BANKING

Consequences of the 1988 Basle Accord should concern those who want more international regulation of financial institutions.

The Dilemmas of International Financial Regulation

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International finance has changed dramatically over the past two decades as governments eliminated barriers to cross-border capital flows and opened their domestic markets to foreign financial institutions. These changes produced an increasingly integrated world of international finance. A number of policymakers, who point to recent financial woes in Asia, Latin America, and Russia, worry that this integration requires increased international regulation of financial institutions. As a 1999 International Monetary Fund study lamented, these crises "leave open the question of whether the official safety nets and monitoring systems have adapted sufficiently to this new financial environment and whether they are still ensuring that incentive structures encourage an appropriate amount of market discipline."

Do we need international financial regulation? The consequences of one regulatory effort, the 1988 Basle Accord that instituted international standards for bank capital, suggests such regulation may be more harmful than helpful.

WHY NATIONS REGULATE BANKS

Governments regulate banks because of the need for a financial safety net to protect depositors and bank shareholders. This safety net — in the form of explicit deposit insurance and implicit guarantees to shareholders — is important because a banking crisis and widespread financial insolvency would have a devastating impact on real economic activity and could have serious political and social repercussions. Conscious of such experiences as the Great Depression and the 1997 Indonesian economic collapse, governments choose to bail out the banks rather than accept widespread insolvency and social crisis.

Ironically, this safety net provides incentive for banks to take on additional risk. Because of the insurance and guarantees, banks are inclined to extend high-interest loans to risky borrowers because such lending will yield a high return if the loans are repaid, but society will shoulder the burden if the borrower defaults.

Because of the potential for economic and political crisis, governments cannot counter this risk-taking by eliminating the safety net. But governments can regulate banks to limit the banks' exposure to risk. For instance, regulators can impose capital requirements intended to ensure that banks have sufficient capital on hand to cover unexpected losses in their lending portfolios. To accomplish this, regulators can enact a standard requirement that forces banks to hold capital equal to a specific percentage of their assets. Regulators can also implement a risk-weighted requirement that requires banks to hold capital in proportion to the risk of their various loans. By matching capital requirements to the overall riskiness of banks' assets, regulators hope to discourage risky portfolios and ensure that banks have resources sufficient to cover losses resulting from high-risk loans. This will minimize the costs to society if and when banking crises do occur. Hence, regulating banks' capital standards is a solution to the problems generated by the prior decision to extend a safety net to the banking system.

THE REASON FOR INTERNATIONAL REGULATION

Given that governments must regulate banks, is international financial regulation necessary to manage international financial integration? That is, have dramatic recent changes in financial activity eroded governments' ability to rely on domestic regulation to maintain the stability of banks incorporated in their countries, thereby

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necessitating a move to international regulation? The short answer is no; international financial integration creates no new market failures that require governments to shift regulation away from independent national authorities. There may be a need for international coordination of regulatory responsibility (for instance, the determining of what country would oversee and insure a multinational bank), but countries can arrange this coordination through agreement and not by internationally harmonizing prudential regulation.

If national regulation and international agreements can handle risk and insurance problems, then why does international financial regulation exist? Countries forged this regulation primarily as a political response to banks' concerns about international competition. In a world in which national regulators set rules independently, some banks in some countries operate under more stringent regulatory standards than other banks in other countries. Disparate national regulations create cost differentials that hurt and help different banks' bottom lines. Banks operating under lax regulation face lower costs than banks under more stringent controls. Hence, the banks in less regulated countries can offer banking services to customers at a lower price. International regulation, by requiring all governments to adopt a set of common standards, eliminates these disparities, creating a "level playing field" in international finance.

The Basle Accord The political dynamic that produced the 1988 Basle Accord nicely illustrates this pursuit of a level playing field. In the 1980s, many of the largest U.S. commercial banks became imperiled by the Latin American debt crisis. The nine largest U.S. commercial banks lent 140 percent of their capital to three countries, Mexico, Argentina, and Brazil, all of which subsequently became unable to service their loans. The dozen largest American banks lent between 83 percent and 263 percent of their capital to five heavily indebted Latin American countries that later announced they were incapable of servicing their debts. Put simply, U.S. commercial banks were in trouble.

American policymakers tried to address this crisis through the International Monetary Fund (IMF). The IMF was to provide Latin American debtor governments with new credits that could then be used to service their loans. This way, commercial banks transferred ownership of a portion of developing countries' debt to the public sector. As part of this arrangement, commercial banks were to restructure their existing commitments and extend additional loans.

To meet this obligation, the IMF needed to boost its resources by 47 percent. Part of that revenue was to come from an $8.4 billion outlay from the United States. Congress agreed to the expenditure, but demanded a tightening of domestic banking regulations and an increase in commercial banks' capital requirements. This met predictable opposition from American commercial banks who were facing tough competition from foreign, particularly Japanese, commercial banks. American bankers argued that existing cross-national differences in bank capital regulations directly contributed to their competitive difficulties; further regulation would only increase that disparity. In response to this opposition, Congress linked higher capital requirements in the United States to the successful completion of an international agreement on capital standards. This led to the Basle Accord, signed by the leaders of the Group of Ten nations in late 1987. Subsequently, more than 100 nations have adopted the standards.

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The political dynamics underlying the emergence of the Basle Accord suggest a more general political process lies at the center of international financial regulation. Governments, wanting to avoid domestic squabbles with their own banks, shift regulation out of the domestic arena and into the international arena. International financial regulation, therefore, has little to do with correcting market failures that arise from international financial integration. Instead, governments adopt international regulations to minimize the distributional consequences of regulatory reform in an increasingly integrated international financial system.

THE DANGER OF INTERNATIONAL REGULATION

WHAT IS THE PROBLEM WITH HARMONIZING INTERNATIONAL regulation? It would seem that requiring all governments to regulate their banks in accordance with a common set of standards would not harm banks' safety and would create a level playing field. But there is a potential for harm that arises from the interaction between the unintended consequences of financial regulation and the glacial nature of international decision-making. This interaction could indeed create a less safe banking system.

The Basle Accord's Unintended Consequences Regulation always has unintended consequences, and these consequences often push regulators further away from, rather than closer to, their goals. This has certainly been the case with the Basle Accord. The accord imposed an eight-per-

cent minimum capital requirement on internationally active banks, but it required additional capital for loans that are considered more risky. The accord established four risk categories, assigning a zero risk weight to governments of nations in the Organization for Economic Cooperation and Development (OECD), a 20 percent risk weight to OECD banks and non-OECD governments, a 50 percent risk for mortgage lending, and a 100 percent risk to all other loans.

Faced with this simple risk classification scheme, banks altered their lending behavior in ways that regulators did not expect. For example, the risk classification provides incentive for banks to hold riskier loan portfolios than they would have held otherwise. Because the regulations assign the same risk weighting and capital costs to all loans within a given category, banks have incentive to shift toward higher-risk, higher-interest assets within each category. For example, a loan to a triple-A rated corporation receives the same risk weighting as a loan to a heavily indebted start-up firm, even though the loan to the start-up has a much higher probability of default. Because the banks charge higher interest to the start-up, they are more inclined to make that loan than to lend money at a lower interest rate to the secure corporation.

The risk classification scheme also offers incentive for banks to engage in regulatory capital arbitrage. When capital requirements are not based on a standard like the probability of insolvency, banks can often restructure their portfolios in order to reduce their regulatory capital requirements without reducing their risk. By securitizing assets, banks can unbundle and repackage risks to transform on-balance sheet assets into off-balance sheet assets that fall into lower risk weight categories. While reliable information on the scale of regulatory capital arbitrage is not available, the Federal Reserve has estimated that securities used to engage in regulatory capital arbitrage account for more than 25 percent of total assets of the United States' ten largest banks. In several individual cases, those securities account for close to 50 percent of total assets.

The problems created by regulatory capital arbitrage pertain less to the off-balance sheet assets and more to the on-balance sheet assets. Banks can only securitize high quality assets at acceptable cost; thus, regulatory capital arbitrage moves higher quality assets off banks' balance sheets in operations referred to as "cherry picking." This causes the average credit quality of banks' on-balance sheet assets to deteriorate as high quality assets disappear and low quality assets remain. Against this lower-quality balance sheet, the Basle Accord's eight percent capital requirement may be insufficient and banks' capital ratios may provide a misleading measure of banks' true financial condition. Because market participants use capital ratios to determine the health of lending institutions, the weakened quality of this information may harm market discipline.

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Revising International Regulations Given these unintended consequences, the Basle Accord may have made banks less, rather than more, secure. These problems have prompted regulators to call for refinement of the accord. Unfortunately, their efforts reveal the difficulty of amending internationally negotiated regulations.

The Basle Committee has proposed two alternatives for assigning risk weights to different borrowers. The first option is to rely explicitly on external ratings agencies, such as Moody's and Standard and Poor's, who link their assessments to explicit risk categories. While this approach would retain the same number of risk categories introduced in the initial accord, it would add greater nuance to the categories. The second option is to rely explicitly on banks' internal rating systems. Large banks rely increasingly upon sophisticated methods of evaluating the risk of individual credit exposures. This option would allow banks to rely upon these techniques to determine the risk attached to particular exposures, subject to supervisory review.

While these proposals address many of the major weaknesses in the initial accord's risk classification scheme, distributive conflicts are frustrating efforts to negotiate their adoption. German authorities delayed publication of the proposed revisions in order to protect advantages the original accord gave to German banks over other countries' banks. The United States and European governments are battling over whether to use banks' internal rating systems to weight risk, with the Europeans claiming that American banks would be unfairly advantaged because European banks do not commonly use such rating systems. Small banks and large banks worldwide are tussling over the same issue. Finally, banks worldwide are arguing that, since the proposed accord does not place similar regulations on other institutions in the financial services industry, the proposals would affect cross-sectoral competitiveness.

The current negotiations over reforming the Basle Accord are producing several layers of gridlock. Better domestic banking regulation is being held hostage until the conclusion of a better international banking agreement. A better international agreement on banking regulation is

being held hostage by distributive struggles between banks incorporated in distinct jurisdictions, between banks of different sizes, and between banks and other financial services providers. These efforts to use international regulation to create a "level playing field" have created harmful delays in the introduction of necessary regulatory reforms.

As long as government-devised regulations are imperfect, they will require continual refinement and adjustment. The speed at which regulators must make these adjustments depends upon the speed at which innovation and unexpected negative effects render the regulations obsolete. In banking, where regulation obsolesces quickly, governments must retain the ability to regularly adjust the regulatory framework. International negotiations are not well suited to the task.

As international financial integration deepens, governments will continue to confront a difficult regulatory dilemma. Domestic financial regulation is likely to produce a safer financial system than international financial regulation, but it can also cause financial institutions to shift their business to countries with less demanding regulations. International financial regulation can eliminate the unwanted competitive consequences of unilateral domestic regulation, but it may produce a weaker financial system. Thus, a domestic approach to regulation produces safer financial institutions but less domestic financial business, while an international approach protects domestic financial business at the price of potentially weaker financial institutions.

Instead of opting for either domestic or international regulation, the better solution may lie in domestic regulation supported by an international agreement on broad principles. Governments could move away from one-size-fits-all international regulations in favor of establishing broad regulatory objectives that each nation could then pursue through domestic regulation. To ensure that each country adopts regulations consistent with international goals, the international community could implement a review process. Such an approach would reduce the competitive consequences of purely domestic regulation while maintaining the flexibility of domestic regulation. R

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