CAPITAL MARKETS, GLOBALIZATION, AND ECONOMIC DEVELOPMENT

Innovations in Financial Markets and Institutions

Editor: Mark Flannery, University of Florida

Other books in the series:

Das, Dilip K.:
Asian Economy and Finance: A Post-Crisis Perspective
Anderson, Seth C. and Born, Jeffery A.:
Closed-End Fund Pricing: Theories and Evidence
Hoshi, Takeo and Patrick, Hugh:
Crisis and Change in the Japanese Financial System
Cummins, J. David and Santomero, Anthony M.:
Changes in the Life Insurance Industry: Efficiency, Technology and Risk Management
Barron, J.M., and Staten, M.E.:
Credit Life Insurance: A Re-Examination of Policy and Practice
Cottrell, A.F., Lawlor, M.S., Wood, J.H.:
The Causes and Costs of Depository Institution Failures
Anderson, S., Beard, T.R., Born, J.:
Initial Public Offerings: Findings and Theories
Anderson, S., and Born, J.:
Closed-End Investment Companies
Kaufman, G.:
Banking Structures in Major Countries
England, C.:
Governing Banking's Future
Hancock, D.:
A Theory of Production for the Financial Firm
Gup, B.:
Bank Mergers: Current Issues and Perspectives

CAPITAL MARKETS, GLOBALIZATION, AND ECONOMIC DEVELOPMENT

Edited by

Benton E. Gup
The University of Alabama

Springer

Library of Congress Cataloging-in-Publication Data

Gup, Benton E.
Capital markets, globalization, and economic development.
Includes index.

ISBN 0-387-24564-2 e-ISBN 0-387-24563-4 Printed on acid-free paper.

Printed in the United States of America.

9 8 7 6 5 4 3 2 1 SPIN 11054894

springeronline.com

To Jean, Lincoln, Andrew, Jeremy, and Carol.

CONTENTS

PREFACE

The progression of globalization is affecting capital markets and economic development. In this context, globalization involves complex and controversial issues that must be dealt with by governments, regulators, corporations (including banks), and investors. These issues include, but are not limited to the extent to which countries around the world are accepting the Basel II bank capital regulations, the effects of globalization on stock and bond markets, new issues in project finance, the impact of corruption, and other important topics.

The book consists of fourteen articles contributed by authors from Australia, Asia, Europe, South America, and the U.S. who provide a wide range of insights that range from applied to theoretical issues. The contributors include academics, government officials, and regulators. Four of the fourteen articles in this book were presented at a special session "Capital Markets, Globalization, and Economic Development," at the 2004 Financial Management Association meeting in New Orleans.

ABOUT THE AUTHORS

Ioana Alexopoulou is an Economist Statistician at the Capital Markets and Financial Structure Division of the Directorate Monetary Policy of the European Central Bank. Her interests have centered on implied volatility, credit risk and the corporate bond market. Her recent research has focused on the investigation and identification of financial stability issues in the current macrofinancial developments. She has a publication "The New Basel Capital Accord and its impact on Japanese Banking: A Qualitative Analysis" in The New Basel Capital Accord ed. Benton E. Gup. She is a graduate of Birkbeck College, University of London.

Masanori Amano is a Professor of Economics at Chiba University, Japan. His Ph.D. is from Hitotusbashi University, Japan. He was a Research Scholar at the London School of Economics, and a Visiting Professor at The University of Alabama. His articles have appeared in numerous journals, and he is the author of a monograph—Money, Inflation, and Output: A Study in International Perspective.

Mohamed Ariff obtained his bachelors with honors from the University of Singapore. His graduate studies were at University of Wisconsin-Madison and University of Queensland. After eleven years in the industry at divisional manager levels, he joined the national University of Singapore in 1981, and left for Monash University to take a chair in Finance in 1996. His books and scholarly articles are on the financial economics of Asian capital markets and banking systems. He has consulted for both private and public bodies, and has been awarded international fellowships/scholarship at Tokyo and Harvard universities and others. He holds an endowed visiting chair at the Universiti Putra Malaysia. He is the President Elect for 2994-2006 of the Asian Finance Association.

Alexandra Bernasek is a Professor of Economics at Colorado State University. Her research deals with gender differences in risk aversion and the implications for financial decision-making. She has an on-going interest in the Grameen Bank in Bangladesh and the problems of providing microcredit. She has published her research in books, academic journals, and policy briefs. She is currently a board member of the Eastern Economics Association, and is a member of the International Association for Feminist Economics.

Andrew H. Chen is the Distinguished Professor of Finance at Edwin L. Cox School of Business, Southern Methodist University. Prior to coming to SMU, he taught at the Ohio State University; University of California, Berkeley; and the State University of New York at Buffalo. Dr. Chen's research includs bank management and regulation, deposit insurance, derivatives pricing and regulation, corporate financial policy, project finance, and corporate pension strategy. He has edited and co-authored many books, and his more than 100 articles have appeared in top academic and professional journals. He has served as chairman, director, and advisory director of several financial institutions and corporations. He a former President of Financial Management Association International and a Director of the Asia-Pacific Finance Association. Currently he serves as the Editor of *Research in Finance*, and a Managing Editor of the *International Journal of Theoretical and Applied Finance*.

Kevin Davis is the Commonwealth Bank Group Chair of Finance in the Department of Finance, Faculty of Economics and Commerce, at The University of Melbourne, where he has been professor since 1987. His research interests include financial markets and instruments, financial institutions management, financial regulation, financial engineering, corporate finance and valuation. In 2003 he was appointed by the Australian Federal Treasurer (as part of the Government's response to the HIH Royal Inquiry) to prepare a report on "Financial System Guarantees" which was released in May 2004 for public consultation.

Gabe de Bondt is a Principal Economist at the Capital Markets and Financial Structure Division of the Directorate Monetary Policy of the European Central Bank. Prior to joining the European Central Bank, he was Economist at De Nederlandsche Bank. His Ph.D. on financial structure and monetary policy transmission in European countries, as received from the University of Amsterdam, has been published by *Edward Elgar*. His research in the field of monetary economics, banking, finance, and financial markets has appeared in numerous journals.

Benton E. Gup is the Robert Hunt Cochrane-Alabama Bankers Association Chair of Banking at the University of Alabama. He also held banking chairs at the University of Tulsa and the University of Virginia. Dr. Gup is the author and or editor of twenty-three books and more than ninety articles about banking and financial topics. He is an internationally known lecturer in executive development and graduate programs in Australia (University of Melbourne, University of Technology, Sydney), New Zealand (University of Auckland), Peru (University of Lima), and South Africa (Graduate School of Business Leadership). He has been a visiting researcher at the Bank of Japan, and at Macquarie University, Sydney, Australia. Finally, he serves as a consultant to government and industry.

Kevin T. Jacques is a senior financial economist in the Office of Financial Institutions Policy at the U.S. Treasury Department. In addition, he is an Adjunct Professor of Finance at Georgetown University. Previously, he taught at John Carroll University, and was a senior financial economist at the Office of the Comptroller of the Currency. His publications have appeared in the *Journal of Banking and Finance, Journal of Financial Services Research*, Federal Reserve Bank of New York's *Economic Policy Review, Journal of Economics and Business*, and the *Southern Economic Journal*.

Ike Mathur is a Professor of Finance at Southern Illinois University. Previously he taught at the Washington University and the University of Pittsburgh. He served as Interim Dean for the College of Business, Chair of the Department of Finance, and Director of Doctoral programs at SIUC. He is the author or co-author of over 100 refereed articles and 14 books. He serves on the editorial board of a number of journals and is the executive editor of *Journal of International Financial Markets, Institutions & Money*, and of *Journal of Multinational Financial Management*.

Bill Megginson is a Professor and holds the Rainbolt Chair in Finance at the University of Oklahoma's Michael F. Price College of Business. He is also a voting member of the Italian Ministry of Economics and Finance's Global Advisory Committee on Privatization and Scientific Advisor for the Privatization Barometer. Professor Megginson's research interest has focused in recent years on the privatization of state-owned enterprises, especially those privatizations executed through public share offerings. He has articles in leading academic journals, and received one of two Smith Breeden Distinguished Paper Awards for outstanding research published in the *Journal of Finance* during 1994. He is author or co-author of seven textbooks. He has also served as a privatization consultant for New York Stock Exchange, the OECD, the IMF, the World Federation of Exchanges and the World Bank.

Gordon Menzies completed a BEc(Hons) at the University of New England (UNE), after which he joined the Reserve Bank of Australia. He won a Bank scholarship to study at the Australian National University, where he won the Robert Jones Prize for the best Master's student. After a number of years working in the Reserve Bank of Australia in the Economic Research Department, he won a Commonwealth Scholarship to undertake a D Phil at Oxford University. He joined the University of Technology, Sydney (UTS) as a Senior Lecturer in Economics. He has taught econometrics at UNE, economics at the Australian National University and was senior Economics Tutor at Christ Church College, Oxford.

Franco Parisi is an Associate Professor and holds the EuroAmerica Chair in Finance at the Department of Business and Finance, Business School, Universidad de Chile. Parisi has been a visiting professor at Rice University, the University of Alabama at Birmingham, and at the University of Georgia. His publications are in International Finance Review, Multinational Financial Management, Emerging Market Review, Research in International Business and Finance, Latin American Business Review, International Review of Financial Analysis, El Trimester Económico, Revista de Análisis Económico, Cuadernos de Economía, Estudios en Administración. Also, Parisi was the Co-Editor in a Special Issue at the International Review of Financial Analysis and Vice President for Latin America-South, BALAS 2003.

Ronnie J. Phillips is chair and Professor of Economics at Colorado State University. He has been a Visiting Scholar at the FDIC, the Comptroller of the Currency, and at the Jerome Levy Economics Institute of Bard College. He is a past president of the Association for Evolutionary Economics (AFEE). His publications on financial system issues have appeared in books, academic journals, newspapers, magazines, and public policy briefs.

Winnie P. H. Poon is an Associate Professor in the Department of Finance and Insurance at Lingnan University in Hong Kong. She formerly taught for East Texas Baptist University and Mississippi State University. And she was a Visiting Scholar at The University of Alabama. Her major research interest is in the area of corporate and bank credit ratings.

Michael P. Ross recently graduated with a B.S. in Business Administration, with a concentration in Finance from Colorado State University. He is currently a law student in the Colorado School of Law at the University of Colorado at Boulder.

Natalie Sutter is a graduate student in finance at the University of Oklahoma's Michael F. Price's College of Business. She has a Bachelor of Business Administration with a major in Economics, a Bachelor of Accountancy, and a Juris Doctorate from the University of Oklahoma. She is licensed to practice law in the State of Oklahoma but is currently concentrating on her graduate studies.

Chris Terry is honorary Associate Professor at the University of Technology, Sydney. His PhD is from New York University. He has taught a range of subjects, including Capital Markets, Public Finance and Microeconomics and co-written four textbooks in the areas of Financial Markets, Microeconomic Policy and Microeconomics as well as contributing many chapters to books in these fields. Chris held various administrative positions including Head of the Economics Department, Head of School of Finance and Economics, Associate Dean (Postgraduate Programs and Research).

Rowan Trayler is a Senior Lecturer in the School of Finance and Economics at the University of Technology, Sydney. Previously, worked for Barclays Bank Australia Ltd, where he held several different positions including, Budget and Planning Manager, and was part of the team that helped establish the new bank in Australia. Since joining the University of Technology Rowan has been closely involved in the development of the postgraduate Master of Business in Finance, lecturing at both the postgraduate and undergraduate level in Banking and Finance.

Jorge L. Urrutia is a Professor of Finance at the School of Business of Loyola University Chicago. He has more than fifty publications in academic journals, including the Journal of Financial and Quantitative Analysis, Journal of Banking and Finance, Journal of Futures Markets, Journal of Financial Services Research, and others. Professor Urrutia also has collaborated in several books. He is associate editor of the Latin American Business Review, Journal of Multinational Financial Management, International Journal of Finance. He was Vice President of Local Arrangements and Director of the Midwest Finance Association. He is currently President Elected of the Business Association for Latin American Studies, BALAS, and director in the North American Economics and Finance Association, NAEFA, and the Multinational Finance Society. Professor Urrutia has taught Chile, Colombia, El Salvador, Japan, and in China as a Fulbright Scholar.

Adrian van Rixtel is a Principal Economist in the Directorate Monetary Policy of the European Central Bank. Previously, he held positions at the De Nederlandsche Bank (Netherlands Central Bank) and private financial institutions both in London and Amsterdam. Mr. van Rixtel took his PhD at the Tinbergen Institute, Free University Amsterdam, in the Netherlands. He has extensive experience covering Asian economies, in particular the Japanese economy, and held visiting scholar positions at the Bank of Japan and Ministry of Finance. He has published a book on the Japanese banking crisis in 2002 with Cambridge University Press ("Informality and Monetary Policy in Japan: The Political Economy of Bank Performance"). His research on Japan has been published in various articles and books and discussed in publications such as The Economist and Wall Street Journal.

1. INSIGHTS FROM A GLOBAL SURVEY ON BANK CAPITAL

BENTON E. GUP

1. INTRODUCTION

The 1988 Basel Capital Accord (Basel I) was widely accepted and applied around the world. However, Basel I became outdated with respect to the risk management of large complex financial organizations (LCFOs). J.P. Morgan Chase & Co. and Citigroup are examples of LCFOs. Thus, the New Basel Capital Accord (Basel II) was introduced in 2001 to deal with LCFOs; and it is a work in progress that is expected to be implemented at year-end 2006. This article provides insights from a survey of countries around the world to determine 1) whether they applied Basel I, and 2) are they going to apply Basel II?

The remainder of the article is divided into three parts. Part 2 provides an overview of the Basel Committee on Banking Supervision, Basel I and Basel II. Part 3 presents the results of the global survey. Part 4 provides the conclusions.

2. AN OVERVIEW OF THE BASEL COMMITTEE ON BANKING SUPERVISION

The Bank for International Settlements (BIS) was established in 1930 to deal with reparation payments imposed on Germany by the Treaty of Versailles following the First World War. Over time, the BIS's activities changed, and now it concentrates "on cooperation among central banks and, increasingly, other agencies in pursuit of monetary and financial stability."[1] There are 55 central banks that are members of the BIS.

Following failure of Bankhus I. D. Herstatt in Cologne, Germany, in 1974, the BIS and banking regulators from the Group of 10 (G-10) countries established the Basel

Committee on Banking Supervision.[2] Currently the Basel Committee on Banking Supervision includes central bankers and regulators from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, The Netherlands, Spain, Sweden, Switzerland, United Kingdom, and the United States.

2.1. The 1988 Capital Accord

A cornerstone of the Basel Committee's framework is the 1988 Capital Accord (Basel I) which provided for a minimum capital requirement of 8% for internationally active banks in order to 1) ensure an adequate level of capital and 2) competitive equality. Basel I focused exclusively on credit risk.

The BIS reported that more than 100 countries apply the 1988 Basel Capital Accord in their banking systems.[3] However, the Basel Committee did not identify the countries. The 8% capital requirement was an arbitrary number—it was not based on studies of the economic capital needs of banks.

In the United States, the 8% Basel I capital requirements apply to all FDIC-insured banks, and similar rules were applied to savings associations. In addition, under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), a total risk-based capital ratio of 8%–9.9% is considered "adequately capitalized," while a ratio of 10% or more is "well-capitalized." Banks with less than 8% risk-based capital are "undercapitalized" and subject to prompt correct action.

In the years that followed the 1988 Basel I Capital Accord, the U.S. experienced massive bank failures in the late 1980s and early 1990s. During the 1980–1996 period, 133 of the International Monetary Fund's 181 member countries experienced significant banking sector problems, including those countries that signed on to the Basel Accord.[4] Large banks in Japan began having problems beginning in 1990, and their problems had not been resolved by 2003. In the late 1990s and early 2000s, there were financial crises in Southeast Asia, Russia, Turkey, and Latin America where bank capital requirements may have had some impact. In the late 1990s, the Basel Committee on Banking Supervision began to focus on "financial stability in the wave of economic integration and globalization."[5] Federal Reserve Governor Olson (2003) identified "the expanded use of securitization and derivatives in secondary markets and vastly improved risk management systems" as two specific areas of change. In addition, regulatory capital arbitrage has undermined Basel I. LCFOs were of particular concern.[6] All of these factors suggest that changes in the capital requirements were needed, and they are forthcoming.

Therefore it was not surprising that bank regulators found that the Basel I leverage ratio was no longer an appropriate measure of a bank's capital adequacy because of changes that have occurred in the banking system. Federal Reserve Vice Chairman Ferguson (2003a) said that "Basel I is too simplistic to adequately address the activities of our most complex banking institutions." He goes on to say "If we do not apply more risk-sensitive capital requirements to these very large institutions, the usefulness of capital adequacy regulation in constraining excessive risk-taking at these entities will continue to erode. Such erosion would present U.S. bank supervisors with a highly undesirable choice. Either we would have to accept the increased risk of instability in the banking system, or we would be forced to adopt alternative—and more intrusive—approaches to the supervision and regulation of these institutions."

2.2. The New Basel Capital Accord—Basel II

The New Basel Capital Accord (Basel II), proposed in January 2001, will replace Basel I when it is implemented by year-end 2006. Basel II applies to holding companies (on a consolidated basis) that are parents of banking groups; but insurance subsidiaries are excluded in some G 10 countries.[7] While Basel I deals only with credit risk, Basel II incorporates market risk and operational risk. As previously noted, Basel II targets LCFOs, and as such, it was "not designed for banks in small unsophisticated developing countries."[8]

In fact, it was not designed for many banks in developed countries either. In the United States, a "bifurcated" regulatory capital framework is proposed.[9] Only about 10 internationally active "core banks" (and thrifts) with assets of $250 billion or more and/or cross-border exposures of $10 billion or more will be required to comply with Basel II advanced internal ratings based (A-IRB) approach to credit risk and the advanced measurement approach (AMA) approach to operational risk. The core banks will account for 99 percent of foreign assets and two-thirds of all assets of domestic U.S. banking organization.[10] They could include U.S. subsidiaries of foreign banking organizations that meet the core bank standards.[11]

Other U.S. banks may opt-in ("opt-in-banks") to Basel II using the A-IRB and AMA approaches. However, the remaining 7,700+ "general banks" in the U.S. will continue to use the Basel I capital standards.[12]

As shown in Table 1, the total risk-based capital ratio for U.S. banks is inversely related to the size of banks. The smallest banks have the highest capital ratios, and the <u>totals</u> for all banks exceed the Basel II capital requirements. The fact that the totals are high does not mean that every bank is adequately capitalized. Table 1 also reveals that 83 banks with asset greater than $10 billion account for 73% of the total assets of all 7,769 banks. Although not shown in the table, the four largest banks (JP Morgan Chase, Bank of America, Citibank, and Wachovia) have total assets of $2.182 trillion, or 31% of total bank assets.[13] Simply stated, the banking system in the United States is highly concentrated in a few large banks.

3. GLOBAL SURVEY

The survey consisted of two questions:

1. Are banks in your country required to comply with the 1988 Basel Capital Accord's 8% risk-based capital?
2. What is your country's position on adopting Basel II?

Table 1. Total Risk-Based Capital Ratios for U.S. Banks, 2003

	All commercial Banks	Assets Less than $100 Million	Assets $100 million–$1 billion	Assets $1–10 billion	Assets Greater than $10 billion
Number of Commercial Banks	7,769	3,911	3,434	341	83
Total Assets ($billions) (% of Total)	$7,603.5 (100%)	$200.7 (2.6%)	$910.0 (12.0%)	$947.3 (12.5%)	$5,544.5 (72.9%)
Total risk-based capital ratio	12.74	17.56	14.27	14.61	12.07

Source: *Quarterly Banking Profile*, Fourth Quarter, FDIC, 2003, Table III-A

Table 2. 66 Responses Used in the Survey

Albania	Brunei Darussalam	El Salvador	Kazakhstan	Mongolia	Slovenia
Argentina	Cameroon	Estonia	Korea	Morocco	South Africa
Algeria	Cayman Islands	Guinea Bissau	Kuwait	New Zealand	Swaziland
Armenia	Chile	Guyana	Lebanon	Nicaragua	Tajikistan
Aruba	China	Hong Kong	Liechtenstein	Norway	Tavalu
Australia	Columbia	Hungary	Lithuania	Pakistan	Thailand
Bahamas	Comoros	Iceland	Macao	Russia	Trinidad and Tobago
Barbados	Croatia	Ireland	Malawi	Rwanda	Turkey
Bermuda	Cyprus	Israel	Mauritius	Sao Tome	Ukraine
Botswana	Czech Rep.	Jamaica	Mexico	Seychelles	United Arab Emirates
Brazil	Eastern Caribbean	Jordan	Moldova	Singapore	Venezuela

In order to get a global perspective, the survey was mailed in November 2003 to the Permanent Missions of the 191 Member States of the United Nations.[14] Excluded from the survey were the previously mentioned 13 countries that served on the Basel Committee on Supervision and 6 additional countries (Austria, Denmark, Finland, Greece, Ireland, and Portugal) that are Member States of the European Union (EU). Members of the EU are required to comply with the Basel I and II capital requirements.

Countries that applied for EU membership, or are considering joining it were included in the survey. Also included in the survey are members of the European Economic Area (EEA), such as Iceland and Norway, which must meet the same capital requirements of the EU countries.

Because of the small number of responses to the mail survey, in January 2004 an e-mail survey was sent to 117 central banks that were listed on the BIS website.[15] Some central banks represent a group of countries or states. For example, the Bank of Central African States (Commission Bankcaire De L'Afrique Central) represents Cameroon (listed in Table 2), Chad, Congo, Gabon, Guinea, and the Republic of Central Africa. Similarly, the Eastern Caribbean (listed in Table 2) Central Bank represents Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent, and the Grenadines. The Bank of Central African States is listed in Table 2 as Cameroon, and the Eastern Caribbean Central Bank is listed as Eastern Caribbean. Therefore, the number of responses understates the number of countries or states that are represented. For simplicity, the terms respondents and countries will be used in the rest of the article.

By mid-April 2004, 66 responses had been recorded from the countries listed in Table 2. The table reveals the global coverage of both large and small countries. The responses of several other countries were not usable because they did not answer the questions.

3.1. Answers to Question 1: Are banks in your country required to comply with the 1988 Basel Capital Accord's 8% risk-based capital?

All of the respondents reported that they had a minimum of 8% or more capital, and many did not answer the question as asked. Thus, it is not clear if the 8% minimum was a result of their needs and regulations, or if it was because of Basel I. As shown in Table 3, 28 respondents have minimum capital requirements that exceed those of Basel I. The list includes both

Table 3. Respondents with Capital Requirements More Than 8%

Respondent	Gross Domestic Product, 2002 est. $ billions	Capital Requirement
Argentina	$431	10%
Armenia	$12	12%
Bahamas	$5	8%+[16]
Bermuda	$2	10%
Botswana	$14	15%
Brazil	$1,376	11%
Cayman Islands	$1	8–15%
Columbia	$252	9%
Comoros	$0.4	10%
Cyprus	$9	10%
El Salvador	$29	12%
Estonia	$16	10%
Jamaica	$10	10%
Israel	$117	9%
Jordan	$23	12%
Malawi	$7	10%
Mauritius	$12	10%
Moldova	$11.5	12%
Mongolia	$5	10%
Nicaragua	$11	10%
Russia	$1,409	10–11%
Seychelles	$1	12%
Singapore	$112	12%
South Africa	$428	8–10%
Tajikistan	$9	12%
Thailand	$446	8.5%
United Arab Emirates	$54	10%
Venezuela	$132	12%

Source: GDP data—*The World Fact Book*, Washington, D.C., Central Intelligence Agency, 2004, http://www.cia.gov/cia/publications/factbook/index.html

large and small countries as measured by their Gross Domestic Products. The most common minimum capital ratio is 10%.

Although 10% may seem relatively high, the data shown in Table 1 revealed that the average capital ratio for all U.S. banks was 12.74%. The capital ratio for the smaller U.S. banks (less than $10 billion in assets) ranged from 14.61% to 17.56%. Comparable data were not available to compute "actual" capital ratios for the respondents.

3.2. Answers to Question 2: What is your country's position on adopting Basel II?

Some of the answers to Question 2 were a straightforward yes or no. But others required judgment to determine how they should be classified. For example, New Zealand is recommending the adoption of the "Standardized approach," so it was classified as a yes in Table 4. Similarly, "We are fully committed to its implementation in Bermuda. However, we are unlikely to be in a position to adopt it in 2006," was counted as a yes. Tuvalu did not adopt Basel I, it only has one bank, and their response was "there is no firm stance as to whether we will adopt it or not.' Tuvalu was classified as a "no." The response from Armenia said "the debate about possible introduction of Basel II is still in place and there is no final

Table 4. Adoption of Basel II

Albania	Brunei Darussalam	El Salvador	Kazakhstan	Mongolia	Slovenia
Yes	Yes	?*	Yes	?*	Yes
Argentina	Cameroon	Estonia	Korea	Morocco	South Africa
Yes	?	Yes	No answer	Yes	Yes
Algeria	Cayman Islands	Guinea Bissau	Kuwait	New Zealand	Swaziland
?	?*	Yes	?	Yes	Yes
Armenia	Chile	Guyana	Lebanon	Nicaragua	Tajikistan
?*	?	Yes	?	?*	No
Aruba	China	Hong Kong	Liechtenstein	Norway	Tavalu
?	Yes	Yes	?	?	No
Australia	Columbia	Hungary	Lithuania	Pakistan	Thailand
Yes	Yes	No answer	Yes	?	?*
Bahamas	Comoros	Iceland	Macao	Russia	Trinidad and Tobago
Yes	?*	Yes	Yes	Yes	?
Barbados	Croatia	Ireland	Malawi	Rwanda	Turkey
?	Yes	Yes	?*	No	Yes
Bermuda	Cyprus	Israel	Mauritius	Sao Tome	Ukraine
Yes	Yes	Yes	?*	?	?
Botswana	Czech Rep.	Jamaica	Mexico	Seychelles	United Arab Emirates
Yes	Yes	?*	No answer	?*	Yes
Brazil	Eastern Caribbean	Jordan	Moldova	Singapore	Venezuela
Yes	?	Yes	?*	Yes	?

? = undecided; ?* = minimum capital requirement greater than 8%

conclusion..."and it was classified as "undecided," and it is noted in Table 4 with a question mark (?). If the answers were too vague to be interpreted, they were classified as undecided. In several cases, the responses consisted of copies of bank regulations (in foreign languages) or references to various web sites. In the case of Mexico, for example, the regulations that were sent to me did not mention Basel I or II, so it was not included in the total number of responses to Question 2. Hungary did not answer that question so it too was excluded. Thus, judgment played a substantial role in determining if the responses were classified as yes, no, or undecided. A total of 63 responses are shown in Table 4. Three (Hungary, Korea and Mexico) did not answer the question.

With that disclaimer in mind, 33 of the 63 responses were classified as yes—they will adopt Basel II in some form. For the most part, these included the larger countries and those that are actively engaged in international trade. As previously noted, some of the countries that said yes are in the process of joining the EU, or they are members of the EEA.

Three countries (Rwanda, Tajikistan, and Tavalu) said no.

Twenty seven respondents were classified as "undecided." All are small countries. Twelve of the undecided respondents have a minimum capital requirement of 8% or higher (reported in Table 3), and they are designated in Table 4 with an asterisk (*) next to the question mark (?*). One respondent said "In Armenia the debate about possible introduction of Basel II is still in place and there is no final conclusion about the timing and etc. My personal opinion that it is too complicated for Armenian Banks." The Cayman Islands responded that "We are still evaluating the adoption of Basel II, however we recognise that an international centre with branches and subsidiaries of international banks some changes to the current approach must be expected."

4. CONCLUSIONS

The 1988 Basel Capital Accord (Basel I) was a major step forward on the road toward the harmonization of bank capital regulations. All 66 of the countries that responded to the survey had 8% or higher minimum capital requirements. Basel II, however, appears to be a bump in the road toward harmonization. In part, this is because the objectives of Basel I and II differ. Basel I was concerned with credit risk, the level of capital, and competitive equality. In contrast, Basel II is targeted at LCFOs, not small and medium size banks.

Thirty three of the respondents surveyed will use Basel II, and most of the remaining respondents are undecided. The division closely follows country size. The larger countries and those that are internationally active will apply it. The "undecided" group tends to be smaller countries and many of them have capital requirements that exceed those of Basel II. Therefore it is highly likely that some of these countries will use Basel II. Only three respondents rejected it.

The most common criticisms by those considering Basel II are that it is too complicated, and not suitable for banks in small unsophisticated developing countries. In addition, the Norwegian Financial Services Association (2003) noted that Basel II has many areas "which either prescribes or opens up for relatively wide national discretions. In many instances such discretion may be used to apply more lenient rules, and thus have the potential to create serious differences in competitive positions of national banking systems in the international market place. The result may well be increased regulatory arbitrage."

Recall that one of the goals of Basel I was "competitive equality." Smaller size banks in many of the countries surveyed have minimum capital requirements that meet or exceed those of Basel II, and they are not really affected by it. However, the information presented here suggests that Basel II may undermine that goal for medium and large size banks that don't opt-in to Basel II using the A-IRB and AMA approaches.[16]

ENDNOTES

1. "BIS History," http://www.bis.org/about/history.htm.
2. For further information about Herstatt, see Gup (1998), Chapter 2.
3. "The New Basel Capital Accord: An Explanatory Note," 2001; also see: The Basel Committee on Banking Supervision, http://www.bis.org/bcbs/aboutbcbs.htm
4. Lindgren, et al., (1996). Also see Gup (1998; 1999).
5. "BIS History, 2003.
6. For further discussion of LCFOs, see Bliss 2002A and B; Herring, 2003; DeFerrari and Palmer, 2001.
7. "The New Basel Capital Accord," Consultative Document, January 2001.
8. "Comments of the Caribbean Group of Bank Supervisors (CGSB) on the Third Consultative Paper on the New Capital Accord," (no date).
9. Advanced Notice of Public Rule Making, Risk Capital Guidelines, August 4, 2003.
10. Ferguson, 2003b.
11. Ferguson, 2003c.
12. Olsen, 2003.
13. Large Commercial Banks, Federal Reserve Statistical Release, December 31, 2003.
14. *Permanent Mission to the United Nations*, 2003.
15. See: http://www.bis.org/cbanks.htm
16. The Financial Stability Institute published the results of a survey on non-Basel committee member countries (Implementation.... 2004). Their results also suggest that Basel II will be accepted, at least in part, over time by many nations.

REFERENCES

Advanced Notice of Public Rule Making, Risk Capital Guidelines, 12 CFR Parts 3, 208, 325, 567, *Federal Register*, August 4, 2003, 45900–459888.

"BIS History," http://www.bis.org/about/history.htm. June 2003.

Bliss, R. R., (A) "Bankruptcy Law and Large Complex Financial Organizations," *Economic Perspectives*, Federal Reserve Bank of Chicago, First Quarter, 2003, 48–54.

Bliss, R. R., (B), "Resolving Large Complex Financial Organization, " Draft, Federal Reserve Bank of Chicago, May 19, 2003.

"Comments of the Caribbean Group of Bank Supervisors (CGSB) on the Third Consultative Paper on the New Capital Accord," Bank for International Settlements: http://www.bis.org/bcbs/cp3comments.htm (no date).

DeFerrari, L. M., and D. E. Palmer, "Supervision of Large Complex Banking Organizations," *Federal Reserve Bulletin*, February 2001, 47–57.

Ferguson, Roger W. Jr., Vice Chairman Federal Reserve Board, Testimony Before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, Committee on Financial Services, U.S. House of Representatives, February 27, 2003 (a).

Ferguson, Roger W. Jr., Vice Chairman Federal Reserve Board, Testimony Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate June 18, 2003 (b).

Ferguson, Roger W. Jr., Vice Chairman Federal Reserve Board, "Concerns and Considerations for the Practical Implementation of the New Basel Accord," Remarks at the ICBI Risk Management 2003 Conference, Geneva, Switzerland, December 2, 2003 (c).

Gup, Benton E., *Bank Failures in the Major Trading Countries of the World: Causes and Consequences*, Westport, CT, Quorum Books, 1998.

Gup, Benton E., *International Banking Crises: Large-Scale Failures, Massive Government Interventions*, Westport, CT., Quorum Books, 1999.

Herring, R., "International Financial Conglomerates: Implications for Bank Insolvency Regimes," Wharton School of Business, University of Pennsylvania, Draft, May 2003.

"Implementation of the New Capital Adequacy Framework in Non-Basel Committee Member Countries," Financial Stability Institute, Occasional Paper No. 4, Basel, Switzerland, Bank for International Settlements, July 2004.

Large Commercial Banks, Federal Reserve Statistical Release, December 31, 2003: http://www.federalreserve.gov/releases/lbr/current/default.htm

Lindgren, Carl-Johan, Gillian Garcia, and Matthew I. Saal, *Bank Soundness and Macroeconomic Policy*, Washington, D.C., International Monetary Fund, 1996.

Norwegian Financial Services Association, "Comments on Consultative Document on the New Capital Accord (CP 3), March 7, 2003, www.bis.org.

Olsen, M. W., "Basel II: Its Implications for Second-Tier and Community-Size Banks" Remarks by Federal Reserve Governor Mark W. Olson at the 2003 Banking Institute, Center for Banking and Finance, University of North Carolina, Charlotte, North Carolina, April 10, 2003.

"Overview of the New Basel Accord," Consultative Document, Basel Committee on Banking Supervision, Bank for International Settlements, Basel Switzerland, January 2001.

Permanent Mission to the United Nations, No. 289, New York, United Nations, February 2003.

Quarterly Banking Profile, Fourth Quarter, FDIC, 2003.

"The New Basel Capital Accord: An Explanatory Note," Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, Basel Switzerland, January 2001.

"The New Basel Capital Accord," Consultative Document, January 2001, 2–3; "Overview of the New Basel Accord, January 2001, # 56, page 11.

The World Fact Book, Washington, D.C., Central Intelligence Agency, 2004, http://www.cia.gov/cia/publications/factbook/index.html

2. THE EFFECTS OF BASEL II ON DEVELOPING COUNTRIES: A SUMMARY OF A GLOBAL PUBLIC GOODS NETWORK EFORUM ON BASEL II

BENTON E. GUP

1. INTRODUCTION

During the May 26–June 14, 2004 period, Global Public Goods Network (gpgNet) held a discussion forum (eForum) on International Financial Stability—Basel II: Accord or Discord.[1] Over 250 participants from around the world registered for the e-Forum, but relatively few submitted comments or replies. This article summarizes some comments and provides excerpts from others that were posted on the gpgNet web site for the eForum.[2] They are presented here in the order in which they were sent. No changes or corrections were made in the comments that are quoted. The full-texts of all of the comments are available on that same website.[3]

Several points suggested for debate included:

- What effects will Basel II have on developing countries?
- What measures could be introduced to reduce the potential negative effects, such as taking the diversification of risk into account?
- Why have measures to curb its potential negative impact on developing countries not been taken into account?

2. COMMENTS AND REPLIES

2.1. Mistakes in Basel Could Harm Developing Countries

The eForum began by asking participants to review a paper by Stephany Griffith-Jones, who argues that Basel II would significantly overestimate the risk of international bank lending to developing economies.[4] This would lead to the increased cost of borrowing by those countries, and to a decline in loans to the developing world. Stephany Griffith-Jones and Stephen Spratt go on to say that sophisticated international banks have diversified their portfolios, but Basel II does not take this risk reducing factor into account.[5]

2.2. Insights from a Global Survey on Bank Capital

Insights from a Global Survey on Bank Capital, by Benton E. Gup, revealed that of the 66 countries that responded to the survey, all met or exceeded the 8% capital requirements of Basel I.[6] About half of the respondents would apply Basel II, and most of the remaining countries were contemplating it. The fact that banks in many countries have excess regulatory capital mitigates some of the effects of Basel II's higher capital requirements for riskier loans.

2.3. Micro vs. Macro

Sunada Sen pointed out that Basel II is focused strictly on the micro-finance of banks; and it ignores the macro-economic aspects of global capital flows.[7]

2.4. Procyclicality

Paul Bance presented a paper on "Prudential Supervision Against Banking Procyclicality: A Critical Assessment of the Line of Defense of the Basel Committee."[8] He says that "The New Basel Capital Accord may heighten the procyclical impact of the financial system through its proposal for a risk-sensitive regulatory framework. The line of defense of the Basel Committee for Banking Supervision relies on a strengthened supervision mix of public and private discipline to carefully monitor banks' positions and actions and to efficiently prevent them from adopting imprudent behaviors. This essay argues that the impact of increasing supervision on banks' prudential behavior is not monotonic through the economic cycle and may be counterproductive in some points of the cycle."

2.5. Making a Fragile System More So

Avinash Persaud and Stephen Spratt argue that Basel II is too complex and places too much emphasis on risk-sensitivity.[9] ". . . the purpose of bank regulation is not to assess private risks: this is the job of the banks and the markets. The purpose regulation is to consider where social risks are different from private risks, and then to use regulatory capital to make those social risks internal to the bank. If the failure of a particular bank would have no negative effects on confidence in the financial system—if, for example, there would be no strong reason to bail out that institution—then it is not clear why we would regulate it any differently than we would regulate a non-financial corporate with concern for the health and safety of its consumers and employees. We regulate banks further because we are worried about their spill-over risks. Sensitivity to private risks is a red-herring. Of course, it is what big banks would like regulators to worry about, because then regulatory capital will be aligned to their narrow risks. Instead regulatory capital should focus on the difference between internal assessments of risk and the regulators' assessment of the wider social risks."

They conclude by saying that "Basle's prescriptions are at the root of its enormous complexity. Complexity is the avenue of capture. Faced with over 200 pages of complex rules and exceptions, the supervisors will be more easily manipulated, the consultants will be happily employed and the big banks will pick off smaller banks straining under the financial costs of implementation."