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Statement of the Shadow Financial Regulatory Committee

On

Revising the Basle Capital Standards

April 26, 1999

Approximately a decade ago, the Basle risk-based capital guidelines went into force in the G-10 countries; the forthcoming meeting of the Basle Committee, scheduled for New York in June, provides an opportunity for an appraisal of the effectiveness of the guidelines in reducing bank risk-taking.

Since their adoption, the guidelines have been criticized for creating generalized risk categories, unrelated to the actual risks of particular bank assets. It is simply not true, for example, that all commercial loans are equally risky, or that all OECD countries' sovereign debts are of the same quality, and there is no evidence that residential mortgages are 50 percent as risky as commercial loans. Yet the guidelines mandate the computation of risk-based capital using exactly these assumptions. Over the years, the Basle Committee itself has recognized many of these shortcomings but has found it difficult to overcome them.

More broadly, what many may have failed to note is that risk-based capital guidelines create incentives that may be inimical to sound and prudent banking—incentives that cannot be suppressed by even the most effective supervision. It is generally acknowledged, for example, that one of the causes of the recent international financial crisis was excessive and imprudent short-term lending by banks in developed countries to their counterparts in the developing world. The fact that the Basle guidelines place a risk weight of only 20 percent on such loans certainly contributed to this problem.

The Basle Committee is reported to be considering relatively minor changes in the guidelines—increasing the risk weights for certain categories, and relating them to credit ratings where these are available. Our concern is that they are simply attempting to fine tune a mechanism that has some fundamental flaws. It is not possible for regulators to devise a formula that accurately reflects the risks that a bank has assumed, and efforts to do so may actually induce banks to make less prudent decisions. Moreover, continuing refinements of the guidelines will always lag developments in the rapidly changing financial marketplace.

The principal and defining defect of the Basle risk-based guidelines is that, because they necessarily mismeasure the true risk of banks' positions (as the market would measure them), they are and always will be essentially arbitrary, reflecting nothing more than the best guess of bank supervisors at a given point in time. As such they do not encourage prudence so much as they distort incentives.

The Shadow Committee is developing a white paper that will be presented at a New York conference on June 14, and submitted thereafter to the Basle Committee. The principal thrust of this proposal will be to introduce market discipline into the mix of regulatory policies that are intended to limit excessive bank risk-taking. Incorporating market-based measures of bank risk into prudential regulatory standards is essential.