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The Proposed BIS New Capital Adequacy Rule. Enhancement of Measures at the Expense of Fairness

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I. INTRODUCTION

In their efforts to strike a balance between deregulation and control, the members of the BIS Committee of the Group of 10 in 1988 introduced the capital adequacy rule for credit risk. It was later followed by an additional rule to incorporate the capital requirements for market risks. The original rule proved to be acceptable world wide and was followed by almost all central banks in the liberal economy countries in disregard of their membership in BIS. Within the past 11 years the banking industry and the regulators realized that the original rule suffered from serious shortcomings. The increasingly static and unrealistic nature of that rule and its arbitrary and contradictory effects in practice forced the regulators to undertake its urgent revision. In June 1999 the members of the Basel Committee on Banking Supervision issued a consultation document to amend the rule so as to make it more effective in addressing credit risks (1).

In spite of the evident improvements in the new rule it is believed to be still far from perfect. This article will be discussing several issues related to the old and new rules. Its ultimate objective is to provide readers and hopefully the regulators with some insights into the viewpoint of the banking industries in the developing world, which may not be represented in the literature of the Group of 10 countries.

The remainder of this article contains the following subparts:

- Problems of the old rule
- Summary of the main attributes of the new rule
- Evaluation of the new rule
- Concluding remarks

II. PROBLEMS OF THE OLD RULE

The problems of the old rule can be categorized in four main groups: the first being related to the risk weights, while the second addresses the capital components, and the third concerns the inability of the rule to deal with sophisticated forms of regulatory capital arbitrage. The last is related to the limited ability of the rule to encourage safer credit practices.

The very crude classification of bank debt into one of four category bands underlines a major problem in the ability of the rule to represent reality. The bands assign 0% for OECD government or central credits, 20% for OECD inter-bank credits, 50% for residential mortgages and 100% for all other claims. This categorization is applied irrespective of the actual credit standing of the counterparty involved. It is unrealistic in so far as it effectively undermines the actual credit assessment process that a bank is supposed to undertake before an advance is made. Under the rules, for example, the lowest credit-rated government debt within the OECD

countries is much cheaper to fund than an advance to a triple-A commercial borrower, as a full 8% capital charge has to be assumed in the second case.

The different treatment and varying definitions of capital also represented major problems in implementing the old rule. The 1988 rule gave national authorities the freedom to define the capital, applying to both tier 1 and tier 2. Such discretion left the door open to abuse and inequality. In addition the failure to include clear rules regarding loss provisions and the revaluation of non-performing assets has transformed the operation of the system into an artificial exercise. Furthermore the 8% standard agreed and its subsequent conversion in many countries into a maximum rather than a minimum requirement has also constituted an element of inequality that has aroused criticism.

The ability of some banks to undermine the rule by innovative financial products and derivatives has presented an additional set of problems in implementation. Through increasingly sophisticated regulatory capital arbitrage, in practice some banks have always been able to avoid charges on capital or being charged at all. The avoidance mechanism includes debt securitization and other similar products and derivatives.

Lastly, it has been observed that high capital costs have significantly undermined the total amount of bank credit available to the markets. The result has been a substantial reduction in credit lines if not their complete elimination. This is contrary to the original objective of the rule, which was to encourage safer credit practices.

III. SUMMARY OF THE MAIN ATTRIBUTES OF THE NEW RULE

The 1999 proposal aims to improve the way regulatory capital requirements reflect underlying risks. In addition it aims to address more fully the recent financial innovations such as asset securitization and credit derivatives, etc. It also intends to ensure that capital requirements match the financial institutions' true risk profile, and lastly it underlines the need to improve risk measurement and control by the banks. The Committee specifically identified the following objectives from the new amendments: to promote safety and soundness in the financial system; to maintain at least the current overall level of capital in the system; to continue to enhance competitive equality; to develop a more comprehensive approach to addressing risks; and to focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication.

The new rule contains three major components: minimum capital requirements, a supervisory review process, and effective use of market discipline.

Concerning the minimum capital requirements, the Committee introduced once more a standardized but modified version of the 1988 rule. However it allowed the utilization of internal credit ratings by some advanced banks. With regard to risk weights to be applied to exposures to sovereigns, the Committee proposes replacing the existing approach by a system that would use external credit assessments for determining risk weights. It is intended that such an approach will also apply, either directly or indirectly and in varying degrees, to the risk weighting of exposures to banks, securities firms and corporate bodies. The result would be to reduce risk weights for high quality corporate credits, and to introduce higher-than-100% risk weight for certain low quality exposures. A new risk weighting scheme to address asset securitization and the application of a 20% credit conversion factor for certain types of short- term commitments are also proposed.

The second basic element of the new framework addresses the supervisory review of capital adequacy. This is to ensure that a bank's capital position is consistent with its overall risk profile and strategy. Such consistency will encourage continuous supervision and early

intervention. In addition, the new framework stresses the importance for bank management to develop an internal capital assessment process and to set targets for capital that are commensurate with the bank's particular risk profile and control environment. This internal process would then be subject to supervisory review and intervention, where appropriate.

Lastly, the efficient use of market discipline encourages high disclosure standards and enhances the role of market participants in encouraging banks to hold adequate capital. The Committee proposes to issue later additional guidance on public disclosure that will strengthen the capital framework.

IV. EVALUATION OF THE NEW RULE

The new proposals have come a long way in avoiding the problems of the old rule. They have dealt with the major limitations and streamlined the capital adequacy regulations towards better management of risk, as well as justified differentiation among different kinds of credit on the basis of their quality. However, one of the main limitations of the new rule is its discriminatory nature; in fact the proposed new rule may provide excellent service to the largest banks in the Group of 10 countries at the expense of the smaller banks and of those incorporated in the developing countries.

The use of banks' internal credit rating and external credit sources to achieve a more realistic measurement of potential counterparty default risk will enhance the adequacy rule significantly. Accordingly, the new rule is expected to be much more realistic when applied.

The possible cost of the new form of mandatory global credit risk requirement is a matter of the utmost concern to the financial industry, and especially to the smaller sized institutions that may not have the critical mass to support the cost of the needed technology. This will definitely give the larger banks an unfair advantage and may in some cases push the smaller ones out of business.

The implementation of the rule will also require the modernization of the infrastructure of the supervisory institutions themselves. Should the rule be expanded outside the Group of 10 countries a significant number of the central banks will find themselves in a very difficult situation. Even those who are willing to commit the requested resources for such upgrading may not be able to do so. A possible consequence of such a situation might be for the home country supervisor to be considered by other central banks as inefficient. This situation may entice the regulatory authorities in other advanced countries to limit the activities of foreign financial institutions in accordance with the requirements of their own local legislation. The ultimate result would be to defeat the spirit of globalization, deregulation, the free market concept, and fair trade.

Reliance on the rating of external commercial agencies will give these entities enormous power, which will not be controlled by any legal body and especially not by the financial regulators. Such an issue may create extreme legal and practical difficulties in the future.

The adoption by the Basel Committee of the norm of capping the rating of financial institutions and other market participants by the rating of the country where they are incorporated is discriminatory in nature. It will completely prevent the financial institutions that are incorporated, for example, in Latin America, the Middle East and Africa from accessing the international money market. It may also in the long run deprive these institutions of other forms of funding.

V. CONCLUDING REMARKS

The consultation paper, issued in 1999, to amend the capital adequacy requirement has addressed the main shortcomings of the old rule. In its attempt to incorporate country risk, it may have opened the door to practical discrimination simultaneously against borrowers and intermediaries who are citizens of the developing countries.

It is extremely important for all parties concerned, including the central banks of developing countries, to understand and appreciate the risks should the proposed rule be adopted in its current form. The Basel Committee on Banking Supervision should be alerted to the possible negative consequence of the new rule on free trade. It is also important to realize that the rule in its current form may be in violation of existing laws such as the Treaty of Rome, which disallow discrimination on the basis of nationality.

If the proposed rule becomes effective in its current form without alteration to nullify the controversy of credit rating capping, the financial institutions incorporated in the developing countries will face severe difficulties in accessing the international money market and possibly in securing other forms of funding. Their options will be limited in meeting the challenges of the new rule. Accordingly the extremely important role of the local and regional banks as intermediaries in the developing countries will be at extreme risk.

NOTES

1. The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the Central Bank Governors of the Group of 10 countries in 1975. It consists of senior representatives of bank supervisory authorities and Central Banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

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