NEW PRUDENTIAL GUIDELINES FOR BANKS

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Thanks, David.

Now that we know the legal facts, I will take on the easier task of speculating about the effects of the capital adequacy requirements.

My contribution will be brief, but first the obligatory warning on the label. Today I will be speaking in a purely personal capacity and the thoughts I will express in no way represent the views of National Australia Bank. After all, regulated bankers must be fair minded and conservative by definition. It is only in a personal capacity that I can be more provocative, but it is much more fun!

In setting the scene for the new prudential guidelines, it is important to describe the set surrounding our star performer on the stage of life - things never happen in a vacuum and the scenery has a great influence on the actors.

Three revolutions are in place, as Chanticleer detailed in the AFR in January:

- Lionel Bowen's corporate and securities law revolution and the proposed centralisation of regulation in Canberra.
- The stealthy revolution taking place in accounting standards.
- The new capital adequacy requirements for banks.

There are also three groups of factors influencing the capital adequacy requirements:

Firstly, the capital adequacy requirements for banks - the so called international convergence of capital measurement and capital standards - is taking place in a global scene amongst several other convergences, namely:

- The convergence of investment and commercial banking, leading to the securitisation of assets and the break down in traditional market barriers.

- The convergence of national markets into global markets.

- The convergence of financial conglomerates, that is the big, beautiful, full service, integrated customer package ambitions held by the many institutions.

- The effect of technology on the transfer of assets, the volatility of markets, and the resulting pressure on payments systems.

- Disintermediation and introduction of new risks to old managers.

Secondly, banks and regulators have very different aims. Banks are looking for profit, innovation, market share growth, competition, the control of costs, and management of risk exposure. Regulators, meanwhile, seek prudence, safety, the comparison of reported financial numbers, exposure containment, and look alike institutions.

Thirdly, around the world politicians have been preaching deregulation, free markets and a reduction in legislation while welcoming international competition. Meanwhile the bureaucrats and supervisors - the Sir Humphries of the world who march to the beat of a different drum - are re-regulating. Their actions are justified in terms of legal and moral duties to national deposit taking institutions, clearing systems and financial exchanges, the protection of national banks from unfair foreign competition, and the protection of the banks from themselves, that is, from over enthusiasm, unwise ambitions and abnormal financial ratios.

Let us now have a look at the objectives of the regulations.

The regulators claim that their regulatory framework is conceptually sound, serving two desirable objectives:

- to strengthen the soundness and stability of the international banking system; and

- to ensure a fair and consistent application of the rules to banks in different countries with a view to diminishing competitive inequalities among banks.

It is difficult to oppose such motherhood concepts. No banker, after all, is going to advocate an unsound, unstable banking system and neither is he going to publicly admit a preference for competitive inequality. However, we know that actions predicated on the most worthy of motives have a habit of producing unworthy and unexpected consequences.

But let us challenge the key concept underlining the new regulations, which is that the amount of capital (or more precisely, the capital to assets ratio) of a bank is fundamental to determining that bank's safety and its competitive path.

Well, all the bank failures that I know of occurred because of bad loans, or from buying overvalued assets, or from runs on deposits. Who ever heard of a bank failing because of lack of capital?

The bank's capital is not a liquid asset, money in the tin, to be used to absorb bad debts or bad luck. Banking is all about making good loans, being hard nosed about the bad ones, and maintaining the confidence of depositors and shareholders by strong, cash generating operating profits and growth. Confidence in banks is all about winning - not capital.

But, accepting that the regulations exist, that they have been built around this capital concept, and these motherhood objectives, let us look at the implementation to date. Internationally it can be described, at best, as spotty. In Australia the rules are effective now, while in Japan they will be effective in 1992, or maybe later! We have a considerable period of time during which the red competitive inequality will be continued or even exaggerated!

Case law is developing as the interpretation and the redefinition of detailed points takes place in the light of specific challenges or questions from banks and their lawyers, settled either locally or after reference to Basle. Significant differences are beginning to emerge between the various countries in their interpretation of and their extension of the principles agreed amongst the participating countries.

I suspect that the Basle Committee will have much work to do in attempting to hold the principles together as the details diverge!

Now let us consider some of the consequences - anticipated or otherwise - of the regulations. The price of credit will increase, encouraging the growth of non-regulated banking and intercompany lending. When one looks at the experiences in the UK with intercompany lending in the 1970s, and when one looks at the track record of banks - experts in credit risk analysis! - one is not encouraged as to the likely success possibilities for amateurs in this business!

There will be a growth in non-regulated financial centres - do I hear a great acclaim for the idea of moving to Tahiti? Or some such pleasant and non-regulated island!

Banking products will be adapted to suit the rules, and banks will grow their activity in low capital cost areas (as defined by the capital adequacy requirements) distorting the allocation of credit to customers and the allocation of resources within banks.

The growth of international megabanks will be encouraged. The trend will reflect the sheer size needed to support relationships between banks and their large global customers under the new

capital adequacy regime. Domestically it will reflect the impact of subjective asset tiering and weighting, driving banks into a limited number of preferred markets. I believe the banks will try to dominate the home mortgage market for instance because of a fifty percent weighting on owner occupied housing loans. In the specific Australian context, banking convergence will force feed the creation of megabanks here, highlighting the plight of the growth restricted Commonwealth Bank and bringing the other major trading banks "into play".

WHERE WILL IT STOP?

- Before liquidity and interest rate risks are incorporated into the requirements? I doubt it!
- Before further subjective and arbitrary tiering of assets by counterparty? I doubt it!
- Before regulating the non-bank financial institutions in Australia? I doubt it!
- Before explicitly charging for the obligatory mandatory deposit insurance which the regulators have decided is "good" for the depositor? I doubt it!
- Before the pendulum swings too far towards regulations (the regulators know best syndrome) and away from free market competition? I doubt it!
- Before global convergence (merging!) of the banking industry? I doubt it!
- Before the lawyers grow rich? Definitely not!

As Professor Warren Hogan of the University of New South Wales said recently "any perception of completeness in the risk adjusted procedures is misplaced. The risk weightings are devised to account almost exclusively for credit risk ... The concept of a risk adjusted asset portfolio is not realised by the measures now being implemented in Australia and elsewhere.

They convey an impression of adaptation to risk which is spurious; the measures are partial in their coverage and ad hoc in specific detail. I can think of no better summary than that of Professor Hogan, and I leave you with the thoughts that:

- The current risk weighting regime is only stage 1.
- While its motherhood objectives cannot be objected to, its details reflect the political and intellectual compromises reached during its difficult creation process in Basle.
- Its consequences will be diverse and far reaching on the financial industry.

- There has been uneven implementation to date, and the divergence of case law will grow.

Marty Feldstein has said that international co-operation for a wrong idea is worse than no co-operation at all. He is not wrong. Let us hope the international regulators know where to stop!