EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

Statement No. 7

Brussels, 7 February 2000

Internal Ratings, Capital Standards and Subordinated Debt

This statement supports the move towards greater reliance on internal ratings, but market discipline should be reinforced by a mandatory subordinated debt requirement.

In June 1999 the Basel Committee proposed a new capital adequacy framework to respond to certain deficiencies of the 1988 Capital Accord. In particular, the risk classification determining capital requirements was too broad, allowing banks to shift assets to higher-risk categories. The 1999 proposal is based on three pillars: the capital adequacy framework, supervisory review, and market discipline. In response to recent criticism the focus of the work on risk classification has shifted from the use of external ratings to banks' internal ratings. In November 1999 the European Commission presented its own proposal and in January 2000 the Basel Committee published an industry survey of the range of practices with respect to internal ratings. We welcome this shift, not least in a European perspective, because external ratings are not well adapted to the European financial system. Subordinated debt has also become the subject of more intense scrutiny, but so far unfortunately only in the United States[1].

It is the position of the ESFRC that the importance of market discipline and the difficulty of achieving it are underestimated in the current proposals. Information disclosure alone will not suffice as long as the incentives for excessive risk-taking remain. Without strong market discipline classification by internal ratings is subject to strong incentives to manipulate the ratings in order to enable continued risk shifting by banks.

Progress on Internal Ratings…

The reliance on internal ratings of credit institutions implies that different institutions may face different capital costs for the same type of loan, as they should in a competitive environment. Another advantage of the internal ratings approach is that it allows banks to consider the risk of each asset within the context of their total portfolios. However, since banks face a degree of protection, they have the incentive to take excessive risk and, therefore, to manipulate the ratings used to allocate capital. Supervisory authorities would have great difficulties controlling such efforts since their access to information about borrowers is inferior. Both the Basel Committee and the European Commission appear confident that information disclosure by banks will alleviate the information asymmetry. Such optimism seems to the ESFRC unwarranted. Banks will always be able to – and have the incentive to – protect information about their exact portfolios and their true risk taking.

Supervisory authorities would face a very challenging task under an internal ratings capital standard even if the mentioned information problems could be resolved. First, the quality of a variety of risk classification systems must be assessed and in some cases improved. Second, many different internal risk classifications need to be translated into a coherent system for allocating capital. Third, capital standards should be consistent across jurisdictions of different supervisory authorities.

… and greater reliance on subordinated debt

The likely difficulties of an internal ratings standard can be alleviated by strong market discipline. Such discipline can be achieved if banks have "credibly uninsured" liabilities. The ESFRC has previously recommended (Statements No. 4 and 5) that subordinated debt should constitute a mandatory part of the capital requirement. The yield spread on such debt would provide a market evaluation of the insolvency risk of a bank. This is the risk of primary concern to supervisory authorities.

Another advantage of subordinated debt is that yield spreads can be used as a basis for setting deposit insurance premia. With such premia banks' incentives to develop strong internal credit rating systems would be enhanced, and well-managed banks would have the incentive to provide relevant information to market participants. The yield spreads would also provide information to the supervisory authorities complementing their own information when they set capital standards for banks using different internal rating systems.

There are difficulties associated with the use of subordinated debt for the purposes described. The debt must be "credibly uninsured" and bank equity capital must not fall too low. Yield spreads may be uninformative as a result of high volatility and/or insufficient liquidity in the market for a bank's debt issues. Small banks may have to be supervised by more direct methods. Supervisory authorities need also watch out for market manipulation by relatively high-risk banks. In spite of these potential problems a subordinated debt scheme is an essential part of a capital standard based on internal ratings. Without such a scheme an internal ratings capital standard is not likely to work, and without an internal ratings standard, a capital standard will not serve its purpose.