

Capital Adequacy Regulation as an Instrument for the Regulation of Banks – From the Basle Accord of 1988 to...

Part I: From the Basle Accord to Precommitment and Other Alternatives

INTRODUCTION

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This special issue of the Swiss Journal of Economics and Statistics includes the papers and proceedings of a conference that took place in Basel on July 3, 1998. It was the third in a series of conferences on capital adequacy regulation as an instrument for the regulation of banks which have taken place in Basel since 1995¹. The first two conferences covered results stemming from a research project directed by Martin Hellwig and myself. That project came to an end in 1996.

In 1997 there was a break. Martin and I, as well as our colleagues in research, took a «sabbatical leave», i.e. we refrained from organising a conference. We thought that the «world», i.e. our academic colleagues, our friends from the regulatory agencies and the many practical bankers who had never deserted us deserved a break. We thought that we had offered them plenty of food for thought. And we waited for the «world» to improve, i.e. to implement the «wisdom» that we so convincingly produced.

1998, ten years after the famous so-called Basel Accord, we were back on stage again. This time, we included Ernst Baltensperger in the team that organised the conference. And, since our local research has somewhat diminished in intensity, we looked for additional support from other, certainly not less competent circles.

I am particularly grateful to WILLIAM R. WHITE from the Bank of International Settlements (BIS) and DANIELE NOUY from the Basel Committee on Banking Supervision who were willing to discuss with us the programme of this conference and to help us attract a number of important speakers. The fact that this conference took place at Basel, the legal seat of the BIS, cannot alone explain this contribution. The ultimate explanation is surely the sincere commitment of the BIS and the Basel Committee to analysis and in-depth discussion.

1. Conference jointly organised by ERNST BALTENSPERGER (University of Bern), NIKLAUS BLATTNER (University of Basel) and MARTIN HELLWIG (University of Mannheim). Financial support from the Swiss Bankers Association, Basel, is gratefully acknowledged.

Starting with the research results that were discussed at our earlier conferences I can mention the following².

– *Capital adequacy rules reinforce corporate governance*

With increased capital the shareholders' interest in the supervision of bank management increases. Shareholders increasingly assume responsibilities which serve the interests of the depositors and of the government which might, in the case of heavy bank losses, be confronted with demands for compensation.

– *Equity creates a buffer for losses but can lead to adverse incentives*

It is true that greater equity can provide a more generous buffer for losses that otherwise would have to be passed on to creditors in the case of bankruptcy. But capital rules also alter the incentives for the bank management as well as for the shareholders. Unwarranted risk weighting can lead to an increase in the overall risk profile of the activity portfolio of a bank. Even «gambling for resurrection» cannot be excluded.

– *More stringent capital adequacy ratios reduce the advantages of financial intermediation*

The essence of financial intermediation is the financing of investment out of depositors' money. True, this leads to a shift of risk to depositors. But to limit this shift by asking banks to finance credits increasingly from equity capital would lead to a reduced scope for financial intermediation and could lead to a notable decrease in the efficiency of capital allocation in an economy.

– *Capital adequacy rules can produce undesirable macro-economic effects*

This is the «credit crunch» proposition. The tightening of capital rules can have effects similar to those of a reduction of money supply of the central bank. Hence, the cyclical situation of an economy has to be taken into account whenever one changes the capital rules. Creditor protection cannot possibly be the only aspect that matters when discussing the subject.

2. See the special volumes of the Swiss Journal of Economics and Statistics, 131st year, December, 1995, issue 4/2. and 132nd year, December, 1996, issue 4/2.

- *An ample coverage of capital is not sufficient protection against insolvency*

This is an empirical finding. With the exception of the state-owned cantonal banks all Swiss banks are subject to the same capital adequacy rules. Nevertheless, risks have in the past varied widely across the banks. International data show that this finding is not limited to Switzerland. Therefore, capital ratios are an imperfect measure of the solidity of banks.

- *Capital adequacy rules can be useful in principle but can be counterproductive in the concrete case*

This is a first and general conclusion from the results mentioned above.

- *Rigid capital rules are not satisfactory, neither from a theoretical nor an empirical point of view*

The existing rigid system requires covering a risk-weighted balance sheet position with at least 8% of own capital leads to unsatisfactory results because it hardly corresponds to the effective position risk which also depends on the actual portfolio of the activities of a bank.

- *Capital adequacy rules cannot be judged independently from the other instruments for the regulation of banks and financial markets*

There is a certain danger for regulators, in their endeavour to protect creditors and motivated by particular events, to intensify their efforts on all aspects of the existing system simultaneously. Under such circumstances, a regulatory «overkill» cannot be excluded.

In the light of this very brief summary of our past research it becomes clear why the developments that have taken place since are to be warmly welcomed.

The shortcomings of rigid capital rules are by now undisputed. The papers and comments given in the first section of the conference convincingly illustrate this. The value-at-risk methodology has assumed prominence in the regulation of capital in the trading book of banks. But even more has been accomplished. There are no longer simple answers to any of the questions related to the capital adequacy rules in all the activities of banking. And new approaches are seriously developed and tested in practice, e.g. «pre-commitment» and other alternatives.

This is how far the first part of the conference went: we looked from the Basel Accord to pre-commitment and to other alternatives which are all designed to increase depositor protection.

In the second part of the conference, we addressed the regulation of banks in the light of the reduction of systemic risk. Here we entered an area which in the recent past has gained prominence for obvious practical reasons.

Two empirical papers show the difficulties in collecting evidence that corroborates the systemic risk content of macro-shocks (changes in the term-structure of interest rates) and of risk externalities (contained in interbank lending). In theory, macro-shocks and risk externalities are both 'officially recognised' threats to the stability of a banking system.

While these papers address the issue of systemic risk within the framework of a closed economy, the panel discussion which followed and with which we closed the conference, addressed the issue of international contagion. What is it and what can be done against it?

Those of you who like me from time to time consult the Michelin restaurant guide know what three stars mean: «exceptional cuisine, worth a special journey». I firmly believe that the third conference on capital adequacy regulation again proved «worth a special journey».

Finally, I express gratitude to all participants also in the name of ERNST BALTENSPERGER and MARTIN HELLWIG. Special thanks go to MARTIN MAURER and MARKUS STAUB from the Swiss Bankers Association. They not only contributed to the research but also organised the administrative side of the conference. Last but not least, thanks are due to PETER KUGLER (University of Basel), editor of this Journal, who was ready to accept the conference papers and proceedings for publication.