Introduction

Capital Adequacy Rules as Instruments for the Regulation of Banks

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On July 7, 1995, a Conference on Capital Adequacy Rules as Instruments for the Regulation of Banks took place in Basel (Switzerland). Basel happens to be the seat of the Bank for International Settlements (BIS), which hosts the so-called Basel Committee on Banking Supervision. For many years important developments in capital adequacy regulation have originated from this Committee, which comprises representatives of the banking regulation authorities from all the BIS member countries.

The Conference was organised by MARTIN HELLWIG and myself, both from the University of Basel. MARTIN HELLWIG and I are currently conducting a research project on the Conference topic. The Conference provided an opportunity to discuss first results of our research with a number of distinguished scholars and bankers and with leading representatives of the Swiss Federal Banking Commission (FBC), the Swiss National Bank (SNB) and the BIS. The names of the participants are listed at the end of this volume.

Financially, the research is supported by the Swiss National Science Foundation (SNSF) and by the Swiss Bankers Association (SBA). Intellectually, the research has benefited from frequent contacts with a group of banking experts (JOSEF WILLIMANN, Union Bank of Switzerland, UBS, Zürich, Chairman; ROLF ENDERLI, Swiss Bank Corporation, SBC, Zürich; and WALTER WIRSIG, Crédit Suisse, CS, Zürich). This group also includes ERNST BALTENSPERGER from the University of Bern. ERNST BALTENSPERGER, as the editor, also accepted to publish the Conference papers in a special issue of the Swiss Journal of Economics and Statistics. The printing of this issue was made possible financially by the three banks mentioned before, i.e., by UBS, SBC and CS.

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The papers contained in the volume reflect results from the work carried out during the first year of the project. Initially, when submitting the research proposal, we felt that in the area of capital adequacy the activism of the regulators strangely contrasted with a certain passivity on the part of economic researchers. Particularly, we believed that a

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systematic analysis of the relationship between the behaviour of banks, capital adequacy rules and bank losses was urgently needed. Since then, the scarcity of academic contributions to the topic has not changed fundamentally. On the other hand, the Basel Committee’s proposed «Supplement to the Basel Capital Accord to Cover Market Risks» of April 1995 was clearly welcome. In this proposal the Committee explicitly utilises concepts that reflect developments in modern financial economics. Hence, better as before, if not yet completely, we are in a position to understand the thinking of this highly respected body. On balance, however, researchers and regulators still stand to gain considerably from further work. And they certainly stand to gain from exchanges of views, from comparing notes, and perhaps even from working together more closely.

In this Introduction I do not propose to summarise the papers and the discussion of the Conference. But I should like to point out a fundamental aspect of what one could call the political economy of practical capital adequacy regulation.

It is not always easy to understand the justification of a particular regulatory rule. Why, e.g., did the Basel Committee in its 1988 Capital Accord chose 8% as the required capital ratio in the Risk Asset Ratio (RAR) formula? Why not 4% or 16%? The papers issued by the Basel Committee then and since do not provide any clues. And what is the theoretical and empirical justification for the factors applied to the conversion of off-balance sheet positions into «virtual» on-balance sheet items or credit equivalents? Finally, what is the evidence upon which the risk weights are based? Which is the relationship between capital rules and other instruments for the prudential regulation of banks? The regulators sometimes seem to think that everything is complementary, i.e., that it can never be wrong to continue to add elements to all regulatory domains together. But what if the relationship is substitutive? It is quite possible to imagine that one favours either capital adequacy rules or deposit insurance. One could also make a case for «narrow banking» with respect to deposit taking institutions instead of subjecting all banks to the same capital adequacy regulation.

I do not claim that it would be easy to produce a theoretically and empirically fully coherent set of capital adequacy rules. The papers contained in this volume illustrate the size of such a task. Pragmatical procedures and recourse to judgment by experienced and prudent observers of the banking scene may always be justified to some extent.

But there is also some danger linked with pragmatism and judgment. It is linked to the incentive structure which appears to govern the regulators’ behaviour. Basically, regulators are not rewarded for the efficiency of their rules but for their success in preventing bank insolvencies, which would lead to losses to bank creditors. When in an agency’s area of responsibility a bank has to be closed and creditors suffer, the public and the political authorities most certainly point to the agency’s presumed laxity. Yet, on the other hand, there is almost no political pressure group that makes sure that an agency’s moderation is duly rewarded.

A particular problem of any merely pragmatic capital adequacy regulation is that it may have a counterproductive effect on the behaviour of banks. A bank whose capital cover is thin is likely to favour activities with modest capital requirements. Worse still,
it might systematically choose those activities which combine low capital requirements with high risk («gambling for resurrection»). This could be the direct road to ruin. In order to survive and to serve the interests of creditors best, a bank needs to maximise risk adjusted returns. In a case where existing capital adequacy rules are ill-founded economically, to force banks to comply with them is not in the best interests of the creditors and hence damaging.

The empirical evidence contained in this volume raises further doubts as to the reliability of existing capital adequacy regulation. No convincing relationship between the size of the capital cover and the estimated probability of insolvency of banks in Switzerland has yet been identified. There are «lavishly» capitalised banks leaning towards insolvency and others with minimum capital that appear extremely safe.

In short, theoretical and empirical considerations convincingly explain why we should be concerned about any considerable imperfections in existing capital adequacy regulations in this country and elsewhere. They also justify the development of alternative regulatory concepts, such as the so-called «limit-risk model» developed in one of the papers included here.

The Conference ended with a Panel discussion. It confirmed that regulators, central bankers, bankers and scholars perfectly sense the responsibility that they at least implicitly share. They are aware of the problems implied in existing regulation, and they all accept the need to improve existing rules. The assessments of specific issues and alternatives still differ of course. This is normal in a field where research has only just begun. Most importantly, however, participants shared the view that it is worthwhile and urgent to continue research and the critical evaluation of its results. Traditional capital adequacy regulation has lost its innocence. Not much can be taken for granted anymore. Given the rapidly increasing complexity of international finance, the globalisation of markets and the quantum jumps in financial technology, this is the only attitude that can be justified.