Basle Committee International Capital Adequacy Standards: Analysis and Implications for the Banking Industry

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I. Introduction

In July 1988 after several years of negotiation among banking regulators, the Basle Committee on Banking Regulations and Supervisory Practices issued its final risk-based capital standards for banking institutions. Twelve nations signed the accord and agreed to implement the capital guidelines. The growing interdependence of the international banking system and the varying levels of bank capital mandated by regulators in different nations led to the need for equivalent requirements among banks worldwide.

The Basle Committee's capital standards represent a significant step toward the convergence of international banking regulations. This advance is not without its critics. In the 1991 Annual Economic Report of the President, the Council of Economic Advisors stressed that the capital guidelines are decreasing the availability of credit in the United States. However, others believe that the new capital standards will be beneficial to the international financial system.


1. The Basle Committee on Banking Regulations and Supervisory Practices is a group of twelve nations whose banking authorities meet periodically to discuss banking supervision. These authorities have reached regulatory agreements in the past. The bank regulatory authorities of the following twelve nations are members of the Committee: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. The Bank for International Settlements (BIS) provides staff support for the Basle Committee. The BIS is an organization of central banks that serves as both a forum where central bankers meet to discuss current financial issues and as an international financial institution. See generally Hackney & Shafer, The Regulation of International Banking: An Assessment of International Institutions, 11 N.C.J. INT'L L. & COM. REG. 474 (1986).


With the increasing instability of this system due to the imprudent credit policies taken by some banks, one commentator has stated that the Basle Committee’s capital standards represent the “single most important regulatory response to the breakdown of the credit system.”

This article will initially focus on the functions of capital in the banking industry. It will then analyze the Basle Committee’s capital standards, comparing them to prior adequacy regulations in the United States as well as to the standards implemented by some signatory nations. Finally, this article will report on changes in the banking industry caused by the capital standards and analyze future implications of these standards.

II. Background

A. Importance and Function of Bank Capital

Bank capital generally consists of the following three primary elements: subordinated debt, preferred stock, and common equity. Subordinated debt includes interest-bearing obligations that pay a fixed amount at a future date. Preferred stock consists of equity issues whose dividend payment is generally fixed. Common equity consists of common stock, surplus, undivided profits, and equity reserve accounts. The Basle Committee’s standards specifically define the elements to be included in bank capital.

Capital in banking institutions serves a different function than in non-financial enterprises. One analyst explained the difference in this manner:

In most business firms, the primary function of capital is to finance the purchase of buildings, machinery and equipment. Its secondary function is to protect long- and short-term creditors, who make funds available to the business. In banking, however, the function of capital is primarily to serve as a cushion or in-

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5. Holders of subordinated debt take after secured creditors have satisfied their claims on the issuer’s assets. G. HEMPEL, A. COLEMAN, & D. SIMONSON, BANK MANAGEMENT: TEXT AND CASES 271 (3d ed. 1990) [hereinafter G. HEMPEL].
6. Preferred stock fixes dividend and asset claims in a stated amount and is subordinated to the claims of depositors and other bank creditors. Preferred stock does not mature and may be convertible into common stock. E. Gardner, Capital Adequacy and Banking Supervision 7 (Bangor Occasional Papers in Economics No. 19, 1981).
7. Id. at note 5.
8. Id. at 261. Subordinated debt may be convertible into common stock. Some variable rate debt may be convertible into fixed rate debt. Life insurance companies and pension funds tend to be heavy purchasers of these securities. Id.
9. E. Gardner, supra note 6, at 7; HEMPEL, supra note 5, at 261.
10. E. Gardner, supra note 6, at 261.
11. See infra notes 76-91 and accompanying text.
surance fund to absorb losses that may occur. As a source of funds for the acquisition of physical assets, bank capital serves a secondary function.\textsuperscript{12}

The United States Comptroller of the Currency made a similar point in the following official statement:

Bank capital has myriad uses and purposes. It allows a bank to gain competitive entry by acquiring the necessary infrastructure to operate. It provides a cushion to withstand abnormal losses not covered by current earnings, enabling the bank to regain equilibrium and re-establish a normal earnings pattern. It serves the important psychological role of maintaining the confidence of public lenders in the bank's ability to meet maturing demands in most market conditions, to sustain present and contemplated growth patterns and to conform to industry standards. In liquidation it provides protection to both depositors and other creditors.\textsuperscript{13}

In essence, bank capital serves four primary functions. First, it inspires public confidence in the bank's viability by absorbing unanticipated losses.\textsuperscript{14} Second, it protects uninsured depositors in the event of bank insolvency.\textsuperscript{15} Third, it pays for the acquisition of physical plants and other resources necessary to operate the bank.\textsuperscript{16} Finally, it serves as a regulatory restraint on unjustified asset growth.\textsuperscript{17} Of these four, the inspiration of public confidence is the primary function of capital.\textsuperscript{18} Depositors must be confident that their money is safe at the bank: Shareholders must feel assured that their investments will not be lost because of imprudent credit policies. Bank regulators must be confident that the bank is in sound financial condition, especially in the United States (U.S.) due to its closely regulated private banking system.\textsuperscript{19}

Capital adequacy of a bank is not the complete solution to ensuring the soundness of the banking system.\textsuperscript{20} For instance, sufficient capital would not have prevented the less developed countries' loan crisis. That condition resulted from the unwise credit policies of some money center banks in the U.S.\textsuperscript{21} Similarly, Texas banks had

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12. E. Gardner, supra note 6, at 7.
13. Id. at 10.
15. Id. at 272.
16. Id.
17. Id. at 272.
18. Id. at 273.
19. Id.
21. Id.
excess capital in the 1980s when they made imprudent loans in the real estate and energy industries. Thus, a lack of capital was not the root cause of the subsequent Texas bank failures.22

As illustrated by the examples above, adequate bank capital will not prevent bank failures.23 In reality, capital adequacy is only one of many factors that affects bank instability and failure.24 Nevertheless, in its effort to coordinate bank regulation among nations, the Basle Committee has focused on capital adequacy and, in particular, its effect on credit risk.

B. Purpose of Basle Risk-based Capital Standards

The growth of the international banking system and the interdependence of the world economy created the need for common bank capital standards across borders.25 To foster stability in the system, bank regulators must cooperate to establish competitive equality.26 Before the Basle standards were issued, regulators worldwide did not require financial institutions to maintain an equivalent capital level, which resulted in very uneven requirements among nations.27 Banks in nations with weak capital regulations had a competitive advantage and could offer products at a lower price.28 This situation created anomalies within the banking system. A common capital standard among the major industrial nations was needed to create a level-playing field.29

Another concern among international banking regulators was that banks were increasing their involvement in off-balance sheet activities.30 Previous capital adequacy regulations did not govern these off-balance sheet activities. Without adequate funds supporting these activities, regulators believed that the banking system was vulnerable
The Basle Committee’s capital standards now require banks to include their off-balance sheet activities when calculating their total risk-weighted assets. Common capital standards will also fulfill other objectives of regulators. First, they will inspire the regulators’ confidence that the banks could withstand any unforeseen losses. Second, a common capital standard set at the proper level will strengthen the banking system and prevent a financial disturbance in one country from spreading and triggering defaults in other nations. Finally, a capital standard gives the bank a stake in its future and discourages it from taking excessive risks with government insured deposits.

Besides equalizing bank capital levels, the Basle Committee’s standards will increase the required amount of capital, at least in some countries. A stronger capital requirement will place a market test on banks and force them to prove to investors that they can generate adequate returns on the capital invested. Furthermore, a stronger capital position will allow banks to take advantage of unexpected business opportunities, such as acquisitions when they arise. However, stronger capital requirements do have their costs. Capital is an expensive source of funds for banks. An increase in the amount of capital required by regulators increases the banks’ costs of doing business and restrains their ability to increase deposits or loans. If other bank competitors do not have the same capital requirements, serious competitive disadvantages result.

C. Brief History of Capital Adequacy Regulation in the United States

Historically, state and federal bank regulators in the United States could set initial capital levels for banks as part of their licens-
ing function, but could not set specific capital levels to absorb unforeseen losses.\textsuperscript{43} Beginning in the early twentieth century, a capital-to-deposits ratio was used by U.S. bank regulators as a measure of capital adequacy.\textsuperscript{44} The rule of thumb was that a 10\% ratio was adequate.\textsuperscript{45}

In the late 1940s, the Office of the Comptroller of the Currency (OCC) used a capital to risk-adjusted assets measure.\textsuperscript{46} Risk-adjusted assets were calculated by subtracting cash and U.S. government securities from total assets.\textsuperscript{47} In a separate effort in 1952, the Federal Reserve Bank of New York developed a method for calculating minimum bank capital by assigning assets to one of six risk-weight categories.\textsuperscript{48} The Federal Reserve Board of Governors (FRB) staff developed another capital adequacy formula called the ABC formula in 1956, but abandoned it before implementation because it demanded excessive capital.\textsuperscript{49}

In the late 1960s and early 1970s, the OCC regulators moved away from capital adequacy ratios as a form of regulation and decided to consider selected factors on a case-by-case basis in evaluating banks.\textsuperscript{50} This change resulted from the regulators' realization that bank capital was only one of several factors determinative of the soundness of a financial institution. In the late 1970s, the OCC, the Federal Deposit Insurance Corporation (FDIC), and the FRB compared selected financial ratios to peer averages as the method to determine capital adequacy.\textsuperscript{51} This ratio comparison technique became part of the CAMEL\textsuperscript{52} scheme of regulation.

In the early 1980s, the OCC attempted to make low capital levels an unsafe and unsound banking practice.\textsuperscript{53} The Fifth Circuit Court of Appeals in \textit{First Nat'l Bank of Bellaire v. Comptroller of}

\begin{itemize}
  \item \textsuperscript{44} G. Hempel, \textit{supra} note 5, at 277. A capital to deposits ratio is a ratio of the bank's capital (shareholder equity and certain long-term debt) to the deposits (both business and consumer) the bank holds for its customers.
  \item \textsuperscript{45} Id.
  \item \textsuperscript{46} Id.
  \item \textsuperscript{47} Id.
  \item \textsuperscript{48} Id. at 278. The six risk-weight percentage categories were the following: 0\%, 5\%, 12\%, 20\%, 50\%, and 100\%. Id.
  \item \textsuperscript{49} Id. The ABC formula combined a capital adequacy test and a liquidity test in determining the required level of capital. Banks involved in arbitrage, mainly money center banks, were required to maintain excessive levels of capital under this formula. The FRB quickly abandoned this concept.
  \item \textsuperscript{50} Id. at 278.
  \item \textsuperscript{51} Id. at 279. The ratios regulators used included: equity capital/total assets, loans/total capital, fixed assets/capital, and asset growth rate/capital growth rate.
  \item \textsuperscript{52} CAMEL refers to the five rating criteria in a bank examination: capital, asset quality, management, earnings, and liquidity. The Federal Financial Institutions Examination Council (FFIEC) formed in 1979 developed this uniform rating system. Each financial institution regulator uses this same general framework.
\end{itemize}
the Currency overturned this regulatory change. During this same period, the U.S. Congress was concerned about excessive loans extended to less developed nations, particularly those made by the money center banks. If banks charged off the entire loss on these loans, some would have had a negative amount of capital. Congress' concern led to the passage of the International Lending Supervision Act of 1983 (ILSA) which authorized bank regulators to set "minimum levels of capital" for banks. Furthermore, ILSA allowed the maintenance of a low level of capital to be considered an unsafe and unsound banking practice and effectively overruled the Bellaire decision. Thus, capital adequacy became a legitimate regulatory objective.

In 1985, after several years of varying capital levels, the three principal federal bank regulators agreed on equivalent capital guidelines for banks. Banks and bank holding companies were required to maintain 5.5% primary capital to adjusted total assets and 6% total capital to adjusted total assets. These minimum capital guidelines had several unintentional effects. They encouraged banks to sell low yield, low risk assets for high yield, high risk assets because total assets were not differentiated for risk. Also, banks' pursuits of off-balance sheet activities increased since these regulatory capital standards did not account for these activities.

As more banks began to fail in the late 1980s, Congress passed legislation requiring bank regulators to implement capital standards for both banks and savings and loans institutions. In January 1987

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55. Money center banks are generally the larger banks located in major financial centers, such as New York, Los Angeles, Chicago, and San Francisco. The recent growth of regional banks in Atlanta, Charlotte, and Columbus has overshadowed the importance of the money center banks.
56. Puleo, supra note 53, at 462.
58. Id. § 3907(a)(1).
59. Id. § 3907(b)(1).
60. First Nat'l Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674 (5th Cir. 1983).
62. The three principal federal banking regulators are the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC).
63. G. HEMPEL, supra note 5, at 279.
64. A bank holding company (BHC) is a corporation that has a bank subsidiary and possibly non-bank subsidiaries that engage in closely related non-bank activities.
66. G. HEMPEL, supra note 5, at 279.
68. Id. See also Norton, supra note 20, at 278.
the Federal Reserve and the Bank of England entered into an agreement to implement common risk-based capital standards for banks in their respective countries.\textsuperscript{70} This agreement served as a catalyst for the conclusion of on-going discussions of the Basle Committee meeting in Switzerland.

In December 1987 the Basle Committee issued its proposed risk-based capital standards for comment.\textsuperscript{71} After making some changes to the standards based upon these comments, the Basle Committee issued its final standards in July 1988.\textsuperscript{72} Bank regulators in the twelve signatory countries will implement the final standards by December 31, 1992.\textsuperscript{73} Meanwhile, international banks within the signatory nations must have met the interim standards by December 31, 1990.\textsuperscript{74}

III. Basle Capital Guidelines

In developing the capital guidelines the Basle Committee intended to achieve two main objectives: to improve the soundness and stability of the world financial system by increasing capital among the major international banks and to create competitive equality among international banks by having them maintain equivalent amounts of capital.\textsuperscript{75} The guidelines focused principally on regulating credit risk and secondarily on country transfer risk.\textsuperscript{76}

The final guidelines comprise four principal components. First, the guidelines provide a common definition of bank capital. Second, they assign bank assets to one of five risk-weight percentages. Third, they include off-balance sheet activities in the calculation of risk-weighted assets by using a conversion factor for each off-balance sheet activity. Fourth, they set a minimum bank capital level as a percentage of risk-weighted assets and allow for a transitional period with interim capital targets to ease the implementation of this new form of capital regulation.\textsuperscript{77} In sum, the capital adequacy formula is:

\textsuperscript{70} BIS REV. No. 43 (March 3, 1987); BANK OF ENGLAND Q. BULL. (Feb. 1987); 52 FED. REG. 5135 (Feb. 19, 1987).
\textsuperscript{71} Basle Standards, supra note 2, at 143.
\textsuperscript{72} Id. at 150 (para. 50).
\textsuperscript{73} Japanese banks have until March 31, 1993, to attain the final capital standard of 8% capital to risk-adjusted assets.
\textsuperscript{74} Basle Standards, supra note 2, at 150 (para. 49).
\textsuperscript{75} Id. at 143 (para. 3). See also supra notes 25-36 and accompanying text.
\textsuperscript{76} Basle Standards, supra note 2, at 147 (para. 33). Country transfer risk is equivalent to sovereign credit risk. Capital guidelines dealing with other risks banks face (i.e., interest rate risk) are under discussion by the Basle Committee. See infra notes 306-09 and accompanying text.
\textsuperscript{77} Basle Standards, supra note 2, at 149-50.
minimum = Tier 1 capital + Tier 2 capital

capital ratio = risk-adjusted + off-balance

assets + sheet items

First, the Basle Committee agreed on a common international definition of bank capital. Bank capital is divided into two components: Tier 1 capital or core capital and Tier 2 capital or supplementary capital.\(^7\) Tier 1 capital includes permanent equity capital such as common equity.\(^8\) For example, noncumulative preferred stock is included in Tier 1 capital, while cumulative preferred stock is not.\(^9\) Tier 1 capital is also composed of disclosed reserves or retained earnings as well as minority investment interests in subsidiaries.\(^10\)

On the other hand, Tier 2 capital consists of elements not considered to be as permanent as the Tier 1 elements. For example, Tier 2 capital includes undisclosed reserves that are accepted by that nation’s bank regulatory authorities as capital.\(^11\) Tier 2 capital is also composed of revaluation reserves or the hidden profits in a bank’s securities portfolio up to a limit of 45% of the hidden gain.\(^12\) In addition, loan and lease loss reserves for general unanticipated losses are a part of Tier 2 capital.\(^13\) Loan loss reserves are limited to 1.5% of risk-weighted assets during the transition period up to December 31, 1992, and limited to 1.25% of risk-weighted assets after that date.\(^14\)

Hybrid debt-equity instruments may be included in Tier 2 capital as well.\(^15\) The distinguishing characteristics of these instruments are that they are unsecured, subordinated, and fully paid: Also, they are not redeemable and are available to participate in bank losses. In addition, their service obligations can be deferred.\(^16\) These instruments include perpetual preferred shares and long-term preferred

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78. Id. at 150-51.
79. Id. at 144 (para. 12-14).
80. Id. With noncumulative preferred shares, if the corporation fails to pay a dividend in one quarter, it need not ever pay it because the dividends do not accumulate. With cumulative preferred, if the corporation fails to pay the dividend the corporation must pay the dividend in arrears before it pays dividends on common shares.
81. Id. Retained earnings consist of the amount of net income not paid out to shareholders in dividends.
82. Id. Undisclosed reserves consist of retained earnings and other funds available to support the bank but not disclosed on publicly available financial statements.
83. Id. This provision was proposed by Japanese bank regulatory authorities and particularly benefits Japanese banks in attaining the minimum capital standards.
84. Id.
86. Basle Standards, supra note 2, at 146.
87. Id. at 152.
shares in Canada, titres participatifs and titres subordonnés a durée indéterminée in France, Genusscheine in Germany, perpetual debt instruments in the United Kingdom, and mandatory convertible debt instruments in the United States. Subordinated debt is also a Tier 2 component if it has a minimum original term of five years. Its value must be amortized 20% per year during the last five years of its term. The contribution of subordinated debt to Tier 2 capital is limited to 50% of Tier 1 capital.

The capital guidelines specify some deductions from bank capital. After January 1, 1993, banks must deduct all goodwill from Tier 1 capital. Investments in unconsolidated subsidiaries must be deducted from the capital amount, and the assets of these subsidiaries must be deducted from the risk-weighted assets of the bank. At their discretion, national banking authorities may require banks to deduct equity cross-holdings in other banks. The Basle Committee did not require the deduction of cross-holdings because these investments aid in the current restructuring of the banking industry in some nations.

Second, all bank assets are assigned to a risk-weight percentage category, which the Basle Committee specifies as the following: 0%, 10%, 20%, 50%, or 100%. The 0% category comprises claims on central governments and central banks in the Organization for Economic Cooperation and Development (OECD) and in countries with special lending arrangements with the International Monetary Fund (IMF) which are associated with the IMF’s General Arrangements to Borrow. Also included within this category are cash,

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88. Id. at 146.
89. Subordinated debt is generally those bonds whose holders, in case of bankruptcy, have a preference to corporate assets just before preferred shareholders and after senior debt holders are paid.
90. In other words, the bank must deduct one-fifth of the value of the subordinated debt each year during the five years before the maturity date of the issue.
91. Id.
92. Id.
93. Id. U.S. regulations allow some goodwill to be included in bank capital under a grandfather provision. See infra notes 153-55 and 249-53 and accompanying text. Goodwill informally refers to the going concern value of a business. In accounting terms, it is the difference between the sale price of a business and the fair market value of the assets of that business.
94. Basle Standards, supra note 2, at 146 (para. 25-27). Equity cross-holdings occur when banks purchase each other’s shares.
95. Id.
96. Id. at 147.
97. The U.S. banking regulators did not take advantage of the 10% risk weight category.
98. The members of the Organization for Economic Cooperation and Development (OECD) include the following nations: Australia, Austria, Belgium, Canada, Denmark, Germany, Finland, France, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.
99. Currently, Saudi Arabia has made this arrangement with the International Mone-
loans collateralized by cash or central government securities, and claims on non-OECD central banks and governments if funded in local currency and supported by liabilities in local currency.

At their discretion national authorities may use the 10% category for claims on domestic public-sector entities. In the 20% category are claims with less than a one year maturity on banks outside the OECD and claims on OECD banks or guaranteed by OECD banks regardless of maturity. Also included are cash items in the process of collection, claims on public sector entities in OECD countries, claims on multilateral development banks, and claims collateralized by securities of these banks.

The 50% risk-weight category includes mortgages on residential property that will be occupied by the borrower or rented to another person. All other assets are included in the 100% category. The 100% group includes all claims on the private sector, interbank loans with maturities greater than one year to non-OECD banks, and claims on commercial companies owned by the public sector.

Third, the guidelines require that regulators account for off-balance sheet activities within risk-weighted assets. To perform this accounting, off-balance sheet activities are multiplied by a conversion factor to obtain an asset figure. This figure is then assigned to one of the risk-weight percentage categories defined above.

Similar to risk-weight percentage categories, the Basle guidelines establish conversion factor categories for off-balance sheet activities. Direct credit substitutes are within the 100% conversion factor category. This category includes general guarantees, standby letters of credit, and asset sales with recourse. Within the 50% conversion factor category are transaction-related contingencies, such as performance bonds and bid bonds, as well as commitments, such as the undrawn portion of a revolving line of credit with

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100. *Basle Standards, supra note 2, at 148.*
101. *Id.*
102. *Id. at 152.*
103. *Id. at 148.* The Basle Committee believed banks located in an OECD member nation presented less credit risk and, therefore, did not place a maturity limitation on these banks, unlike banks located in nations outside the OECD.
104. *Id. at 152.*
105. Multilateral development banks include the World Bank, the Interamerican Development Bank, the Asian Development Bank, the African Development Bank, and the European Development Bank.
106. *Basle Standards, supra note 2, at 148.*
107. *Id.*
108. *Id.*
109. *Id. at 149.*
110. *Id.*
111. *Id. at 153.*
112. *Id.*
113. *Id. at 149.*
a maturity greater than one year. Finally, within the 20% conversion factor are short-term, self-liquidating trade-related contingencies arising from the movement of goods, such as documentary credits collateralized by the underlying shipment (e.g., letters of credit). Commitments that have a maturity of less than one year or that can be unconditionally canceled at any time, are within the 0% conversion factor group.

The Basle Committee’s guidelines establish a method for converting interest rate and foreign exchange items to risk-weighted assets. At the discretion of the national regulatory authority, interest rate and foreign exchange related items can be accounted for by two methods: the mark to market method or the original exposure method.

Once the assets have been assigned to risk-weight percentage categories, and off-balance sheet activities have been accounted for, banks must maintain the minimum capital level set by the Basle Committee, the fourth component of the capital standards. The Committee set 8% of risk-adjusted assets as the common minimum capital level of banks. The minimum level of Tier 1 capital is 4% of risk-adjusted assets. Within Tier 1 capital, the loan loss reserves component cannot account for more than 1.25% of risk-weighted assets. In addition, Tier 2 capital cannot be greater than Tier 1 capital. The subordinated debt component of Tier 2 capital cannot be greater than 50% of the bank’s Tier 1 capital.

Realizing that the new risk-based capital guidelines would place extra demands on some banks, the Committee provided for a transitional period for the implementation of the final 8% standard. By December 31, 1990, banks must attain a 7.25% capital-to-risk-weighted assets ratio with 3.625% of that ratio being Tier 1 capital. During the interim period, 10% of Tier 1 capital may consist of Tier 2 capital elements, while loan loss reserves may account for up to 1.5% of risk-weighted assets.

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114. Id. at 149.
115. Id.
116. Id.
117. The mark to market method calculates the replacement cost of the foreign exchange or interest rate contract. The majority of the Basle Committee, including the U.S., favored adoption of this method. Id. at 153-54.
118. The original exposure method, a simpler method, requires application of set conversion factors to the interest rate and foreign exchange contracts. Id. at 154.
119. Id. at 150.
120. Id.
121. Id.
122. Id.
123. Id.
124. Id. After January 1, 1993, the loan loss reserves can only equal 1.25% of risk-adjusted assets.
IV. Implementation of the Basle Capital Standards

A. Legal Status of the Capital Standards

The Basle Committee’s capital guidelines are neither legally enforceable as a treaty\(^{126}\) nor do they have legal force by themselves. Rather, the separate national governments are charged with their implementation.\(^{126}\) Each signatory nation has committed itself to follow the guidelines in good faith\(^{127}\) and has begun to implement the capital standards, largely abiding by the tenets of the Committee’s guidelines.\(^{128}\) The Basle guidelines have improved upon past capital adequacy regulations because they differentiate between risk levels, consider off-balance sheet activities, minimize disincentives to hold low risk assets, and provide for greater consistency in capital requirements among international banks.\(^{129}\)

B. Current Implementation

Regulators have begun to implement the final standards in order to meet the deadline for implementation at the end of 1992. The Basle Committee and national regulators consider the 8% minimum capital requirement to be just that—a minimum.\(^{130}\) Because the capital guidelines do not take into account all the risks associated with banking,\(^{131}\) regulators expect banks to maintain capital levels significantly above the 8% minimum. In the United States, bank regulators have stated that if banks wish to expand or to engage in risky activities, they must maintain a capital ratio above the minimum level;\(^{132}\) thus, regulators are likely to encourage banks to maintain higher capital ratios.\(^{133}\)

Despite the good faith efforts of the signatory nations’ bank reg-

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\(^{125}\) GAO, supra note 25, at 3.

\(^{126}\) Kindel & Barrett, Super Bank, FINANCIAL WORLD, March 5, 1991, at 28 (hereinafter Kindel).


\(^{128}\) GAO, supra note 25, at 13.

\(^{129}\) Brumbaugh, supra note 34, at 10A; see supra notes 43-68 and accompanying text on past capital adequacy regulations.

\(^{130}\) GAO, supra note 25, at 22.

\(^{131}\) These other risks include interest rate risks, foreign exchange risks, operational risks, and fiduciary risks. Senate Report, supra note 36, at 13.


ulators and the improvements made by the Basle Committee’s standards over previous attempts at bank capital regulation, the success and effectiveness of the standards will depend upon their implementation by the individual national banking regulatory authorities. However, the standards themselves give national regulators some discretion in implementation. Some regulators are already utilizing this control to their domestic banks’ advantage.

C. Implementation in the United States

Bank regulators in the United States have expanded the application of the Basle Committee’s capital guidelines to include all banks, not just international banks as the Basle Committee intended. Application to all banks in the United States is not appropriate because the U.S. has a unique dual bank regulatory system. Money center banks have wider geographic risks than community banks. The composition of the asset portfolios of the two types of banks is completely different. Blanket application of the Basle Committee’s capital standards to all banks ignores these differences.

The Basle Committee intended the standards to apply to parent companies only if the parent company was a bank. Federal Reserve regulations apply the Basle Committee’s standards, with some changes to the definition of capital, to all bank holding companies (BHCs). Generally, Tier 1 capital includes common equity, retained earnings, noncumulative preferred stock, and minority equity interests in consolidated subsidiaries. For BHCs, the Federal Reserve regulations include cumulative preferred shares in Tier 1 capital up to a maximum limit of 25% of Tier 1 capital, with the remainder of cumulative preferred being applied to Tier 2 capital. The Basle Committee’s standards allowed only noncumulative preferred in Tier 1 capital, not cumulative preferred. This change in the capital definition favors U.S. banks by allowing a new source of cap-

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134. Basle Standards, supra note 2, at 144 (para. 6).
137. Id.
138. Puleo, supra note 53, at 466.

The Bush Administration in October 1991 issued a proposal that would raise the 25% limit on the amount of preferred shares to be included in Tier 1 capital of BHC. Basel Loophole to Allow US Banks to Raise Capital, Boost Lending, THOMSON’S INT’L BANKING REGULATOR, Oct. 11, 1991, at 1.
142. Puleo, supra note 53, at 469.
ternal into Tier 1 capital. Since foreign banks consider U.S. BHCs, rather than individual bank subsidiaries of BHCs, to be the operating business unit, the Federal Reserve Board’s (FRB’s) definition of BHC capital should follow the Basle Committee’s capital definition strictly rather than relaxing the definition of core capital.

One weakness of the guidelines is the loose definition of Tier 2 capital which allows national regulators to include various forms of quasi-equity in their individual definition of bank capital. In contrast, the strict definition of Tier 1 capital allows it to serve as a consistent capital comparison among international banks. As previously discussed, U.S. regulators weakened the strict Tier 1 capital definition by allowing BHCs in the U.S. to include both cumulative and non-cumulative preferred shares in Tier 1 capital. The three federal bank regulatory agencies created two sets of capital adequacy rules—one for state banks and one for BHCs. These regulations allowed BHCs to meet the Basle Committee capital ratios more easily.

Using year-end 1989 data and the FRB’s definition of bank capital, only three BHCs of the top fifty would not meet the Basle Committee’s ratio. If the more strict definition was applied, twelve of the top fifty BHCs would not meet the Basle ratios. Furthermore, these twelve BHCs control just under 50% of the assets of the top fifty BHCs. Some commentators argue that these differences in the capital definition are necessary because BHCs represent corporate structures unique to the U.S. This argument is not sound because similar corporate structures exist in other nations.

U.S. bank regulators have differentiated the application of the Basle Committee’s guidelines to state banks and BHCs in other ways. Certain hybrid debt/equity instruments included in a bank’s Tier 2 capital under the Basle standards can also be included in the Tier 1 capital of a BHC under the FRB regulations. BHCs must fully deduct goodwill acquired after March 12, 1988, from Tier 1 capital, but may include goodwill acquired before that date in Tier 1 capital.
capital until the end of the transition period in 1992. Under the regulations, the FRB can exclude the investment in and assets of an unconsolidated subsidiary of a BHC on a case-by-case basis. If the FRB orders the deduction of the investment, half will be from Tier 1 capital and half will be from Tier 2 capital.

U.S. regulators have promulgated a separate set of capital adequacy rules to operate concurrently with the Basle guidelines. In addition, U.S. regulators require banks to maintain a minimum leverage ratio of 3%. This ratio measures equity against total assets, not risk-weighted assets. The objective is to ensure that banks with low credit risks will, nevertheless, maintain a minimum level of capital to protect against other types of risk. Nearly all banks meet this minimum leverage ratio, but regulators frequently require a higher leverage ratio depending on the financial condition of the particular bank.

D. Implementation in Europe and the EC

Other nations have begun to change their banking laws to conform with the Basle Committee’s standards. Switzerland and the United Kingdom, like the U.S., formally changed their banking regulations. The Swiss Federal Council required all Swiss banks to meet the new capital requirement by December 31, 1989. In October 1988 the Bank of England issued notice that all United Kingdom banks must comply with the capital standards by December 31, 1989. France and Germany did not formally change their banking regulations, but rather reached agreements with each of their internationally active banks. Japan implemented the Basle Committee’s standards through ministerial notification and applied them only to banks with establishments overseas.

156. Brumbaugh, supra note 34, at 10A.
157. Senate Report, supra note 36, at 74. A concern in developing the leverage ratio was that if the ratio was too high it would “destroy risk reduction incentives of a risk-based system.” Id. at 13. Too high a ratio would run counter to the objectives of the Basle risk-based capital scheme.
158. Brumbaugh, supra note 34, at 10A.
159. M. Feldstein, Revise Bank Capital Standards Now, Wall St. J., March 6, 1992, at A8. Feldstein advocates a return to a uniform 3% ratio now that the Basle standards are in effect.
160. GAO, supra note 25, at 14. See also Price Waterhouse, Bank Capital Adequacy and Capital Convergence (1991). This survey details regulatory changes made by various national governments as they implement the new capital standards.
161. GAO, supra note 25, at 14.
162. Id.
163. Id. Japanese banks without international offices can choose whether to follow the
The European Community (EC) implemented the Basle Committee's standards through two capital adequacy directives issued by the Council of Ministers in 1988: the Own Funds Directive and the Solvency Ratio Directive. An EC directive creates a general binding obligation upon member states, but it leaves to each state the means by which to fulfill the obligation. Member states were required to comply with the Solvency Ratio Directive provisions by January 1, 1991. The Solvency Ratio Directive, like the Basle Committee's capital standards, focuses on credit risk; meanwhile, another directive, the Capital Adequacy Directive, focuses on market risk. The Solvency Ratio Directive applies to all credit institutions and requires bank capital to be equal to 8% of risk-weighted assets. The formula is:

\[
\text{solvency ratio} = \frac{\text{own funds}}{\text{risk-adjusted assets} + \text{off-balance sheet items}}
\]

The directive applies five risk-weight categories: 0%, 10%, 20%, 50%, and 100%. The EC granted an important exception to the implementation of the final guidelines to banks in Germany, Denmark, and Greece. Bank mortgages on commercial property in those countries are assigned to the 50% risk-weight category (rather than 100%) until January 1, 1996, provided that the loan does not exceed more than 60% of the financed property's value. Other EC countries must apply the 100% risk-weight to these loans. Thus, the German, Danish, and Greek banks temporarily have a significant competitive advantage over other banks. The reason for the exception is the great number of institutions that grant mortgaged-backed loans in those nations; this exception allows them extra time for Basle capital ratios. As of August 1990, ninety-one Japanese banks follow the Basle guidelines; sixty-four banks follow domestic regulations. Id.
transition.170

The Own Funds Directive establishes a laundry list of elements of capital from which member states can choose to include in their definition of bank capital.171 The structure of the Directive allows member states the opportunity to influence the competitive position of their credit institutions by selecting a favorable mix of these elements.172

The directive labels Tier 1 capital as original own funds and Tier 2 capital as additional own funds.178 The directive lists loan loss reserves or funds for general banking risks as an element of either Tier 1 or Tier 2 capital. Tier 1 capital may include loan loss reserves, but loan loss reserves will not contribute towards the sum of capital setting the maximum limit of Tier 2 capital.174 This difference from the Basle Committee’s standards regarding the application of loan loss reserves is only temporary because the Commission will be issuing a report that will recommend whether to assign loan loss reserves to Tier 1 or Tier 2 capital.175 Furthermore, excessive use of loan loss reserves as capital would detrimentally affect the banks’ credit rating.176

In essence, the EC directives follow the Basle Committee’s standards, but allow EC Member States the opportunity to manipulate the definition of bank capital at the margin. EC national bank regulators may use this flexibility in a manner advantageous to their individual domestic banking institutions. Because not all Member States have passed enabling legislation, the complete effect of the directives is currently not apparent.

E. Other Issues Regarding Implementation

Differences in implementation by signatory nations has weakened the objective of competitive equality sought by the Basle Committee. One contentious issue is which reserves are included in Tier 2 capital.177 Some bank regulators do not consider loan loss reserves to be capital. Banks incorporated in nations without a liberal Tier 2 capital definition may be at a competitive disadvantage.178 Consolidation of bank subsidiaries raises another contentious issue. The Basle Committee intended that nations would apply the ratios on a con-

171. Id. at 31.
172. Id.
173. Id. at 32.
174. Id.
175. Id.
176. Id.
177. GAO, supra note 25, at 26-27.
178. Id.
Nations have made various policy choices in implementing the guidelines. The EC directives appear to require more bank capital than the Basle Committee's guidelines require. In contrast, the Japanese government changed financial regulations to allow Japanese banks to meet the Basle capital ratios. The Japanese government abandoned restrictions on the issuance of convertible bonds, created a subordinated loan market, and created a securitized loan market. In the U.S. the Federal Reserve requires BHCs to deduct their investment in securities subsidiaries. In contrast, European regulators allow banks to participate in these activities. In the U.S., the capital in a bank subsidiary does not count towards the Basle Committee's capital ratio, but in Europe it does.

Differences in accounting rules create other variations in implementation of the capital ratios. In the United Kingdom some banks use doubtful property revaluations to increase capital. In France, the banks use share swaps with other banks to increase their capital. Finally, various signatory governments are taking advantage of the leeway provided for in the Basle Committee's standards by assigning assets to the lowest acceptable risk-weight category. Other nations are applying the Basle ratios to all banks when it was intended that the ratios apply only to international banks. Banks not subject to the Basle Committee's capital guidelines have a competitive advantage over banks subject to the guidelines, such as U.S. domestic banks, because they need not maintain the same stringent level of capital.

F. Implementation in Japan

Banks in different nations will have different burdens in imple-
menting the Basle Committee's capital guidelines. The inclusion of hidden reserves as part of bank capital will probably help countries such as Japan and Germany whose banks have a substantial amount of these reserves. 190 Although Japanese members of the Basle Committee proposed that Tier 2 capital include the value of hidden reserves 191 and the Basle Committee accepted their proposal, it limited inclusion of hidden reserves to 45% of their value. 192 The Nomura Research Institute estimated that in July 1988, before the big decline in the value of the Tokyo stock market, 45% of hidden reserves equaled 6% of the risk-weighted assets of Japanese city banks and 9% of risk-weighted assets of long-term credit banks. 193 Thus, Japanese banks relied heavily on their hidden reserves in order to meet the Basle Committee standards.

When regulating Japanese banks, the Japanese Ministry of Finance will only check risk-based capital on March 31st of each year, the end of the fiscal year for Japanese corporations. 194 Analysts expect bank assets to drop at this time because Japanese corporations will reduce their debt to dress up their balance sheets. 195 Prior to March 31st each year, banks will sell dollars to decrease the value of dollar-denominated assets and, therefore, boost their capital ratio. 196 Furthermore, 40% of bank assets are held in foreign currencies; therefore, any drop in the value of foreign currency will reduce the value of bank assets. 197 Also, Japanese banks have fewer risk-weighted assets because they hold fewer off-balance sheet items than other international banks. 198 This once-a-year evaluation of capital levels and a generally lower amount of risk-weighted assets may give Japanese banks a competitive advantage over other banks after the Basle Committee's standards are implemented at the end of 1992.

Just as the Japanese regulators choose when to enforce the standards, different national regulators can resolve other issues to favor their domestic banks. The Basle Committee left to the discretion of national regulators whether crossholdings in other banks should


192. Basle Standards, supra note 2, at 145.


194. Id.

195. Id.

196. Id. A decrease in the value of the dollar relative to the yen will decrease the yen value of dollar-denominated assets. If yen-denominated capital remains the same, the capital ratio increases.

197. Id.

198. Id. at 44. Letters of credit and loan commitments are examples of off-balance sheet items with a 50% conversion factor that are now accounted for under the Basle guidelines.
count as bank capital. Among Japanese banks, these crossholdings are significant. By including crossholdings within bank capital, regulators have the opportunity to boost bank capital of domestic banks and give them a competitive advantage. The Basle Committee also gave national regulators discretion in assigning government-backed securities to risk-weight categories. Although the Basle Committee thought that this discretion would have a minor impact on the effectiveness of the guidelines, regulators can use the discretion to benefit domestic banks. It is likely that the Japanese Ministry of Finance will assign these assets to the lowest risk category, 0%, while the Federal Reserve has already assigned similar assets to the 20% risk category, thus, requiring more capital support from U.S. banks.

V. Implications

A. Banks Generally In Compliance

At the end of 1990, 78% of United States' largest 300 commercial banks met the 1992 Basle Committee's capital standards, as did ninety-two of the top one hundred U.S. BHC. While most U.S. banks have complied with the new capital standards, a significant portion are not yet in compliance. Problem loans resulting in increases to loan loss reserves and weak earnings have hindered banks' abilities to improve their capital ratios. According to an earlier estimate, as of March 1990, 562 U.S. banks holding approximately 36% of total bank assets had not achieved the 1992 Basle Committee's standards. The banks that had not met these standards needed an additional $24 billion in capital in order to meet the standards.

Similarly, in Japan two of the largest fifteen international banks had not met the 1992 Basle Committee's standard as of March 1991. This is a dramatic improvement over the situation in September 1990, when only one of the big Japanese city banks reached

199. Id. at 40; Basle Standards, supra note 2, at 146 (para. 25-27).
201. Id.
202. Basle Standards, supra note 2, at 144 (para. 6).
203. Osborn, supra note 191, at 40.
204. Lipin & Horowitz, 78% of Big Banks Meet '92 Capital Rules, Amer. Banker, March 28, 1991, at 1. 96.4% of all U.S. commercial banks met the Basle standards as of June 30, 1990. See also GAO, supra note 25, at 16.
206. Id.
207. Senate Report, supra note 36, at 12.
the 8% minimum capital requirement. However, the number of Japanese banks out of compliance could increase dramatically because of fluctuations in the value of the Tokyo stock market. Since Japanese banks have relied heavily on hidden reserves to attain the Basle Committee's capital ratio, they are very susceptible to stock market movements. The penalties for not attaining the capital ratio by March 1993 may be severe for Japanese banks. Credit rating agencies may downgrade the banks' credit ratings and, thereby, cause an increase in the banks' cost of capital. The Bank of Japan may issue some harsh guidance and constrain the banks' growth. Foreign bank regulators may not let the banks pursue new foreign business until they increase their capital. Bank regulators and credit rating agencies in other countries would probably act in the same or similar manner with respect to their domestic banks.

B. Industry Structure and Bank Policies Change Because of Standards

To avoid these adverse consequences, banks have changed and will continue to change their business policies and strategies in order to enable them to comply with the Basle capital standards. The standards themselves have caused a restructuring of the banking industry into capital haves and have-nots.

Already, a tiering has occurred among banks according to their respective capital levels. Banks with adequate or excess capital are able to raise additional capital at advantageous rates and are able to take advantage of the resulting wider margins between loans and bank capital. The Basle Committee's capital requirements have accentuated this situation. Well-capitalized institutions will be able to expand their business with new products and new geographic locations at the expense of their poorly capitalized competitors. As

209. Europe's, supra note 186, at 59.
210. Alexander, Black September, The Banker, Nov. 1990, at 110. A one thousand point move in the Nikkei stock index equals approximately a 0.2% change in the typical bank's capital ratio. Ratios, supra note 208. Likewise, a ten yen move in the dollar-yen exchange rate equals approximately a 0.2% change in a bank's capital ratio. Id.
211. The Basle Committee resisted the inclusion of hidden reserves in Tier 2 capital because of the volatility of its value. Alexander, Black September, The Banker, Nov. 1990, at 110. The events of 1990-92 in the Tokyo stock market support the Committee's skepticism.
212. Japanese banks are given an extra three months to attain the final 1992 capital standards.
213. Id.
214. Id.
215. Id.
216. Id.
217. Friesen, supra note 188, at 14A.
poorly capitalized institutions sell assets to boost their capital ratios, the well-capitalized institutions will be able to buy these assets at advantageous prices.\footnote{218}

In 1987 United States banks had capital requirements equal to approximately 6\% of assets.\footnote{219} The Basle Committee's standards require banks to maintain an 8\% capital requirement. Furthermore, in the past, banks could include goodwill and loan loss reserves in their calculation of capital.\footnote{220} Under the Basle standards, goodwill is not considered capital and loan loss reserves can be applied to the capital account to a maximum amount equal to 1.25\% of risk-weighted assets.\footnote{221} Loan loss reserves in the past accounted for most of the banks' capital requirements.\footnote{222} Now, banks can no longer rely on loan loss reserves to fulfill their regulatory capital requirements and will use one of the methods described above to raise capital.

The Basle Committee's capital guidelines are likely to cause significant changes in various bank policies. In short, to meet the guidelines, banks must raise capital or sell assets. To raise capital, banks may manipulate their financial statements. The limitation of loan loss reserves as a component of bank capital to 1.5\%, then 1.25\% of risk-adjusted assets may discourage banks from increasing reserves against possible loan losses.\footnote{223} Banks currently hold loan loss reserves equal to approximately 4\% of assets.\footnote{224} Holding such high loan loss reserves, when only an amount equal to 1.25\% of risk-adjusted assets will count toward capital, is an expensive use of funds. Therefore, banks may apply funds to retained earnings that they otherwise would have applied to loan loss reserves.

C. Banks Forced to Raise Capital

Banks will attempt to raise capital by issuing new debt or equity, but current market conditions will make both of these options expensive.\footnote{225} Banks will issue more subordinated debt because it may be included in Tier 2 capital.\footnote{226} The disadvantage of subordinated debt over equity is that bank operating income is decreased by the interest charges on the debt.\footnote{227} In the past, banks have raised subor-
ordinated debt by placing it privately with Japanese investors, but under the current market climate, this is no longer possible.\textsuperscript{228} In the fall of 1990, Japanese banks issued nearly $4 billion worth of subordinated debt.\textsuperscript{228} Japanese insurance companies purchased most of these issues by selling securities on the Tokyo stock market which further exacerbated the capital problems of the Japanese banks by driving down the value of the banks' stock portfolios.\textsuperscript{230}

As the above example of Japanese banks scrambling for new capital illustrates, the capital regulations are flawed because they do not identify new sources of capital for banks.\textsuperscript{231} Financial institutions, lacking access to capital markets, issued capital in 1990 at half the rate of 1989.\textsuperscript{232} In the current market, investors do not wish to buy equity, preferred stock, or subordinated debt. They are willing to purchase senior debt, but this type of debt does not count as Tier 1 or Tier 2 capital.\textsuperscript{233} Despite poor market conditions, banks have relied on the issuance of subordinated debt and perpetual preferred stock to bolster bank capital.\textsuperscript{234}

Another technique used to increase capital is to issue hybrid debt instruments.\textsuperscript{235} With the current weakness of the equity markets, banks are relying on debt-type instruments to meet the new standards.\textsuperscript{236} This method is fine when the market value of shares is increasing and earnings are rising, but can create significant risks if the economy enters a recession.\textsuperscript{237}

In addition, there has been an attempt to issue new preferred shares, but market conditions require a high rate of return on any new issue.\textsuperscript{238} The Basle Committee's guidelines do not place any limit on the amount of non-cumulative preferred shares in Tier 1 capital, but these shares are difficult to sell, principally because of

\begin{itemize}
  \item \textsuperscript{228} Lewis & Marsh, \textit{Too Many Hungry Mouths to Feed}, \textit{Euromoney}, Dec. 1990, at 37 [hereinafter Lewis].
  \item \textsuperscript{229} Alexander, \textit{supra} note 210, at 111. Sumitomo issued $700 million of subordinated debt on July 12, 1990; Mitsui Taiyo Kobe issued $1 billion on Sept. 5-6, 1990. Soon thereafter, Bank of Tokyo issued $800 million; Fuji issued $700 million; Nippon Credit issued $500 million; and other Japanese banks issued $1 billion more by September 31st. \textit{Id.}
  \item \textsuperscript{230} \textit{Id.}
  \item \textsuperscript{231} L. BRYAN, \textit{supra} note 4, at 58-59.
  \item \textsuperscript{232} Cahouet, \textit{Managing for Capital Conservation as Markets Get Tighter}, Amer. Banker, Feb. 26, 1991, at 14A. In 1987, banks in the U.S. issued approximately $18 billion of stocks and bonds; in 1988 banks issued $13 billion; in 1989 banks issued $15 billion; and in the first nine months of 1990, banks issued $6 billion. \textit{Id.}
  \item \textsuperscript{233} \textit{Id.}
  \item \textsuperscript{234} \textit{Id.}
  \item \textsuperscript{236} \textit{Id.}
  \item \textsuperscript{237} \textit{Id.}
  \item \textsuperscript{238} Mitchell, \textit{supra} note 225, at 14.
\end{itemize}
their non-cumulative feature. Furthermore, some nations’ laws do not allow the issuance of perpetual, non-cumulative preferred shares. The United States is currently the only significant market for these types of shares.

The Basle guidelines may encourage more banks, at least in the United States, to use employee stock ownership plans (ESOPs) as a source of capital. These plans allow employees to purchase stock of the bank. ESOPs are a limited source of additional capital for banks because the number of employees who provide the capital is limited. An ESOP enhances stock growth and benefits employees, but, on the downside, it dilutes current shareholder voting power. Also, an ESOP requires financing to purchase the shares. A bank in need of capital may find it difficult to obtain financing for an ESOP.

The Basle Committee’s guidelines may also encourage banks, especially those in Europe, to hold assets and capital in several different currencies. Fluctuations in currency values may increase assets and, thus, lower the value of a bank’s capital ratio. This change in value caused by currency fluctuations occurs principally when bank capital is held in only one currency. To compensate for this uncertainty, banks may issue capital in several different currencies.

D. Industry Consolidation Discouraged

The most dramatic way for a bank to increase its capital ratio is to merge with another bank and slash non-interest expenses. Ironically, the Basle Committee’s capital standards may discourage mergers and the consolidation of the banking industry in the United States and in Europe. According to the guidelines, all goodwill (usually generated from bank acquisitions) must be deducted from Tier 1 capital. Because financial institutions must deduct goodwill from

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240. Lewis, *supra* note 228, at 34.

241. *Id.* See also Kantowitz, *It Looks Like Equity but Feels Like Debt*, EUROMONEY, May 1991, at 42 (Supp.).


244. *Id.*


246. *Id.*

247. *Id.* See also Kantowitz, *supra* note 241, at 44. Preferred shares in U.S. dollars serve as a hedge to fluctuations in the value of dollar-denominated assets.


249. Puleo, *supra* note 53, at 472. The Federal Reserve has created a grandfather exception for goodwill acquired before March 12, 1988, and for goodwill obtained from the acquisition of a troubled depository institution. *Id.*
Tier 1 capital, acquisitions using the purchase accounting method\textsuperscript{250} will become more costly;\textsuperscript{251} therefore, offer prices may decline because the market is relatively smaller.\textsuperscript{252} Stock-for-stock acquisitions are still possible, but the potential shareholder dilution if the parties’ price-earnings ratio differ makes these transactions less attractive.\textsuperscript{253}

E. Securitization Encouraged

Given the current market conditions, new capital issues alone will not enable banks to attain the Basle Committee’s standards. Decreasing assets by sale or securitization will be necessary.\textsuperscript{254} It is likely that there will be an increase in the securitization of assets;\textsuperscript{255} in fact, securitization is already increasing dramatically.\textsuperscript{256} In 1989, $25.2 billion of securitization deals occurred. In the first nine months of 1990, $33 billion of these deals were closed.\textsuperscript{257} By utilizing this technique, a bank removes assets off its balance sheet and does not include them in its risk-weighted assets calculation. Securitization expands the market of loan buyers allowing non-depository institutions such as insurance companies, pension funds, and individuals to purchase mortgage loans.\textsuperscript{258} In addition, the bank can retain servicing rights on the securitized assets and, thus, generate fee income without having to maintain capital in support of this line of business.\textsuperscript{259}

Securitization will change the composition of banks’ loan portfolios.\textsuperscript{260} Banks will make more residential mortgages because they are in a lower risk weight category (50\%) than commercial loans

\textsuperscript{250} Purchase accounting is a conservative method to account for the acquisition of a target company because it forces the acquiror to restate the target’s assets and liabilities to market. Cahouet, \textit{supra} note 232, at 15A.

\textsuperscript{251} \textit{Id.}

\textsuperscript{252} Lipman, \textit{New Risk-based Capital Guidelines Will Change Banks’ Future}, \textit{107 Banking L.J.} 4 (1990). See also Osborn, \textit{supra} note 191, at 36. The goodwill rules will not only discourage the acquisition of banks but may also discourage the acquisition of technology-based subsidiaries such as Citibank’s purchase of Quotron. Osborn, \textit{supra} note 191, at 48.

\textsuperscript{253} Osborn, \textit{supra} note 191, at 48.

\textsuperscript{254} Lewis, \textit{supra} note 228, at 39. By the end of 1991, Security Pacific plans to sell 10\% of its $89 billion balance sheet to increase its Tier 1 capital ratio to 5\%. Fairlamb, \textit{supra} note 214, at 58.

\textsuperscript{255} Orabutt, \textit{supra} note 67, at 10A; see also Mitchell, \textit{supra} note 213, at 15.

\textsuperscript{256} Lewis, \textit{supra} note 228, at 36.

\textsuperscript{257} \textit{Id.} See also Henriques, \textit{Rates Down, Offerings Up in One Note Category}, N.Y. Times, June 23, 1991, at F15. From January to June 1990, $13.7 billion of asset-backed securities were issued. In the same period in 1991, $19.1 billion of asset-backed securities were issued. \textit{Id.}

\textsuperscript{258} Brumbaugh, \textit{supra} note 34, at 8-9.

\textsuperscript{259} Lewis, \textit{supra} note 228, at 36.

\textsuperscript{260} Brumbaugh, \textit{supra} note 34, at 9.
They are encouraged to bundle residential mortgages into securities because these mortgage-backed securities have a lower risk-weight than non-securitized residential mortgages. Ginnie Mae securities are within the 0% risk-weight category; Freddie Mac and Fannie Mae securities are in the 20% risk-weight category.

Financial establishments generally will use the securitization technique to convert high risk-weight assets to low risk-weight assets. Likewise, foreign banks have the same incentive to securitize assets. Banks may use the capital freed by securitizing assets to support high risk, high yield loans because low risk, blue chip corporate customers seek financing in the commercial paper markets. In addition, if assets are not sold outright, asset growth will be strategically decreased (i.e., decrease of bank lending and closer scrutiny of credit applicants).

Banks in the U.S. must structure their asset sales carefully. Under U.S. banking regulations, if the sales are with recourse or if the banks retain any risk of loss, the assets are not taken off the books for risk-based capital purposes. Ultimately, a sale of assets is a short-term solution to the capital problems. In the long run, the banks will lose their hard earned market share if they continue to liquidate assets.

261. Id.
263. Id. See also Norton, supra note 20, at 319.
264. Lipman, supra note 252, at 4. Banks can use innovative techniques to enhance the creditworthiness of securitized assets. When securitizing credit card receivables, banks can use a spread account. In this account, the bank deposits in escrow the spread between the interest paid on the securities and the higher interest paid on the assets underlying the securities. The use of the spread account to enhance the creditworthiness of credit card receivables securities was approved by the Federal Financial Institutions Examination Council (FFIEC) on November 21, 1986. Puleo, supra note 53, at 489-90.
265. Osborn, supra note 191, at 44.
266. Capital Adequacy: Bringing Out the Tin Helmets, The Economist, Oct. 13, 1990, at 88; see also Brumbaugh, supra note 34, at 8-9. Large corporate customers have found in recent years that issuing their own debt on the commercial paper markets is significantly less expensive than borrowing funds from a commercial bank.
267. GAO, supra note 25, at 16.
269. Mitchell, supra note 220, at 15. If banks continue to sell assets, employee morale
F. Asset Portfolio Restructured

Because of the Basle Committee capital standards, banks will likely restructure their asset portfolios. The institution of different risk-weight categories for different assets requiring varying capital investments has encouraged the banks' shuffling of assets. Banks are swapping high risk-weight assets for low risk-weight assets. The guidelines are flawed in that they do not match capital requirements to loan quality. For instance, all commercial loans require the same amount of capital regardless of the creditworthiness of the borrower—whether a blue chip corporation or a nearly bankrupt airline.

This regulatory structure, although simple, may have the unintended consequence of encouraging banks to book high risk, high yield loans over low risk loans because the capital requirements for these two types of loans are the same. The risk-weight categories by their nature will encourage banks to favor a lower risk-weight asset over a higher risk-weight asset even when there is no credit quality difference between the two assets. For example, a bank may choose a high yield revenue bond of a financially unstable city (risk weight of 20%) over a commercial loan to a blue chip corporation (risk weight of 100%).

Competition between financial institutions in the market segments consisting of low risk-weight assets will increase resulting in thinner margins. Residential mortgages will become more attractive than commercial loans. Off-balance sheet activities, such as lines of credit, will become more expensive because they require additional capital. Loans to other banks will become more attractive because they require less capital (20% risk-weight category). Banks will switch their 100% risk-weighted commercial mortgages for lower risk-weighted Freddie Mac or Ginnie Mae mortgage-backed securities. Loans to OECD governments require no addition to bank capital.

will decrease and the bank will not be able to maintain its position in the global banking system. Osborn, supra note 191, at 47-48.

271. Bryan, supra note 4, at 59.
272. GAO, supra note 25, at 25.
273. Model, supra note 190, at 791.
274. Boyle, Bankers See a Possible Shakeout in the Letter-of-Credit Business, The Bond Buyer, April 26, 1990, at 8A.
275. Lipman, supra note 252, at 3-4. Bank lobbyists are attempting to change the regulations to allow some commercial mortgages to be included in the 50% weight category. Basel Loopholes to Allow US Banks to Raise Capital, Boost Lending, THOMSON'S INT'L BANKING REGULATOR, Oct. 11, 1991, at 1.
276. Id. at 4.
278. Osborn, supra note 191, at 40. See supra note 263 for further information on Ginnie Mae and Freddie Mac securities.
279. Basle Standards, supra note 2, at 147-48. Less creditworthy governments in the
The regulators argue that differentiating credit risks to a finer degree would make the guidelines unworkably complex. That reasoning is correct, but price controls generally are complex. These capital guidelines act to a certain degree as price controls of banking products.\textsuperscript{280} One long-term result of the standards for the banking industry will likely be that high quality assets will bypass the banking system because capital requirements are too high for these assets. In contrast, low quality assets will move into the banking system because capital requirements are too low for those assets.\textsuperscript{281}

Furthermore, the capital standards do not distinguish between banks.\textsuperscript{282} All must meet the 8% requirement even though some banks are more financially secure than others. Some banks may need more capital to keep operating; other well-managed banks may need less. They will also have to change their portfolio management techniques because different assets will have to attain different returns in order to generate the overall return on equity demanded by investors.\textsuperscript{283} Banks, particularly European banks, that hold shares in corporations will reevaluate their holdings to ensure that the investments are generating adequate returns on capital.\textsuperscript{284}

G. Prices of Banking Products Increased

The Basle Committee’s standards are affecting how bank managers price their products despite the fact that the Basle Committee never intended for managers to use risk-weight categories in making pricing and lending decisions.\textsuperscript{285} Fees on undrawn loans have risen sharply.\textsuperscript{286} In addition, banks are less likely to participate in multiple option facilities\textsuperscript{287} and other credit arrangements at the thin margins charged in the late eighties.\textsuperscript{288} Lending margins in general were increasing in 1991 because of the effect of the capital guidelines and

\footnotesize

OEC\textsuperscript{D}, such as Belgium, Greece, and Portugal, will benefit by easier access to credit. Sesit, \textit{New Bank Rules are Expected to Spur Volume on Global Securities Markets}, Wall Street Journal, July 17, 1991, at C1.

\textsuperscript{280} Bryan, supra note 4, at 60.

\textsuperscript{281} \textit{Id}. at 60. Some commentators would argue that a similar phenomenon happened in the savings and loan industry in the early 1980’s. See generally L. Bryan, \textit{Breaking Up the Bank} (1988).

\textsuperscript{282} Bryan, supra note 4, at 59.

\textsuperscript{283} See generally Petty, supra note 133. The article provides a good discussion of the different financial management techniques required under the new capital adequacy rules.

Banks will focus more resources on risk management so that they can channel resources into less capital-intensive products. Fairlamb, supra note 209, at 59.

\textsuperscript{284} Osborn, supra note 191, at 54.

\textsuperscript{285} GAO, supra note 25, at 25.


\textsuperscript{287} Multiple option facilities (MOF) allow borrowers to obtain financing in several different forms (\textit{i.e.}, euronotes, U.S. dollar commercial paper, or bank bills) at the discretion of the borrower. \textit{Id}.

\textsuperscript{288} \textit{Id}.
the less aggressive posture of Japanese banks which have been slowing their asset growth to meet the standards.\(^{289}\) Also, prices of loans to non-OECD nations have increased because of the Basle standards.\(^{290}\) Banks will likely increase the fees of their products resulting in a further loss of customers to other financial institutions which are not subject to the Basle Committee's standards.\(^{291}\)

H. Competitive and Cost Imbalances in the Financial Services Industry Created

The Basle Committee's standards will disadvantage banks relative to other financial institutions. While the guidelines create a level playing field among international banks, they generally do the opposite with respect to the overall financial services market.\(^{292}\) While banks change policies and decrease lending in order to meet the new strict capital standards, other financial institutions can increase their lending at a lower cost because they are not subject to the same stringent capital requirements.\(^{293}\) Capital requirements are not the only impediment to competitive equality among banks; the Basle Committee did not attempt to address the numerous tax, accounting, economic and regulatory differences between nations which create inequalities among banks.\(^{294}\)

The Basle Committee guidelines do not require banks to disclose their risk-based capital ratios. Nevertheless, some banks are disclosing their ratios in order to advertise their financial strength. During the interim period, some confusion will necessarily result un-

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290. Hall, International Loan Risk Rules Haunt Post-war Gulf, The Reuters Library Report (March 17, 1991) (LEXIS, Nexis library, Omni file). A loan to Saudi Arabia in February, 1991, was priced at fifty basis points above London Interbank Rate (LIBOR). A loan to Kuwait would theoretically be one hundred points above LIBOR — a very high rate for a country that was one of the nation's richest. Id.

The Basle standards place loans to governments and central banks of OECD and non-OECD countries in different risk weight categories. This difference will undoubtedly discourage non-OECD sovereign lending. Gulf nations complained about the difference in risk weight category stating that the Government of Turkey, a member of the OECD, is not a better credit risk than some of the oil-rich Gulf states which are not members of the OECD. The invasion of Kuwait by Iraq illustrates the credit risk the Basle Committee recognized. Id.

In November 1991 the Arab Monetary Fund based in Abu Dhabi held a meeting to consider responses to the Basle Committee's decision to place loans to most Arab nations in the high risk category. Kawash, Arab States Consider Action on Basel Decision, Agence France Presse (Nov. 15, 1991) (LEXIS, Nexis library, Omni file).

291. Osborn, supra note 191, at 36. These institutions include insurance companies and credit companies such as Ford Motor Credit Corporation and General Motors Acceptance Corporation.

292. The Basle Committee is discussing this competitive inequality issue with securities regulators currently. GAO, supra note 25, at 28.

293. Kindel, supra note 126, at 28.

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Til all nations implement the final 1992 standards. Eventually, the Basle ratios, particularly the Tier 1 capital ratio, will serve as a better comparison of financial strength of international banks for investors and analysts.

The Basle guidelines impose additional costs on banks. Increased regulation generally is a burden on business and increases their reporting costs. More importantly, increased regulation also focuses the banker’s mind on regulation and away from the market and servicing customers’ needs. Under the Basle framework, regulators must assign new financial products to a risk category. In the past, banks generally dealt only with their national regulators. Now, under the Basle Committee’s standards, national regulators must get the consensus of their international peers to change the standards. Likewise, banks must realize that they are in effect dealing with two sets of regulators when it comes to capital requirements.

I. Future Developments

In order for the Basle Committee’s standards to achieve their objectives, more nations must adopt the standards. Unless more nations adopt the principles underlying the standards, the banks located in the original twelve signatory nations will be at a competitive disadvantage. Members of the Basle Committee are members of other international forums and, therefore have the opportunity to persuade other nations toward adoption. The Council of Ministers of the EC has issued directives that implement similar capital requirements. Because of these directives, five additional nations have effectively adopted the Basle Committee’s standards; several nations, including Australia, Austria, New Zealand, Singapore, and Bahrain, have voluntarily agreed to implement the standards in their respective countries.

The Basle Committee continues to revise and to develop its cap-

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295. Id. at 27-28.
296. Id. at 22.
297. Osborn, supra note 191, at 54.
298. Id.
299. GAO, supra note 25, at 25.
301. Note, supra note 190, at 793.
302. These other forums include the OECD, the SEANZA Forum of Bank Supervisors, the Nordic Supervisory Group, and the Commission of Banking Supervisory and Regulatory Administration Authorities of Latin America and the Caribbean. Id. at 794-95, nn. 134-35.
303. See supra notes 160-76 and accompanying text.
304. These five nations are the following: Ireland, Portugal, Spain, Greece, and Denmark. They are members of the EC but not of the Basle Committee.
305. GAO, supra note 25, at 23. One report states that thirty-two nations have implemented bank capital guidelines similar to those in the Basle standards. Other nations are planning to implement similar standards. Price Waterhouse, Bank Capital Adequacy and Capital Convergence (1991).
ital standards. It is currently working on new position risk standards for foreign exchange, equity and interest rate risk.\textsuperscript{306} The interest rate risk measure was tested during 1991.\textsuperscript{307} The Basle Committee is also considering whether to set higher capital requirements for banks and other financial conglomerates.\textsuperscript{308} Also, U.S. banking regulators have stated that the 1992 capital ratios may not be sufficient and are considering raising the capital requirements.\textsuperscript{309} This issue is still evolving and will undoubtedly undergo future changes that will have an equivalent, if not greater, impact on the banking industry.

VI. Conclusion

The Basle Committee's standards improve on past attempts of risk-based capital adequacy regulation. The standards will force banks to change their strategies and policies in order to comply with the more stringent capital requirements. Prices of some banking products will increase, and securitization of assets will become more prevalent. The standards will discourage consolidation within the banking industry to a certain extent and make banks less competitive in the financial services industry generally.

Bank regulators will continue to revisit this issue of adequate bank capital, and changes in the standards will occur as regulators review their effects on the banking industry.\textsuperscript{310} With changes already under way, capital adequacy will prove to be the banking issue of the 1990s.

VII. Addendum

Since this article was written in the summer of 1991, significant changes have occurred in the stock markets in the United States and Japan. The Nikkei index, a broad measure of the Japanese stock market, has fallen in value by 50% over the past two years.\textsuperscript{311} In March and April 1992, the index fell even further. The Topix index, an even broader measure of share prices on the Tokyo stock exchange, closed at 1408 on March 18, 1992,\textsuperscript{312} which is below its ten

\begin{itemize}
\item \textsuperscript{306} Brumbaugh, \textit{supra} note 34, at 14.
\item \textsuperscript{307} \textit{Senate Report, supra} note 36, at 15, (statement of Robert C. Clarke, Comptroller of the Currency); \textit{id.} at 38-39 (statement of William Seidman, Chairman, FDIC). The Office of Thrift Supervision has postponed until late 1992 the implementation of interest-rate risk regulations within the overall capital adequacy regulations. \textit{OTS Delays Incorporating Interest-Rate Rule}, \textit{57 BNA's Banking Report} 294 (Aug. 19, 1991).
\item \textsuperscript{309} Orabutt, \textit{supra} note 67, at 10A. \textit{See also Risk-based capital, supra note 133.}
\item \textsuperscript{310} \textit{See supra} notes 306-09 and accompanying text.
\item \textsuperscript{311} \textit{Further Still to Fall}, The Economist, March 14, 1992, at 89.
\item \textsuperscript{312} \textit{On the Edge}, The Economist, March, 21, 1992, at 82.
\end{itemize}
year moving average.

The more widely watched Nikkei index fell below the 20,000 level mark on March 16, 1992. On March 18 the Nikkei index was 19,764. The decrease in share prices has detrimentally affected the level of Tier 2 capital of Japanese banks. Japanese city banks currently maintain Tier 1 capital at a level slightly above the required 4% minimum which only leaves a thin cushion against a rising number of bad loans. Forty-five percent of unrealized gains in a bank’s share portfolio may be included in Tier 2 capital. In March 1991 Japanese city banks counted 19 trillion yen of unrealized gains as Tier 2 capital. In September 1991 this amount had decreased to 16.3 trillion because of the decline of share prices. In March 1992 unrealized gains only amounted to 13.2 trillion yen. The amount of unrealized losses Japanese city banks applied towards Tier 2 capital decreased by nearly one third over a one year period. By another estimate, given the current financial structure of the eleven Japanese city banks, if the Nikkei index falls below 20,000 as it did in March 1992, at least four banks will be below the minimum Basle capital ratio. If the Nikkei index falls below 16,000, as many as eight of the eleven city banks will be below the Basle minimum. As a result, Japanese city banks are finding it even more difficult to meet the Basle capital standards. Managers of these banks appear not to be worried about failing to comply with the standards. The only sanction the banks could receive would be a prohibition on further international expansion which is not currently a high priority given their other problems (e.g., rising number of bad loans and a slowing of the Japanese economy).

In contrast, the stock markets in the U.S. have improved over their lackluster performance in 1990 and early 1991. This fact was especially evident towards the end of 1991. For the entire year 1991, banks raised $3.3 billion in common stock and $4.2 billion in preferred stock. This is nearly four times the amount of capital raised in 1990. In the fourth quarter alone, banks raised $800 million of preferred stock and $800 million in common stock. In the fourth quarter of 1990, banks only raised $11 million of common stock and

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313. *Id.* The Nikkei index in January 1990 was 37,951. At the end of 1990, the index was 24,087. In March 1992 the index had fallen below 20,000 to 19,764. *Id.*
314. *Id.*
315. *Id.*
317. *Id.*
320. *Id.*
$100 million of preferred stock. Banks issued $5.4 billion in subordinated debt in 1991 compared to $1.4 billion in 1990. In early 1992, Chemical Bank and Nationsbank announced that they plan to issue new equity. Chemical announced that it will issue $1.4 billion in new equity in 1992. Some analysts estimate that banks overall may issue up to $5 billion in new equity in 1992. The price of the bank stocks generally increased 83% from January 1991 to January 1992. Therefore, banks are attracted to the equity markets and are better able to increase their capital by new equity offerings.

Contrary to the assertion in Section III(c) of the article, U.S. banks in 1992 are finding it easier to raise equity capital in the stock market. The stock market in 1992 is much healthier than in 1991 or 1990. As a result, U.S. banks are issuing equity in order to attain the Basle capital standards. Given the market's strength and lower interest rates, equity issues are a much more attractive and viable method of increasing capital than asserted in the article.

321. Id.
323. Id.
324. Id.