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Statement of the Shadow Financial Regulatory Committee

On

The Basel Committee's New Capital Adequacy Framework

In June 1999 the Basel Committee on Banking Supervision issued a proposal for a new capital adequacy framework for internationally active banks. It is intended to replace the 1988 Basel Committee Accord on credit risk.

The Basel Committee's discussion of its proposal recognizes the desirability of influencing bank risk and capital management by enhancing market discipline, but makes no recommendations that would have this effect. We offer criticisms of the proposed reforms and suggest a new direction for improving minimal regulatory standards for capital.[1] Among other things, we recommend supplementing the existing framework with a minimum subordinated debt requirement.

The Basel Committee recognizes that the 1988 Accord has some fundamental drawbacks:

> 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

[1] This statement expands on the Joint Statement on the same topic issued on June 14, 1999 by the Shadow Financial Regulatory Committees of Europe, Japan and the United States.

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 addition, it has been widely recognized that the current standards encouraged excessive lending by international banks to Asian banks -- and thus helped lay the foundation for the Asian financial crisis -- by providing for only a 20 percent risk weight on such loans.

The Basel Committee's proposal replaces the existing system of credit risk weightings with a system that uses rating agencies' credit assessments to determine risk weights. The Basel Committee is also considering allowing, at some future time, 'sophisticated banks' to use their internal ratings of loans as a basis for setting regulatory capital charges. Moreover, as a potential successor for the internal ratings systems, the Basel Committee intends to investigate whether these sophisticated banks could use credit-risk portfolio models for calculating regulatory capital requirements. The Basel Committee does not propose any changes to the definition of regulatory capital, and intends that the new framework should "at least maintain the current overall level of capital in the system."

An analysis of the existing Basel 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

In constructing new risk weights, the Basel Committee's proposal places new reliance on the assessments of external agencies' credit ratings and, in the future, on internal bank risk ratings. The goal of moving away from arbitrary, categorical measures of risk is laudable; but, in practice, neither commercial rating agencies nor banks' internal risk ratings are reliable regulatory tools.

The proposal appears to make progress by increasing the number of risk categories and using commercial credit ratings to rationalize the risk weights. However, the proposal still rejects measuring required capital based on a bank's entire portfolio, and instead incorrectly maintains the current approach of simply adding up the capital required for individual asset categories. Furthermore, the proposed risk weights would not be derived from private ratings in a consistent manner, as entities with similar default risks and ratings are given different risk weights and vice versa. 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 – providing assessments to investors.

The move toward greater reliance on banks' self-measured risks could be an improvement, but only if credible penalties could be levied on banks that consistently underestimate their risk. However, it is likely to be politically and economically difficult for government agencies to penalize banks when they suffer losses and become undercapitalized, particularly when information about bank compliance remains solely in the hands of the regulators. Therefore we urge that information about banks' internal risk management and the regulators' determination of the reasonableness of bank risk estimates be made public. If this is not done, regulatory forbearance is likely.

Measuring Bank Capital

Although the Basel Committee does not propose changes in its definition of capital, we believe some significant improvements should be made. In particular, for regulatory purposes, banks should adopt market-based accounting for assets and liabilities, which would provide a measure of capital that more meaningfully reflects their 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 (properly structured) can provide a credible buffer against losses to depositors (or deposit insurers) because it is not protected from the risk of loss. In this sense, it can serve as a substitute for equity capital. Indeed, as we argue below, a minimum proportion of credibly unprotected subordinated debt should be mandated as part of a bank's capital adequacy requirement. Accordingly, we favor removing the distinction between Tier 1 and Tier 2 capital.

Establishing Minimal Standards for Risk-Based Capital

The Basel Committee does not propose any changes in the ratio of capital to risk-adjusted assets. We believe a higher ratio is warranted. 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 the current minimum capital ratios should be increased to mirror the capital ratios that banks would hold in the absence of government deposit guarantees.

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 bank capital ratios reflect regulatory rather than market requirements. Risk weights offer regulators opportunities to manipulate credit flows and inaccurate risk weights offer banks 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. While it is hard to judge which approach is better, we believe that either a simple leverage requirement or the Basel Committee's proposed changes in the calculation of risk weights would be superior to the current procedures. In the longer run, with increased market discipline brought about by the use of subordinated debt the bank's capital ratio would be determined by market forces.

Enhancing and Harnessing Market Discipline

Although the Basel Committee's reform proposal recognizes the desirability of enhancing market discipline to influence bank risk and capital management, it does little to enhance market discipline. We propose supplementing the Basel 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 encourage the use of market assessments to enforce effective regulatory capital standards.

The uninsured subordinated debt requirement could act as an important mechanism for enhancing market discipline, for banks as well as for regulators. If a bank suffered losses of asset value and/or faced increases in asset risk, purchasers of newly issued subordinated debt would discipline the bank by raising yield spreads or inducing the bank to act in credible ways to reduce asset risk or raise equity. These creditors have powerful incentives to act as risk disciplinarians of banks. Unlike equity holders, they hold fixed income claims 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 hurt subordinated debt holders because high risk increases the probability of their not being fully repaid.

Yields on outstanding subordinated debt provide a reliable and visible measure of overall bank risk. These yields also could provide a basis for determining deposit insurance premia. In addition, banks' difficulties in issuing and rolling over subordinated debt and the yields on this debt could serve as triggers for regulatory interventions to restrict bank risk taking that would supplement the clearly established principles and rules, commonly referred to as 'structured early intervention and restructuring' or 'prompt corrective action', that were adopted by the United States in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). And if regulators under political pressures resort to forbearance, the increasing yield spreads on uninsured debt will keep signaling that to the world.