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The Basle Committee's Proposals for Revised Capital Standards: Rationale, Design and Possible Incidence

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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising the awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s.* Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series.*

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Governments of Denmark and the Netherlands, as well as contributions from the countries participating in the meetings of the G-24.

THE BASLE COMMITTEE'S PROPOSALS FOR REVISED CAPITAL STANDARDS: RATIONALE, DESIGN AND POSSIBLE INCIDENCE

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United Nations Conference on Trade and Development, Geneva

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Abstract

The Basle Capital Accord of 1988 was the outcome of an initiative to develop more internationally uniform prudential standards for the capital required for banks' credit risks. The objectives of the Accord were not only to strengthen the international banking system but also to promote convergence of national capital standards, thus removing competitive inequalities among banks resulting from differences on this front. The key features of this Accord were a common measure of qualifying capital, a common framework for the valuation of bank assets in accordance with their associated credit risks (including those classified as off-balance-sheet), and a minimum level of capital determined by a ratio of 8 per cent of qualifying capital to aggregate risk-weighted assets.

The 1988 Basle Agreement was designed to apply to the internationally active banks of member countries of the Basle Committee on Banking Supervision but its impact was rapidly felt more widely and by 1999 it formed part of the regime of prudential regulation not only for international but also for strictly domestic banks in more than 100 countries.

From its inception the 1988 Basle Accord was the subject of criticisms directed at features such as its failure to make adequate allowance for the degree of reduction in risk exposure achievable through diversification, at the possibility that it would lead banks to restrict their lending, and at its arbitrary and undiscriminating calibration of certain credit risks. In the aftermath of the East Asian crisis other issues of special interest to developing countries also became a focus of attention: firstly, the Accord's effectiveness in contributing to financial stability in developing countries; and, secondly, the incentives which the Accord was capable of providing to short-term interbank lending, a significant element of the volatile capital movements perceived as having contributed to the crisis.

The eventual response of the Basle Committee to the belief in the need for an overhaul of the framework of the 1988 Accord was its proposal of June 1999 for a New Framework for Capital Adequacy (henceforth New Framework) incorporating three main elements or "pillars": minimum capital rules based on weights intended to be more closely connected to economic risk than those of the 1988 Accord, supervisory review of capital adequacy in accordance with specified qualitative principles, and market discipline based on the provision of reliable and timely information. However, the rules of the 1988 Accord may have a continuing practical relevance since a version modified in certain ways (such as the inclusion of more stringent criteria for the short-term interbank loans qualifying for a low risk weight) may be included in the Basle Committee's revised proposals owing to disagreements expressed during the consultation process over the proposals concerning numerical standards for capital adequacy in the New Framework.

The New Framework contains two basic approaches to such numerical standards for capital adequacy, the standardized and the internal-ratings based approaches. A feature of the standardized approach is the contentious proposal for recourse to the ratings of credit rating agencies in setting weights for credit risk. Moreover, owing to technical difficulties the Basle

Committee's proposal regarding the internal-rating based approach is still somewhat tentative and likely to be applied only to large banks with sophisticated systems for handling credit risk.

An issue of special interest to developing countries in the context of initiatives for reform of the international financial system regarding the second and third "pillars" of the New Framework is their likely incorporation in criteria for surveillance of compliance with the Core Principles of Effective Banking Supervision. In both cases this incorporation may be a source of considerable difficulties: in the case of the second "pillar" owing to the problems of formulating effective guidelines for the surveillance of different dimensions of banks' capital adequacy; and in the case of the third "pillar" owing to possible obstacles to the implementation improved transparency for banks hitherto subject to lax standards in this area.

The most contentious of the New Framework's proposals is that for recourse to the ratings of credit rating agencies in setting weights for credit risk. The paper reviews evidence suggesting that the recourse to the ratings of credit rating agencies for setting risk weights may actually exacerbate fluctuations in the cost and availability of external financing for developing countries. This would be an unfortunate outcome in the context of the New Framework's potential contribution to greater international financial stability, since a major part of this contribution would be in the form of the improved procedures for pricing and allocating bank loans which the framework is intended to foster.

The Basle Committee's progression from being a source of regulatory initiatives directed at internationally active banks of its member countries to its current role as a global standards setter has raised questions concerning its representativeness – questions which are particularly understandable in relation to rules regarding capital adequacy that are a linchpin of regimes for prudential supervision. Here the paper proposes an approach involving an extension of procedures already used for its work by the Basle Committee.

Various implications of long-term trends in the control and regulation of banking risks are highlighted by the proposals of the New Framework. Changes in this area are taking place at different rates in different countries, complicating the task of global standard setting especially with regard to the objective of a reasonable degree of uniformity (and thus of contributing to a "level playing field"). The changes are also increasing the skills required for banking supervision and are leading to the introduction of new activities and operations by banks for many of which supervisory capacity, especially in most developing countries, is not yet prepared. Appropriate policy responses to some of these changes are fairly straightforward in principle, though not necessarily easy to implement in practice: for example, countries can license banks to engage only in activities which they have the capacity to supervise. Solutions are more difficult, and thinking is in many respects more preliminary, concerning the challenge posed to the establishment of globally uniform standards by the heterogeneity of the set of banks to which such standards must be applied, and concerning the problems posed for effective banking supervision by the growing complexity of banking operations.

Table of contents

Page