Introduction

Capital Adequacy Rules as Instruments for the Regulation of Banks

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This supplement to the *Swiss Journal of Economics and Statistics* presents material from a conference on *Capital Adequacy Rules as Instruments for the Regulation of Banks*, which took place in Basle on July 5, 1996. As such it complements the December 1995 supplement, which presented papers from a conference on the same subject a year earlier. Both conferences were organized by NIKLAUS BLATTNER, of the University of Basle, and myself. Their purpose was partly to present results from an ongoing joint research project and partly to stimulate some interaction of discussion of banking regulation between academics, bankers, and regulators (in alphabetical order).

The area of banking regulation has not always been marked by intense interaction between academics and practitioners. Indeed, from the times of Regulation Q to the enactment of the 1988 Basle Accord on Capital Adequacy Requirements for Credit Risks, it has been an area where people were sure of their views, with little need to listen to each other. At the same time, not much academic research was actually done in the area; this has only changed with the various banking crises of the eighties and early nineties and the tightening of capital adequacy regulation of banks following the Basle Accord.

However the certainties of yesteryear are disappearing. This is most obvious in the development of proposals to extend the 1988 Basle Accord to market risks. When the Basle Committee on Banking Supervision presented the first such proposal in April 1993, it seemed that the regulatory train was moving full speed ahead on a track built by traditional practice, with little analysis of the likely economic effects of the proposed measures. However the industry's reactions then made it clear that conceptually and procedurally this proposal was lagging behind some of the approaches to risk measurement and risk management that had been developed by financial institutions themselves. Because of these reactions, the Basle Committee's revised proposal of April 1995 allowed for the possibility that capital adequacy requirements for banks bearing market risks be based on the banks' own risk models rather than any exogenously set, rigid regulatory standard. This acknowledged that in a world of rapidly changing risk meas-

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urement and risk management techniques, it may be better to leave room for experimentation by the industry than to rely on the certainties of yesteryear.

Even so, the speed with which new regulatory measures are enacted is quite remarkable. The naive academic onlooker is tempted to compare the speed with which the regulatory community moved from the April 1993 and April 1995 proposals to the actual Amendment to the Capital Accords to Incorporate Market Risks of January 1996 to the time and expenses it takes for a private company to get a new drug approved for sale or a new stock approved for listing on an exchange. Remarkably, both the 1988 Accord and the 1996 Amendment to the 1988 Accord were enacted with hardly any evidence about the economic effects of capital requirements for banks.

This being said, it must be acknowledged that until very recently the academic community itself has offered little theoretical and practically no empirical research on the subject. This shortcoming provided the main motivation for a research project that has been pursued at the University of Basle over the past two years. The papers by GEHRIG and SHELDON in this volume as well as its predecessor present some of the results of this project. On empirical as well as theoretical grounds they throw doubt on the received wisdom that increases in required and/or actual bank capital necessarily enhance the safety of bank deposits.

If the academic economist is skeptical about capital adequacy regulation, what alternatives does he have to propose? Doesn't one have to do *something* to protect depositors from fraud and recklessness of the institutions to whom they entrust their funds? I submit that at this point the question may be ill-posed. Since the mid-seventies, traditional systems of banking regulation have been crumbling because they were ill-suited to a world of innovation and change. At this point there is as yet no sign that the pace of change in banking and finance is abating. The question then is what relations of regulators and regulated can be at all in a sector experiencing such remarkable change. The papers by BLATTNER and GOODHART in this volume address this question. Not surprisingly, their conclusions are very tentative. More importantly their reasonings show very clearly why some of the conventional, relatively mechanical approaches to banking regulation will not do any more.

The 1996 Amendment to the Basle Accord raises the question of what is feasible in the relation between regulators and regulated in a rather more specific sense: If banks can use their own risk models to determine capital requirements for market risks, how does that affect the role of the bank supervisor? What scope is there for model manipulation, and how will supervisors assess the quality of the models that are approved for use in this context? These questions were the subject of a panel discussion at the end of the conference. The participating practitioners in this discussion seemed to be agreed that for risk models currently in use and risk modelling as currently practiced, the problems of manipulability and quality assessment are relatively small in comparison to the same problems elsewhere in banking, e.g., in the evaluation of loan portfolios. At the same time, there also seemed to be agreement that the new approach to bank capital regulation is going to have profound effects on the day-to-day tasks of bank supervisors

and on the way they interact with the bankers. However these procedural aspects of banking supervision seemed to be as yet uncharted, to be left for exploration in future practice.

A year earlier, at the close of the 1995 conference, I had suggested that the step from conventional certainties to an awareness of the actual difficulties – conceptual and procedural – of banking regulation in a rapidly changing financial system was a major step ahead. I might have added that mutual discussion of the issues between the different groups can play a major role along the way – both, in raising awareness of difficulties and in providing orientation for further thought. In this sense, NIKLAUS BLATTNER and I personally have profited greatly from both conferences. We hope that a sense of the interchange that took place comes across in the account of the conference that is given in this volume as well as its predecessor.

It remains for me to say thanks: Thanks first of all to the Swiss National Science Foundation and to the Swiss Bankers Association for jointly funding the research project on which the conference was based, one the fundamental research, the other the applied research under the project. Thanks also to a committee of experts (ERNST BALTENSPERGER, University of Berne, ROLF ENDERLI, Swiss Bank Corporation, Zurich, JOSEF WILLIMANN, Union Bank of Switzerland, Zurich, WALTER WIRSIG, Crédit Suisse, Zurich), who provided us with a regular sounding board for the ideas that we were discussing. Thanks finally to ERNST BALTENSPERGER as Editor of this Journal for agreeing to publish the conference proceedings as a supplement to the *Swiss Journal of Economics and Statistics* and to the Swiss Bankers Association for financing this supplement. NIKLAUS BLATTNER and I are grateful for all this support. We are also grateful for the contributions of all participants to the discussion at the conference and to this volume. We hope that the interchange between academics, bankers and regulators which this conference and its predecessor have brought will continue as surely as the discussion about the prudential regulation and supervision of banks.