

HEINONLINE

Citation:

Hal S. Scott, The Competitive Implications of the Basle
Capital Accord, 39 St. Louis U. L.J. 885 (1995)

Provided by:

Harvard Law School Library

Content downloaded/printed from [HeinOnline](#)

Tue May 1 11:48:03 2018

-- Your use of this HeinOnline PDF indicates your acceptance
of HeinOnline's Terms and Conditions of the license
agreement available at <https://heinonline.org/HOL/License>

-- The search text of this PDF is generated from
uncorrected OCR text.

-- To obtain permission to use this article beyond the scope
of your HeinOnline license, please use:

[Copyright Information](#)



Use QR Code reader to send PDF to
your smartphone or tablet device

THE COMPETITIVE IMPLICATIONS OF THE BASLE CAPITAL ACCORD

HAL S. SCOTT*

I. INTRODUCTION

THIS paper deals with the impact of the Basle Accord on competition between U.S. and foreign banks, with an emphasis on competition between United States and Japanese banks¹. By way of introduction, let me briefly describe the 1988 Accord, which specifies a minimum capital/risk-weighted asset ratio of 8% for international banks.

A. *Parties*

The Accord is a gentleman's agreement among central banks in countries that are part of the Basle Supervisors Committee of the Bank for International Settlements (BIS), the G10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom and United States) plus Switzerland and Luxembourg. The Accord was effectively extended in 1989 to several non-G10 European Union (EU) countries when the EU adopted its Own Funds Directive based on the Basle framework. This meant that Denmark, Greece, Ireland, Portugal and Spain were also covered.

Many more countries have unilaterally adopted the Accord to strengthen the reputation of their banks for having adequate capital and to enable them to operate in countries like the United States that require conformity with Basle standards as a condition for entry.

B. *Subject Matter*

What does the Accord do? First, it sets a capital/risk-weighted assets ratio of 8%. Second, it defines what counts as capital. There are two tiers. Tier I is basically tangible equity. Tier II includes some hybrid debt-equity instruments like perpetual preferred stock and subordinated debt, and certain reserves including loan loss and revaluation reserves. Third, it determines how

* Nomura Professor of International Financial Systems, Harvard Law School.

1. This paper is largely based on Hal S. Scott and Shinsaku Iwahara, *In Search of a Level Playing Field, The Implementation of the Basle Capital Accord in Japan and the United States*, Occasional Paper 46 (Group of Thirty, 1994). Unfootnoted statistics are taken from this source.

to risk-weight assets, using weights ranging from 0% for Organization for Economic Cooperation and Development (OECD) government debt to 100% for all commercial loans to private obligors. Fourth, it determines how to convert off-balance sheet items into the equivalents of risk-weighted assets. In this connection it devises a special regime for interest rate and foreign exchange contracts.

C. Objectives

The Accord had two objectives. The first was to increase the safety and soundness of international banks. Countries are concerned with the failure of foreign banks. Host countries are concerned that local depositors in branches of foreign banks could lose money, even if the host countries do not insure the deposits. Also, the failure of a large foreign bank with placements from, or settlement obligations to, other large banks could cause an international chain reaction of banks failures. Capital adequacy requirements are intended to reduce the possibilities of such failures.

The second objective of the Accord was to make the competitive playing field more even for international banks by eliminating the competitive advantage from higher leverage ratios. For example, before the Accord, Japanese banks had significantly lower leverage ratios than those required of U.S. banks: 4-6% as compared to 6-7%. This paper evaluates the second objective in terms of competition between major international U.S. and foreign banks.

D. Conclusions

The major conclusion of the paper is that the Basle Accord *could not* appreciably even the playing field between United States and foreign banks. Other, more powerful factors are at work that distort this competition. In addition, the various provisions of the Accord, for example the definition of capital, have had different impact in various countries because of differences in each country's accounting and tax rules, and regulation generally. Given these disparate effects, it would be a total accident if the Accord did make the playing field more even.

II. REGULATORY DIFFERENCES: THE BAILOUT DIFFERENTIAL

A principal reason why the Basle Accord could not appreciably even the competitive playing field between United States and foreign banks arises from what can be called the bailout differential.

A. Competitive Advantage of Bailout Differential

In a perfect market, creditors of more leveraged firms would seek higher rates of interest than creditors of their less leveraged competitors. Government

safety nets, to some extent, prevent this from happening in banking. Due to deposit insurance, bailout policies, government ownership and lender of last resort facilities, which combine to protect bank creditors against bank failure, bank creditors may be relatively indifferent to the leverage ratios of their bank debtors.

But the strength of safety nets differs among countries. For example, there is strong evidence that the Japanese safety net is stronger than the one in the United States. No depositor in Japan has lost a single Yen due to bank failure since the end of World War II, whereas there have been significant losses for U.S. depositors, and the trend is clearly in the direction of more losses. During 1992, the Federal Deposit Insurance Corporation (FDIC) resolved one-hundred twenty failed banks. In sixty-six, including the \$8.8 billion First City Bancorporation, the sixty-second largest U.S. bank holding company, uninsured depositors lost money.² The United States safety net is also weaker than those of many European countries which have fewer but larger banks (too big to fail), or which have state-owned banks.

B. Gross and Net Subsidies

It is also possible that foreign banks enjoy a higher *net* subsidy from safety nets than do their U.S. counterparts. Roughly speaking, the net subsidy is the value of the safety net less the cost of government regulation.

Both United States and foreign banks are subject to considerable regulation. Many studies have concluded that the cost of United States regulation is quite high.³ Although no comparative studies exist, it seems likely that the cost of such regulation is higher in the United States than in many European countries where there is less of a tradition of detailed regulation and reporting. Japanese regulation is also very costly; the Ministry of Finance closely monitors and guides the actions of banks. However, much Japanese regulation seems aimed at managing competition, which may actually increase Japanese bank profitability. Thus, some European and Japanese banks may have a higher *net* as well as gross subsidy from larger safety nets.

C. Higher Capital Ratios for United States Banks

Given that the Japanese and European safety nets are stronger, creditors will demand higher interest rates from United States banks than they do from European or Japanese banks with the same leverage because the overall risk of lending to United States banks is higher. It also follows that if United States banks want to pay the same rates as their foreign competitors, that they

2. Federal Deposit Insurance Corporation, *1992 Annual Report* 32-34.

3. See John P. Danforth, "Who Pays for the High Cost of Excessive Bank Regulation," 12 BANKING POL'Y REP. 24 (May 3, 1993) (studies cited therein).

must be less leveraged. United States banks must have more capital to make up for weaker government guarantees.

Table 1 sets out the 1993 capital ratios of the ten largest Japanese and United States banks.

TABLE 1. CAPITAL RATIOS OF JAPANESE AND U.S. BANKS

BANK	TOTAL	TIER I ¹	TIER II ²
JAPANESE BANKS (September 1993) ³			
Daiichi	9.80	5.00	4.80
Sakura	9.05	4.52	4.52
Fuji	9.82	5.11	4.71
Mitsubishi	9.81	4.90	4.90
Sanwa	10.20	5.18	5.02
Sumitomo	9.91	5.45	4.45
Tokai	9.27	4.63	4.63
Tokyo	10.41	5.44	4.97
IBJ	9.25	4.62	4.62
LTCB	9.25	4.62	4.62
U.S. BANKS (December 1993)			
BankAmerica	12.03	7.61	4.42
Citibank	11.61	6.69	4.92
Nations	11.87	7.58	4.29
Chemical	12.40	8.30	4.10
Chase	13.68	8.81	4.87
Bankers	16.49	9.97	6.52
Morgan	14.86	10.61	4.25
Wells Fargo	15.59	10.62	4.97
1st Interstate	13.16	9.96	3.20
Banc One	14.37	10.63	3.74

¹ Basically, equity and earnings.

² Debt instruments representing residual claims, like preferred stock and subordinated term debt, as well as revaluation and loan loss reserves.

³ The data on U.S. banks are actually for bank holding companies. This is the proper comparison because the nonbanking operations of Japanese banks are conducted in subsidiaries of banks rather than in nonbanking subsidiaries of the parent holding company. Our comparison thus takes into account the consolidated data for nonbanking operations in both countries.

Source: Federal Reserve, Japanese Securities Report.

All of the banks exceed the total minimum required BIS capital ratio of 8%, but U.S. banks have higher ratios than Japanese banks. The average total ratio of the ten largest U.S. banks in 1993 was 13.6% as compared with 9.67% in Japan, almost a 4% differential.

Table 2 sets out the 1993 capital ratios of the ten largest European banks.

TABLE 2. 1993 CAPITAL RATIOS OF EUROPEAN BANKS

BANK	TOTAL	TIER I	TIER II
Credit Lyonnais	8.3	4.4	3.9
Deutsche Bank	11.3	5.7	5.6
Credit Agricole	9.8	8.0	1.8
Societe Generale	9.1	5.9	3.2
ABN-AMRO	11.2	6.9	4.3
Banque Nat'l de Paris	9.5	5.6	3.9
Barclays	9.8	6.0	3.8
Nat'l Westminster	10.8	5.7	5.1
Dresdner Bank	11.2	5.6	5.6
Union Bank of Switz.	10.2	8.3	1.9

Source: American Banker

The average total capital ratio of the European banks in 1993 was 10.12%. While this is higher than the Japanese ratio of 9.67%, this is still 3.5% lower than the United States ratio of 13.6%. The four French banks, which enjoy a significant safety net advantage from state ownership, have an average ratio of 9.18%, an even lower ratio than that of the Japanese.

In addition, as Table 3 shows, capital ratio differentials between U.S. and Japanese banks do not appear to have narrowed as a result of the Basle Accord.

TABLE 3. RATIO OF TANGIBLE EQUITY TO TOTAL ASSETS, JAPANESE AND U.S. BANKS, 1986-92

YEAR	JAPANESE BANKS (percent)	U.S. BANKS (percent)	DIFFERENCE (percentage points)
1986	1.91	5.30	3.39
1987	2.20	4.98	2.78
1988	2.56	5.68	3.12
1989	2.73	5.17	2.44
1990	2.94	5.34	2.40
1991	3.12	5.87	2.75
1992	3.42	6.83	3.41

Source: Federal Reserve, Japanese Securities Report

Similar results obtain when comparing U.S. and European banks during the 1987-1992 period, as show in Table 4. While the U.S.-European differential

is considerably smaller than the U.S.-Japanese differential, the differential increased rather than decreased as Basle was phased in.

TABLE 4. RATIO OF TANGIBLE EQUITY TO TOTAL ASSETS, EUROPEAN AND U.S. BANKS, 1987-92

YEAR	EUROPEAN BANKS (percent)	U.S. BANKS (percent)	DIFFERENCE (percentage points)
1987	4.02	4.98	.96
1988	4.19	5.68	1.49
1989	4.19	5.17	.98
1990	4.23	5.34	1.11
1991	4.34	5.87	1.58
1992	3.92	6.83	2.91

Source: American Banker

This does not necessarily mean that the bailout differential is responsible for the United States differentials. Lower Japanese ratios may merely reflect the recent economic downturn in Japan, particularly real estate loan losses and the fall of the price of shares on the Tokyo Stock Exchange. Or the higher U.S. ratios could reflect the need to escape United States Prompt Corrective Action regulation⁴ which require a 10% rather than an 8% ratio. All one can say is that the continued existence of the bailout differentials between U.S. and foreign banks is consistent with the analysis that U.S. banks need more capital to compensate for a weaker safety net.

D. Higher Efficiency for U.S. Banks

Holding more capital is costly for U.S. banks even if it allows them to pay competitive prices for funding. The only way U.S. banks can compensate for this cost of capital is to be more efficient than their Japanese counterparts. Efficiency gains would have to offset the lack of subsidies. There is no hard evidence that U.S. banks are more efficient than their Japanese competitors, but most people in the industry believe this is the case. Efficiency comparisons are more difficult to make between U.S. and European banks as a group.

4. See Section 131 of the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242, as implemented by regulations of the Federal Reserve Board, 57 Fed. Reg. 44866 (Sept. 29, 1992).

E. Impact of the Bailout Differential

If this paper is correct about the bailout differential, there are severe limitations on the ability of the Basle Accord to even the playing field. It simply does not address differences in safety nets.

Further, one might consider whether the Basle Accord has actually made things worse for U.S. banks. There is some evidence that the marginal cost of capital increases as more capital is raised. If this is true then raising the minimum ratio to 8% may have made it more expensive for U.S. banks to maintain the higher capital ratio difference with their foreign competitors. Prior to Basle, they may have had to hold 8% to match the Japanese 6%, whereas after Basle they may have to hold 12% to match the Japanese 10%. It may be more expensive to maintain the latter differential.

Finally, one can question how meaningful it is, in the modern world of finance, to level the playing field between banks in different countries. Today, the traditional business of banking is increasingly conducted by non-banks, finance companies and insurance and securities firms that are entirely outside the Basle framework. The failure of the Accord to deal with this central fact may result, at best, in equalizing competition on an increasingly narrow and irrelevant playing field. The Capital Adequacy Directive of the European Union addresses this issue to some extent within the Union, but the problem remains internationally. Indeed, the major beneficiaries of the increased "equal" costs imposed by Basle may be firms that compete with banks but are not subject to such costs. One recent study found that Basle risk-weights of 100% for all private borrowers were resulting in U.S. banks making less commercial loans.⁵ The result is that more funding will be done in the capital markets. The recent Basle proposals to impose market risk regulation on banks that may not, in many countries, be imposed on securities firms, will further contribute to this problem.

III. THE UNPREDICTABLE IMPACT OF COMMON CAPITAL STANDARDS

When one focuses on the effects of the Accord itself, it becomes apparent that it would be an accident if the Accord evened the playing field. This follows from the different and unpredictable impact common capital standards can have within countries with different markets, regulations, tax and accounting systems.

5. B. Hall, 7 J. OF THE JAPANESE AND INT'L ECON. 408 (1993).

A. Market Differences: Capital Instruments and Assets

There are two market differences between the United States and other countries that affect the impact of the Accord. First, some foreign banks, particularly Japanese banks, have less access than U.S. banks to certain cheaper equity substitutes that qualify as capital. Second, foreign banks tend to put a higher proportion of their investments in assets with higher risk-weights (commercial loans) as compared with U.S. banks. Regulations importantly contribute to both of these market differences. The result may be that capital requirements, implemented in exactly the same way in various countries, may be more onerous for European and Japanese banks.

1. Capital Instruments

Japanese banks have not been able, due to legal impediments, to take advantage of the Basle rules permitting the use of preferred stock. Also, European banks do not generally issue non-cumulative perpetual preferred stock. Indeed, Italian banks do not use any Tier II hybrid instruments. Insofar as this results in foreign banks using more expensive forms of capital, they are at a competitive disadvantage with U.S. banks which make significant use of such instruments. Perpetual preferred stock is an important source of Tier I capital for U.S. banks, 14.3%. Japanese banks, by contrast, have no domestic perpetual preferred stock.

European banks, however, may appear to have some capital advantages over U.S. and Japanese banks. For example, German and Swiss banks can include undisclosed reserves in Tier II capital. Moreover, all EU banks can include disclosed general reserves in Tier I capital—the EU allows this to encourage disclosure of reserves. It is questionable, however, whether this really gives European banks a competitive advantage. All these reserves are generated by earnings, and retained earnings count as Tier I capital for U.S. banks in the same way general reserves count for European banks. While German and Swiss banks can include undisclosed reserves (generated by earnings) in Tier II capital, Tier II capital levels are limited to 50% of Tier I levels.

2. Asset Composition

The Basle Accord assigns different risk-weights to different kinds of assets, for example 0% to government debt, 50% to residential mortgages, and 100% to other loans to private obligors. The United States, unlike Japan and the European Union, has in a number of instances adopted higher risk-weights than required by Basle, thus giving foreign banks capital advantages on those items. Further, some European countries have diverged from the Basle minimum risk-weights. For example, under the European Union Solvency Ratio Directive,

German, Dutch and Greek banks may, until 1996, use a 50% risk-weight for loans backed by mortgages on commercial property, whereas Basle requires these assets to be risk-weighted at 100%.

The competitive impact of the risk-weight system cannot, however, be measured solely by assessing country divergences from the Basle minimum standards. The Basle choice of risk weights for particular assets can itself have competitive impact. For example, if it were the case that Japanese banks tended on average to have assets in higher risk-weight categories than United States banks, they might be at a competitive disadvantage. There is evidence that this is the case.

For example, Basle allows a 50% risk weight for residential real estate loans, that is loans fully secured by mortgages on residential property. In principle, Japanese banks could, like their U.S. competitors, take advantage of this risk weight. But there is less financing of residential real estate in Japan due to different housing conditions. In 1992, U.S. banks had a higher percentage of assets in residential mortgages—3.4% more—and a lower percentage of assets in commercial loans—5.3% percent less—than their Japanese competitors. This meant lower capital requirements for U.S. banks.

In summary, differences in markets and regulation between the United States and other countries, as illustrated with respect to capital instruments and types of loans, can importantly affect the impact of capital requirements. In the two examples set out above, the result seems to favor the United States, but other differences could well favor foreign banks. For example, it is clear that Japanese banks, and probably some European banks, are significantly favored by more lax enforcement of capital requirements.

B. Accounting and Tax Differences: Revaluation Reserves

It is also important to evaluate the accounting and tax differences between countries in assessing the competitive impact of common capital requirements. The treatment of revaluation reserves is a good example.

1. Revaluation Reserves under Basle

The Basle Accord permits banks to include 45% of the difference between the carrying cost and market value of securities as Tier II capital. This form of capital is referred to as a latent revaluation reserve. Japan has implemented the Accord by permitting revaluation reserves on securities held in investment accounts but not trading accounts (investment securities are not expected to be sold within a year of acquisition). Revaluation reserves on securities constituted 40.5% of Japanese banks' Tier II capital in 1992. The United States and most European countries, on the other hand, have prohibited using revaluation reserves on securities.

As a result, one might be tempted to conclude that Japan is highly advantaged as a result of this difference in implementation of the Accord, but when accounting and tax factors are taken into account, this may not be the case.

2. U.S. and Japanese Accounting Rules

The accounting rules in Japan and the United States for valuing securities held by banks are summarized in the table below. One can focus on debt securities in the trading account (actively traded securities) to see how these rules operate.

COUNTRY AND SECURITY	TRADING ACCOUNT	INVESTMENT ACCOUNT
JAPAN		
Debt	Lower of historical cost or market	Election between historical cost, and lower of historical cost or market
Equity	None allowed	Lower of historical cost or market
UNITED STATES		
Debt	Market	Historical cost
Equity	None allowed	Lower of aggregate historical cost or aggregate market

On the trading account, the United States practice of marking-to-market generates more capital in an up market (falling interest rates). This is because all asset gains run through the income statement and flow into capital. If an asset appreciates by 100, this generates a 100 increase in both assets and capital (by way of income) on the balance sheet. Since the Japanese do not mark up to market or use revaluation reserves for the trading account, they count no gains as capital. In a down market (rising rates), banks in both countries are in the same position. They lose the entire loss because banks in both countries must mark down to market. Thus, U.S. banks are at an advantage.

In theory, Japanese banks could compensate for this disadvantage by engaging in gains-trading, that is selling appreciated securities rather than holding them. But this is not a viable strategy in practice. Selling will only

generate after-tax gains of 50%, given Japanese 50% tax rates, much less than the 100% generated for United States banks under the accounting rules.⁶

This example illustrates that the real effect of a rule can only be judged when one knows how it operates in the real world of an accounting and tax system. Revaluation reserves seem to give the Japanese an advantage but given U.S. mark-to-market accounting and high Japanese tax rates, U.S. banks actually have the advantage.

As among the European Union, Japan and the United States, however, EU banks have the advantage with respect to revaluation reserves on fixed assets, especially real estate. While Basle permits banks to count 100% of gains on fixed assets as capital, Japanese and U.S. banks are prohibited by their regulators from doing so. They can try to minimize the disadvantage by gains trading (sale and leaseback of appreciated properties), but this only generates after-tax gain as capital.

IV. CONCLUSIONS

There are two key points in this paper. First, the Basle Accord could not appreciably even the playing field between U.S. and foreign banks, given the bailout differential. Second, even if the Accord could make the playing field more even, it would be a total accident if it did so, given the disparate effects of regulatory, market, accounting and tax differences among countries. This being the case, the Accord cannot be justified as having made the playing field more even between U.S. and foreign banks.

The justification for the Accord must then squarely rest on safety and soundness grounds, and any benefit on that account must be weighed against possible credit crunch cost. That calculus is beyond the scope of our paper.

This article shows that we should be less sanguine about competitive benefits of international banking agreements given the fundamental differences that remain between countries. Of course, future agreements might address the differences, but then again they may not.

6. In the investment account, where Japanese banks can use revaluation reserves, they may still lose out to United States banks in an up market. Japanese banks generate 45% of the gains as capital, whereas United States banks are now permitted under GAAP to mark up a substantial portion of the gains in this account, thus potentially generating 100% of the gain as capital. However, United States regulators, reversing their original proposals, have prohibited the use of mark-to-market rules for investment securities for purposes of determining regulatory capital. *See, e.g.,* Board of Governors of the Federal Reserve System, Final Rule, 59 Fed. Reg. 63241 (Dec. 8, 1994). This appears to be out of concern with the volatile impact it might have on bank capital. Interestingly, regulators have reversed course during a period of rising interest rates where use of mark-to-market rules results in a loss of capital on debt securities.

