Better than Basle

IT IS an amazing feat of marketing and public relations that banks have still not quite shed their image of sober respectability. Again and again in recent years, they have proved themselves a public menace. All over the world, if you see acute economic distress, the chances are that banks are implicated not merely as bystanders but as perpetrators. When you consider the incentives they face, it is little wonder.

The main source of the problem, paradoxically, is the steps governments have taken to make their banking systems safer. Banks are inherently unstable, because of the promise they make to redeem deposits at par on demand: this makes them susceptible to runs. To maintain confidence and prevent runs, governments almost everywhere underwrite the banks' debts--that is, the money they borrow from their depositors--either explicitly (through deposit insurance) or implicitly (by letting it be understood that banks will not be allowed to fail). This assurance may be good news for depositors but it is very bad news for everybody else. It makes banks greedy for risk.

How so? The reason is simple. Once deposits are protected, depositors have no reason to keep an eye on what banks are doing. If banks lend recklessly, it is taxpayers who are at financial risk, not depositors. However outlandish their lending policies, banks can raise money from depositors at a risk-free rate. The difference between this risk-free rate and the rate that banks would have to pay if deposits were uninsured is a subsidy from governments to banks: the riskier the lending, the bigger the subsidy.

Consider what happens when a bank gets into trouble. It has an even greater incentive to make very risky loans at high interest rates--to gamble on redemption, as the sober professionals put it. Shareholders cannot lose more than their equity: their losses are capped. On the reckless upside, however, there may be salvation. Very often the gamble fails. Banking crises, usually associated with asset-price bubbles (because that is where the risky lending goes), nearly always follow this pattern. The economy is left to suffer the consequences. Thank heavens, though, that whatever happens, those deposits are safe.

It is not too much of an exaggeration to say that deposit insurance is what makes bank regulation necessary. Plainly, however, regulation has proved inadequate to the task. The proposed new Basle standards acknowledge that the existing rules (announced in 1988) are too crude. Banks must maintain a minimum amount of capital (equity, mainly) in relation to their loans: the riskier the loans, the more capital they must have. The suggested revision adds two ideas to the same basic regime: in deciding how much capital is needed, make greater use of, first, credit-rating agencies' measures of risk and, second, banks' internal risk-management models.

Neither of these ideas is without its difficulties. A regulatory role for private credit ratings may be subject to Goodhart's law: that "any observed statistical regularity will tend to collapse once pressure is placed on it for control purposes." The agencies might become less reliable: the new demand for favourable ratings is likely to elicit a supply. It might be necessary next to regulate the rating agencies (perhaps by using information from the agencies that would spring up to rate the rating agencies). Regulating risk-management models is not easy either; nor is ensuring compliance with the models; and nor is devising penalties for non-compliance. The increasing sophistication that banks bring to "regulatory arbitrage" (repackaging their risks so as to evade capital requirements) puts the entire enterprise in doubt.

At a conference of academics, bankers and officials in New York this week, a consensus emerged that the Basle approach is fundamentally flawed. Is there an alternative? Indeed there is. It is to make markets rather than regulators carry more of the supervisory burden. That can be done in two ways: by narrowing the scope of deposit insurance and by requiring banks to issue specific kinds of credibly uninsured debt.

On the first, Harald Benink of Maastricht University and George Benston of Emory University told the conference that deposit guarantees should be explicitly confined to accounts paying a relatively low rate of interest, and that these insured deposits should be more than fully backed by safe liquid assets (such as treasury bills and commercial paper). This is a variant of the "narrow bank" model long favoured by many reformers. The difference is that it calls, in effect, for narrow banks within broad banks--so it does not demand a radical restructuring of the industry, with separately constituted narrow-banking firms. That makes it more feasible.

The second element was championed by Charles Calomiris of Columbia University, who is a tireless advocate of a role for subordinated debt in bank regulation. The idea is straightforward. Oblige banks to issue a certain amount of debt (say 2% of their assets) that is junior to deposits. Why does this help? Because the incentives of subordinated-debt holders are closely aligned with those of the deposit-insurance fund (and hence of taxpayers). If the bank fails, the debt holders will lose money. Crucially, however, unlike the bank's shareholders, these creditors have no interest in the upside potential of a gamble for redemption: however that punt turns out, the most they can receive is the value of their fixed claim. So the yield on this subordinated debt should reflect the market's assessment of the risks the bank is taking. Regulators could then cap this yield--in effect, obliging the bank to cap its risks, as judged not by regulators but by the market.

The idea is not new. What is new is the support it seems to be gathering. On this occasion, Mr Calomiris met with at least guarded approval from nearly every quarter--most notably, from assorted American officials. If this keeps up, people will start thinking that a radically different approach to regulating banks may actually be possible, as well as merely desirable.