate) risk weights (as in a simple leverage requirement) or to set varying (but also inaccurate) risk weights. To the extent that risk varies across loans, and to the extent that risk weights capture much of that variation, it may be desirable to maintain a capital standard based on regulatory risk weights. While it is hard to judge which approach is better in general, we believe that either a simple leverage requirement, or the Basle Committee's proposed changes in the calculation of risk weights would be superior to the current system.

Enhancing and Harnessing Market Discipline

Given the inadequacies of the current standards, and the Basle Committee's proposed reforms, for ensuring accurate measurement of risk and capital, and an adequate amount of capital, we propose supplementing the Basle Committee's capital standards with an additional subordinated debt requirement. This requirement would ensure a continuing market assessment of the extent of bank portfolio risk and capital, and the use of market assessments to enforce effective regulatory capital standards. The Basle Committee's reform proposal also recognizes the desirability of enhancing market discipline to influence bank risk and capital management, but does little to enhance market discipline.

The uninsured debt requirement could act as an important mechanism for enhancing market discipline, both to banks as well as regulators. If a bank suffered losses of asset value and/or faced increases in asset risk, uninsured debt holders would discipline the bank by raising yield spreads or inducing the bank to act in credible ways to reduce asset risk or raise equity. Uninsured debt holders have powerful incentives to act as risk disciplinarians of banks. Contrary to equity holders, they hold a fixed income claim and are not entitled to share in upside gains. Increased asset risk may benefit shareholders of insured banks when capital is low or negative, but more asset risk always hurts uninsured debt holders because high risk increases the probability of their not being fully repaid.

Informed market opinion, such as those revealed in yield spreads on credibly uninsured debt, could provide a reliable measure of overall bank risk on which to base regulatory guidelines. Yield spreads on uninsured debt could provide a basis for determining deposit insurance premia, where such deposit insurance systems exist. Also, yield spreads could serve as triggers for regulatory interventions to restrict bank risk taking. To avoid regulatory forbearance those interventions should be based on clearly established principles and rules, commonly referred to as ‘structured early intervention and restructuring’ or ‘prompt corrective action’.