

*Some Thoughts About International
Convergence of Capital Adequacy Standards ⁽¹⁾*

The proposed framework on International Convergence of Capital Measurement and Capital Standards, endorsed by the Group of Ten central bank governors in July 1988, is an essential issue for the member states of the GCC, who followed the ongoing discussions very closely and with great respect for the Basle Committee on Banking Regulations and Supervisory Practices.

The objectives of the Basle proposal were to achieve a common standard for measuring banks' capital adequacy, based on a risk-based capital measure, and to establish a common minimum capital target for banks operating internationally, which should strengthen the stability of the G-10 banking system. The Basle proposal was generally similar to the United States-United Kingdom Agreed Proposal on Primary Capital and Capital Adequacy Assessment of early 1987. In addition, it took nearly ten years of discussion by the EC supervisory authorities as part of the move towards a single

(1) Delivered on October 13, 1988, in Tokyo, Japan, on the occasion of the 5th International Conference of Banking Supervisors

European market for financial services by 1992, as well as a series of trial calculations including the major internationally-oriented banks of these countries. The main principles of the proposal have been discussed at former banking supervisory conferences, especially in Amsterdam.

The GCC banking supervisory authorities noted the desirability of comparable adequate minimum capital standards for banks under similar circumstances, believing that such an approach would be a practical way of strengthening the capital standards of the banks and therefore the soundness of the international banking system. Nevertheless, the GCC countries had strong reservations about some elements of the proposed approach.

One issue of high interest to the governors of the central banks and monetary authorities of the GCC countries was the “Country Risk Approach”. The Basel Committee considered different versions of incorporating country transfer risk into its framework. An early version considered distinguishing between claims on domestic institutions and claims on all foreign entities. The approach finally adopted involved a differentiation between two groups of countries, one group consisting of members of the OECD and any country that has concluded special arrangements with the IMF (associated

with the General Arrangements to Borrow ⁽¹⁾), and the other group representing the rest of the world.

The December 1987 version of the Basel Proposal was, an improvement, in the GCC to view over the 1986 version. A regression towards arbitrary country classification raises questions about its rationale. The GCC strongly believed that assigning risk weights according to crude formal distinctions leads to a gross simplification of a complex issue. Ignoring the different financial positions of the various countries and their banks does not resolve the issue completely, but leaves the possibility of future disagreement wide open. To adopt a purely formal criterion of country groupings for weighting credit risk is unfair and technically unsound, and it will lead to distortion of fund allocation in the international banking system.

One explanation given for the differentiation was the varying credit standing of industrialized and non-industrialized countries. In relation to the GCC, the implementation of such an idea implies that

⁽¹⁾ The specially defined group, to which low-risk weights are assigned, includes the G-10 countries as well as Australia, Austria, Denmark, Finland, Greece, Iceland, Ireland, New Zealand, Norway, Portugal, Saudi Arabia and Turkey.

some of the GCC's major debtor countries have a better rating than their creditors: it seems that the rules were created by the authorities of the same debtor countries. The international statistics showing this contradiction were published by the Bank for International Settlements (BIS), the GCC's major debtor countries have a better rating than their creditors: it seems that the rules were created by the authorities of the same debtor countries. The international statistics showing this contradiction were published by the Bank for International Settlements (BIS), which published the capital adequacy paper. The latest BIS statistics about international banking and financial market developments show that the funding of international banks by the GCC countries was three times higher than their borrowing level. Among the industrialized countries, assets and liabilities balance each other, more or less. Moreover, the major industrialized countries have also taken good advantage of international borrowing facilities.

Taking these fundamental facts into consideration, it should be obvious that the proposed differentiation concerning the country transfer risk does not strengthen the solvency of international banks from the GCC point of view. However, it does help to supply governments, government-owned industries and banks in the OECD countries with cheaper money. It further helps to fulfill their requirements because of the huge amount of debt now on their bal-

quirements because of the huge amount of debt now on their balance sheets in relation to public borrowers and in relation to the effective existing level of own funds. And, what is of especial concern, it is not sound in relation to economic and other fundamentals of 1988.

Another explanation of the proposed country transfer risk approach is that it is based on the attitude towards the free movement of capital. In that respect it is further necessary to ask, if no restrictions on the free movement of capital is envisaged in the EC, G-10 or in the OECD countries? It is well known that the GCC do not practice such restrictive measures. Policies of free capital movement not only benefit the GCC, they are also to a large extent beneficial to the industrialized countries, their borrowers, and their banks.

The proposal of the Basel Committee on International Convergence of Capital Measurement and Capital Standards was expected to be accepted not only by the G-10 countries but also by the other countries as well. If the proposed system should become a worldwide one, it should be truly international. For the GCC, truly international means real participation in the discussion before a framework is published and a real chance for fundamental input from everyone and not only approval by acclamation.

The IMF staff has expressed concern to the Basel Committee about the country classification method. The Fund staff is concerned about the implications of establishing such a sharp differentiation between risk asset weights for bank claims on Fund members, especially when such differences do not fully reflect prudential considerations. The IMF has expressed these concerns to the Secretariat of the Committee on Banking Regulation and Supervisory Practices at the Bank for International Settlements, and the management formally objected to the U.S. supervisory authorities about the earlier proposed use of the Fund's industrial country category for this purpose.

A truly international effort to reach common capital adequacy criteria. might begin with the establishment of a working group, which will go through the whole issue again and offer a logical and sound approach based on economic and financial criteria. Such a group could not be really effective if it included representatives of all countries. Perhaps representatives of major regional economic groupings from various parts of the world could work together with the Basel Committee to modify the July 1988 version of the Capital Adequacy Standards.

Such a group could, for example, start its discussions on the country transfer risk approach. In general terms, consideration of a mix of the following facts might be useful:

- the size of the country's quota in the IMF
- the Reserve Tranche at the IMF
- the general financial position of the country with the Fund
- the general position of the country in the SDR accounts
- the overall financial position of the country and its economic potentialities

All these ideas and other aspects would be discussed in the proposed working group, which would present its results afterwards to a special conference. In that conference, a fully international approach to capital adequacy could be adopted.