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Micro-Challenges for Financial Institutions

Introductory Statement

It is a pleasure to participate in this panel and I deeply thank the OeNB for the invitation. I am honoured, in particular, to have the opportunity to comment on Basel II as along with Governor Caruana.

In the international scenario of financial regulation, the most important micro-challenge is probably the one of coping with the *introduction of Basel II*. The vast majority of authorities, experts and operators think that the substance of Basel II is – more than anything else – a powerful and beneficial incentive for banks to improve their risk monitoring and risk management capabilities. One can criticize Basel II in various ways and on many grounds but this favourable judgment, in my opinion, remains true.

This assessment is equivalent to saying that Basel II is more a method to improve the way in which banks calculate their *economic capital* than a change in a binding minimum *regulatory capital* ratio. Economic capital is the expression we use to indicate the amount of capital that banks would chose in absence of capital regulations. When economic capital is larger than regulatory capital, it is also the amount of capital that compliant banks, in fact, have.

Theoretically the calculation of the economic capital of a bank requires the minimisation of a *bank's loss function* trading off the marginal extra cost of capital with the marginal extra benefits of reducing the probability that the bank looses its franchise value. Quite differently, regulatory capital should result, for every bank, from the maximisation of a *social welfare function* trading off a higher *macroeconomic* cost of credit with a lower *systemic* risk of banks' failure. It is important to stress

that, in principle, capital regulation, even if it is tailored to the different characteristics of individual banks, is aimed at avoiding *systemic* failures. As a consequence, regulatory capital should depend also on the specificities of a banking system as a whole as well as on the features of several different elements of financial regulation, of supervision and of the methods of crisis management that prevail in the system. For instance, given the difficulties to distinguish solvency from liquidity crises, optimal capital regulation should take into account also the existing rules and arrangements for central banks' lending of last resort.

The relationship between economic capital and regulatory capital has not been analyzed in depth in the literature. Basel II official papers are explicit in stating that the new regulations are aimed at reducing the gap between economic and regulatory capital. But so far insufficient efforts have been made to understand what this shrinking of the gap exactly means; which is just one of the many possible examples of the fact that the economic theory of financial stability and of financial regulation is seriously underdeveloped. We are far from being able to check whether our regulations are the optimal ones. The impressive differences of opinion on Basel II are among the consequences of the lack of a solid, well established theory behind the regulations. Also as a university teacher of both monetary theory and policy and of prudential regulation, I feel rather uneasy when I consider how differently robust are the theoretical foundations of my lectures on optimal monetary policy strategies and institutions and the theory behind my teaching on topics of optimal financial regulation.

My knowledge of the literature is probably insufficient, but the only paper that I know which develops in a sufficiently articulated and analytical way the theory of the relationship between economic and regulatory capital is a very recent paper co-authored by Rafael Repullo.[1] One of the conclusions of this paper is that economic capital tends to be, within a reasonable parameter region, higher and increasing when the degree of competition between banks is higher and rising, mainly as a consequence of the fact that bank margins are a substitute for bank capital in cushioning from insolvency risks. The paper also shows an obvious inverse correlation between economic capital and the risk-premium component of the cost of capital. With a sufficiently

[1] *Elizalde, A. and R. Repullo. 2004. Economic and Regulatory Capital: What Is the Difference? CEPR Discussion Paper No. 4770. December.*

low cost of capital and a sufficiently high degree of bank competition, regulatory capital can turn out to be lower than economic capital. In this case regulatory capital is non-binding and banks' capital ratios are – as it often happens in reality – well above minimum required ratios.

The case of *non-binding capital ratios* is relevant. The excess of economic over regulatory capital can be used by banks also as an important signalling devise for the markets. Among the consequences of the possibility that capital ratios are non-binding there is a substantial decrease in the risk of pro-cyclicality of capital regulations. More importantly, I think, to the extent that minimum capital ratios can be non-binding, there is less risk that the ratios required by Basel II will turn out to be dangerously too low, especially for large banks. This risk had already been noted some years ago by the European Shadow Financial Regulatory Committee (ESFRC)[2] and is now feared also by important US regulatory authorities.

Minimum regulatory capital, though, can be often *strictly binding*, which happens when economic capital is low. Economic capital can be low, for instance, when bank competition is low and bank margins are high. It can also suddenly become lower than regulatory capital (and therefore strictly binding) when, for instance, a sudden increase takes place in the bankers' risk propensities, a parameter that influences only economic capital while regulatory capital depends on the much more stable risk aversion of the authorities. Economic capital can happen to be low, I maintain – I cannot cite any literature on this point –, also when banks are too big to fail and, more generally, when implicit or explicit bail-outs or subsidies are expected in favour of borrowers and/or in favour of lending or securities-buying banks. With non-binding regulatory capital, the risk that the complex methods with which it is calculated result in capital ratios that are too low, compared to the socially optimal values that would guarantee an adequate protection against systemic crises, is a material risk.

Looking at the current debate on Basel II, the risk of too low mandatory ratios is just one among the many issues that are discussed. An issue which is also connected to the risk of serious delays in finalising and applying the new rules. At the end of April US federal banking supervisors[3] decided to postpone the publication of implementation details, throwing into doubt the timetable of the new rules. They argued that their own testing had suggested that Basel II would result – because of unclear reasons – in a sharp drop in required capital. More generally, the attitude of the US and of some other countries towards the new Basel Accord suggests that there is a risk that the Accord is applied in different ways, with different timing and to a different extent in different parts of the global financial world, which would endanger the credibility of international financial regulation as

[2] *"The ESFRC thinks these estimates are too conservative, and there will be a substantial overall reduction of the regulatory capital requirement. … This significant reduction in the amount of capital held by banks in the EU and G10 is contrary to the stated objective of the Basel Committee, and it may have potentially adverse consequences for the stability of the banking system"– in: ESFRC. 2003. Bank Supervisors' Business: Risk Management or Systemic Stability? Statement No. 16. Basel and Zurich. May 2003 (http://www.ceps.be/Article.php?article_id=283). See also (on the CEPS website) the other ESFRC Statements on Basel II, starting from Statement No. 4 in 1999 and including the recent Statement No. 19, 2004.*

[3] *See Global Risk Regulator. Vol. 3, Issue 5. May 2005.*

well as the effectiveness and efficiency of the new Basel pillars.

Among other problems on the Basel front[4] let me just mention one that is very general and potentially important. I like to call this problem the *problem of double discretion*. It has to do with the role of Pillar 2, which gives supervisory authorities substantial discretionary powers in various directions, including the validation of the methods with which the ratios of Pillar 1 are applied by the banks. In my opinion the discretion is double because, even when a bank is fully compliant with Pillar 1 ratios, the authorities can ask that bank, in special circumstances – including the case of obviously insufficient ratios resulting from validated models – to hold additional capital. I am worried about the extent of the authorities' discretionary powers for three reasons. First because, as in other types of economic policies, when the ratio of rules to discretion diminishes and goes below a certain critical value, various inconsistencies can cause a loss of credibility and efficiency of the policy stances. Second, because when high levels of discretion are allowed the behaviour of national authorities can differ very much and, as a consequence, the integration, the efficiency and the stability of the international banking sector can suffer. Third, because discretionary decisions in prudential policies can shift the perceived responsibility of banking risks from the banks to the authorities, whose support – even in the form of at least partial bailouts – is then expected in times of difficulty, triggering, if necessary, government interventions. Suppose that a bank fights for some time to get the authority's approval of its Pillar 1 internal rating model and then struggles again to comply with additional capital required on the basis of Pillar 2 as well as with other detailed and intrusive discretionary supervisory requirements. Now think what might happen if this bank, after complying with all the required measures, enters a period of serious difficulties and solvency problems. Isn't it true that this bank will feel like having a sort of right to be helped in a substantial way, considering that the vast amount of discretion used by the supervisor can look like a patronage of its risk management decisions? The problem becomes obviously larger with the size of the bank and can result in a socially risky amount of *moral hazard*.

Let me conclude by mentioning a few other issues that, besides Basel II, are among those that make the present situation of international financial regulation, in my opinion, a rather difficult one. Problems with International Accounting Standards are well known and deeply linked with Basel issues. Company law and corporate governance are also a connected source of concern. Transatlantic cooperation in financial regulatory matters is progressing, but certainly not very fast and it often leads to discover more problems than those that it partially solves. At the European level, difficulties with the Financial Service Directive threaten the efficiency of the Union's capital market: for vari-

[4] *Including the major issue of coming to a better definition of the numerator of the Basel's ratio, i.e., of what banks can count as their eligible capital.*

ous reasons, they have also a potential cost in terms of stability. The Financial Services Action Plan has been successful in producing 39/42 planned directives but the number of directives that have been adopted and implemented by individual member states is both low and badly known: in this respect I find the European Commission's Green Paper[5] a somewhat weak document and I hope that the name & shame method will be soon used much more intensively to discipline member states. The Green Paper adventures into suggesting the idea of the 26th regulatory regimes for specific financial products.[6] This can be an interesting perspective, but the much more natural proposal to stop playing the tricky mutual recognition game, to abandon the acrobatic idea of lead supervisors, while simply putting the 15 to 20 largest European international banks under a *single 26th regulatory and supervisory umbrella*, with strong central coordination and total sharing of information (plus, perhaps, an opting-in clause for smaller banks that might prefer this 26th regulatory setting) seems completely unfeasible from a political point of view, during a period when cross-border mergers and acquisitions are going through such strange and unbelievable stories as the ones that are presently happening in my own country. In several countries, often triggered by the lack or by the delay of action of regulators and supervisors, magistrates are massively invading the fields of financial transparency, correctness, regulation and supervision.

The scenario does not seem encouraging. It is a discouraging paradox that in a situation where it is so difficult to produce new regulations in an appropriate way, the loudest voice coming from the markets is a protest against *over-regulation*. It is even worse that this protest is often perfectly right and well justified, and this is where I would like to conclude. ❧

[5] *COM (2005) 177. Green Paper on Financial Services Policy (2005–2010). http://europa.eu.int/comm/internal_market/finances/docs/actionplan/index/green_en.pdf*

[6] *Ibidem, section 4.*