

*The Role of Credit Rating Agencies  
in the Establishment of Capital  
Standards for Financial Institutions  
in a Global Economy*

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AM DELIGHTED TO have this opportunity to comment upon Steven Schwarcz's illuminating chapter on the role of credit rating agencies.<sup>1</sup> As I find myself largely in agreement with the analytical framework his chapter proposes, my comments will focus on extending his analysis to additional issues that arise when governmental bodies incorporate the views of private credit rating agencies into supervisory procedures. This regulatory incorporation of the work of rating agencies has become commonplace in the United States over the past few decades and, as Schwarcz indicates, the Basel Committee on Banking Supervision (Basel Committee) recently proposed to include analogous procedures in the Committee's revised capital adequacy standards.<sup>2</sup> Regulatory incorporation of private credit rating presents new and difficult questions of public policy, as well as complicating the question whether these rating agencies should be the subject of more extensive regulatory supervision. The Basel Committee's recent proposal offers an excellent example of these complexities and my comments will focus on this recent exemplar of regulatory incorporation of the work of private rating agencies. The Basel Committee's proposed reliance on credit rating agencies also illustrates the difficulty of setting global regulatory standards that are supposed to be implemented in a variety of countries at differing stages of economic development.

<sup>1</sup> S. L. Schwarcz ch. 18, above.

<sup>2</sup> Basel Committee on Banking Supervision, *A New Capital Adequacy Framework* (Consultative Paper, June 1999) <<http://www.bis.org/publ/bcbas50.pdf>>. After this chapter was prepared, the Basel Committee published a revised accord. See Basel Committee on Banking Supervision, 'Overview of The New Basel Capital Accord' (Consultative Doc. Jan 2001) <<http://www.bis.org/publ/bcbaca03.pdf>>.

BACKGROUND ON REGULATORY INCORPORATION OF CREDIT RATING  
AGENCIES

As Schwarcz's chapter explains, the traditional role of credit ratings has been to assist investors in evaluating the debt securities of particular corporations. While the issuer typically pays its agency's fee, the ratings are designed to help investors assess the issuer's creditworthiness. *To* preserve the value of their ratings in this market, credit agencies need to maintain a good reputation for accurate ratings, and the desire of the agencies to maintain their reputations enhances the credibility of ratings. As Schwarcz suggests, this alignment of interests is what makes the market work in this area. The trilateral relationship among issuers, rating agencies, and investors is illustrated in Figure 19.1.

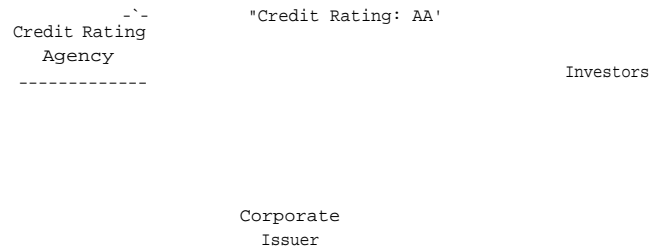


Fig. 19.1. *Traditional role of rating agencies*

Recognising the unique capacity of private credit rating agencies to evaluate the creditworthiness of a broad range of issuers, regulatory agencies in the United States have made increasing use of ratings in supervisory settings.<sup>3</sup> A Basel Committee working group recently issued a working paper which surveys regulatory incorporation of rating agencies in a broader range of jurisdictions. According to this study, the United States makes the greatest use of regulatory incorporation, but a number of other jurisdictions have recently followed suit, prompted by the Basel Committee's market risk amendment to the original

<sup>3</sup> For a more complete discussion of the ways in which US regulatory agencies have incorporated private credit agencies, see F. Partnoy, "The Siskel and Ebert of Financial Markets: *Two* Thumbs Down for the Credit Rating Agencies" (1999) 77 *Wash. U L Q* 619; A. K. Rhodes, "The Role of the SEC in the Regulation of Rating Agencies: Well-Placed Reliance or Free-Market Interference?" (1996) 20 *Seton Hall Legis. J* 293. See Basel Committee on Banking Supervision, *Credit Ratings and Complementary Sources of Credit Quality Information* (August 2000) 42-43, 54 (Working Paper No. 3) <[http://www.bis.org/publ/bcbs\\_wp3.pdf](http://www.bis.org/publ/bcbs_wp3.pdf)> (hereinafter cited as "Credit Ratings Working Paper").

Basle Accord. In this comment, I refer to these uses collectively as regulatory incorporation of rating agencies, but I also distinguish among several different kinds of regulatory incorporation. One use entails the definition of jurisdictional boundaries. When Schwarcz refers to SEC Rule 3a-7 under the Investment Company Act of 1940,<sup>4</sup> he is citing an example of this sort of regulatory incorporation. In the United States, when a corporation invests in a pool of securities, the corporation is presumptively subject to regulation under the Investment Company Act of 1940, a legal regime designed to protect investors from various sorts of investment frauds. In the 1980s, this jurisdictional structure created problems for the emerging market for securitised assets. Eventually, the SEC created an exemption from the 1940 Act for pools of securitised assets with an adequate rating from an accredited rating agency.<sup>6</sup> The logic of this exemption was that, if the pool received a good enough credit rating, then the investor protections of the 1940 Act would be superfluous. In this context, an adequate credit rating has become the path to exemption from supervision.<sup>7</sup>

Another common context for regulatory incorporation of rating agencies is where supervisory standards impose restrictions on the structure of the balance sheet of a regulated entity, such as a bank or insurance company or securities firm. Sometimes the authority of a related entity to hold a certain type of investment will depend on whether or not the investment has received a rating from a private rating agency; at other times the amount that the firm is permitted to invest in a particular security will rise or fall depending on whether or not the security is rated. A good example of this approach can be found in the SEC rules governing money market mutual funds. Under rule 2a-7 under the 1940 Act,<sup>8</sup> the authority of money market mutual funds to invest in a corporation's debt securities depends on the number of firms that have rated the securities and the quality of the ratings. Rather than developing its own standard for appropriate investments, the SEC piggybacks on the pre-existing work of rating agencies.<sup>9</sup>

Another context in which private credit rating agencies participate in regulatory standards is in the area of capital requirements. Often, the amount of capital a regulated entity is required to maintain depends on the volume of the entity's assets—for example, in a simple regime, eight dollars of capital might

<sup>4</sup> 17 CFR § 270.3a-7 (2000), discussed in S. Schwarcz, 298.

<sup>5</sup> 15 U.S.C. §§ 80a-1 to 80a-64 (2000). For an overview of this regulatory structure and a discussion of the definition of investment company under the 1940 Act, see H. E. Jackson and E. S. Symons, *The Regulation of Financial Institutions* (Minneapolis, Minn., West Publications, 1999) 811-50.

<sup>6</sup> See SEC Final Rule on Exclusion from the Definition of Investment Company for Structured Finance, 57 Fed. Reg. 56,248-01 (Nov. 27, 1992) ("[r]ating agency evaluations tend to address most of the [1940] Act's concerns regarding abusive practices, such as self-dealing and overreaching by insiders, misvaluation of assets, and inadequate asset coverage").

<sup>7</sup> In a similar spirit are rules that liberalised the disclosure obligations of investment-grade bonds. See SEC Form S-3 under the Securities Act of 1933.

<sup>8</sup> 17 CFR § 270.2a-7 (2000).

<sup>9</sup> See also 12 CFR § 704.6 (2000) (using similar technique to determine authority of corporate credit unions to invest in debt).

be required for every 100 dollars of assets. More complex capital requirements vary the amount of capital required for various types of assets, and one way US regulators have distinguished among assets is to permit lower capital reserves for assets that have higher credit ratings.<sup>10</sup> Again the logic underlying these distinctions is that higher credit ratings imply that the assets are less risky than other, unrated or lower-rated assets.

#### RATING AGENCIES UNDER THE BASEL COMMITTEE PROPOSALS OF JUNE 1999

The Basel Committee proposals of June 1999 are an example of regulatory incorporation of rating agencies into the development of capital standards." Under the original Basel rules—developed in the 1980s—all commercial loans were subject to the same capital requirement of 8 per cent. Under the Committee's recent proposal, the amount of capital required for commercial loans would vary between 4 per cent and 12 per cent depending on the credit rating of the issuer. Loans to issuers with high ratings—either AAA or AA in the S&P system—would be subject to only 4 per cent capital ratings.<sup>12</sup> Loans to issuers with the next tier of ratings—A+ to B- in the S&P system—would retain the current capital requirement of 8 per cent. Loans to issuers with lower ratings would be subject to 12 per cent capital requirements. Loans to borrowers without credit ratings would remain subject to the current 8 per cent capital rules. (The Basel Committee's current and proposed capital requirements for commercial loans are summarised in Figure 19.2.)

Issuer	Current	Proposed
AAA to AA	8 %	1.6%
A+ to B-	8 %	8
Below B-	8 %	12%
Unrated	8 %	8 %

Fig. 19.2. *Basel Committee's current and proposed capital requirement for commercial loans*

The Basel Committee's proposed reliance on private credit ratings has an intuitive appeal. To begin with, the Committee's original approach to commercial loans was undeniably crude. While the original Basel proposals made distinctions between other categories of assets (for example, sovereign debt and bank credits), all commercial loans had the same risk weightings and that

<sup>10</sup> See, e.g., 17 CFR § 240.15c3-1 (2000) (net capital rules for SEC-registered broker-dealers).

<sup>11</sup> In this comment, I limit my remarks to the aspects of the Committee's proposal dealing with corporate borrowers. The proposal has analogous recommendations for sovereign debt and bank credits.

<sup>12</sup> Throughout this comment, I will refer to the S&P rating system for illustrative purposes. As Schwarcz explains in his chapter, other agencies have different but analogous nomenclature. See S. L. Schwarcz, 299-300.

meant that bank loans to blue chip companies such as IBM and Microsoft were subject to the same capital requirements as loans to the most risky start-up enterprises, even though the credits clearly exposed lenders to substantially different amounts of risk. The Basel Committee's proposed incorporation of private ratings into capital adequacy calculations attempts to redress this flaw in the original proposal.

#### CRITICISMS

Despite the appeal of the Committee's proposed use of private credit ratings, the proposal has been subject to a series of criticisms, ranging from technical critiques to fundamental challenges.<sup>3</sup> On the technical side, various economists have questioned whether the Basel Committee has properly incorporated private credit ratings into its proposal. For one thing, critics have argued that the Committee's proposal lumps too many different kinds of companies into the same category and that the Committee should have provided for more than three groupings of borrowers to reflect the true range of credit quality across borrowers. In addition, commentators have suggested that the Basel Committee proposals do not reduce capital enough for good credit risks or impose adequate penalties on poor credit risks. The variation in capital requirements that the Basel Committee has proposed, according to this line of argument, should be greater than the 4 per cent to 12 per cent suggested in the Committee's June 1999 proposal.

These technical critiques accept the proposal's basic approach—to vary capital requirements to reflect the credit rating of individual borrowers—but propound various revisions better to reflect a more accurate presentation of differences in the credit quality of various borrowers. For example, in a January 2000 paper, Sanders and Altman performed a variety of econometric analyses of the past performance of issuers with various kinds of credit ratings and made a series of estimates of more appropriate classifications and capital requirements.<sup>4</sup> Figure 19.3 illustrates the kinds of results they generated for a four-tier classifications system (as opposed to the three-tier system in the Committee's June 1999 proposal).

Figure 19.3, which reports only one of several different approaches presented in the Altman and Saunders paper, suggests that the very best borrowers (those with AAA or AA under the S&P system) should have capital requirements of only 1.4 per cent, whereas borrowers with the lowest credit ratings (those ranked B- and below) should have capital requirements of roughly

<sup>3</sup> For a multi-faceted critique of the Basel proposal, including a collection of authorities critical of the use Committee's proposed use of private credit rating agencies, see US Shadow Financial Regulatory Committee, *A Proposal for Reforming Bank Capital Regulation*, (Statement No 160, 2 March 2000) <<http://www.aei.org/shdw/shdw160.htm>>.

<sup>4</sup> See E. I. Altman and A. Sanders, "An Analysis and Critique of the BIS Proposal on Capital Adequacy and Ratings" (January 2000) <<http://www.stern.nyu.edu/~ealtman/bis.pdf>>.

Issuer (under S&P under standards)	Current	Proposed	'Appropriate' Capital Requirements
AAA to AA	8%	1.6%	1.4%
A to BBB	8%	8%	2.3%
BB to B	8%	8%	7.1%
Below B-	8%	12%	17.0%
Unrated	8%	8%	n.a.

Fig. 19.3. Alternative capital requirements based on private credit ratings from Altman & Saunders (January 2000)

17 per cent.<sup>15</sup> Thus, whereas the Basel Committee allowed for only a threefold variation in capital requirements (from 4 percent to 12 per cent), the implication of Figure 19.3 is that more than a tenfold differential would be appropriate. The Saunders and Altman data also suggest that there are substantial differences in the appropriate capital charges for borrowers in the A to BBB and those in the B to BB category, even though the Basel Committee's proposal would have lumped all of these borrowers into a single category. Whereas the Basel Committee would have imposed an 8 per cent capital requirement on all of these borrowers, the Saunders and Altman analysis would suggest a substantial difference in the capital requirement for higher rated borrowers in this group (2.3 per cent) as compared with lower-rated borrowers (7.1 per cent).

Preliminary pronouncements of officials close to the Basel Committee suggest that the Committee is cognizant of these technical critiques of its June 1999 proposal and will likely produce an amended proposal allowing for greater distinctions among categories of borrowers and perhaps even more variation in the capital requirements required for different kinds of loans.<sup>16</sup> The Committee may even allow for distinctions based on the internal rating systems of individual banks.<sup>17</sup> The Committee will, however, be hard pressed to address more fundamental criticisms of this aspect of its June 1999 proposal and still maintain any reliance on private credit rating agencies. In ascending order of severity, these criticisms concern the proposal's distinction between rated and unrated

<sup>15</sup> See E. I. Altman and A. Sanders, "An Analysis and Critique of the BIS Proposal on Capital Adequacy and Ratings" (January 2000) <<http://www.stern.nyu.edu/~saltman/bis.pdf>>, 12.

<sup>16</sup> See Update on the Major Initiative to Review the 1988 Capital Accord, Speech by William J. McDonough, President, Federal Reserve Bank of New York, before the 4th Annual Supervision Conference of the British Bankers Association (19 June 2000) <<http://www.ny.frb.org/pihome/news/speeches/2000/mcdon000619.htm>> (suggesting that the Committee may revise its proposal to add more risk classifications). Subsequently, the Basel Committee did adopt a revised proposal which included more variation of capital requirements. See Overview of the New Basel Capital Accord, n. 1 above.

<sup>17</sup> For a report on this topic, see Basel Committee on Banking Supervision, *Range of Practice in Banks' Internal Rating Systems* (January 2000) <<http://www.bis.org/publ/bcbs66.pdf>>.

borrowers; the manner in which the proposal would operate in times of economic down-turn; and the proposal's failure to measure overall-portfolio risk.

One fairly obvious anomaly of the Basel Committee's proposal is the fact that it imposes a lower capital requirement on loans to unrated borrowers (8 per cent) than it does on borrowers with low credit ratings (12 per cent for issuers with ratings of B- and lower under S&P standards). While there may be particular instances in which this distinction is appropriate, commentators have questioned whether the distinction is generally justified.<sup>19</sup> If not, it imposes an unwarranted capital penalty on loans to borrowers with lower ratings, in effect steering credit towards unrated borrowers. (Conversely there may be some low-risk unrated borrowers that should be subject to a capital requirement lower than 8 per cent.) This problem surrounding the distinction between rated and unrated borrowers may be an inevitable by-product of factoring credit ratings into capital requirements when not all credit risks are rated.<sup>19</sup> And thus there is no obvious way for the Basel Committee's proposal to be amended to address this concern.

A separate concern about the Basel Committee's proposal reflects an unease with the premise that information provided by private credit rating agencies will actually assist supervisory authorities in setting capital standards. One version of this concern derives from observations that credit rating agencies tend to raise the credit rating of borrowers in economic boom times and lower the credit ratings in times of economic difficulty.<sup>20</sup> While this practice may accurately reflect default risk to investors and thus be a sensible practice in the context of the traditional role of credit rating agencies—it has a potentially perverse effect if incorporated into government-imposed capital requirements. It allows banks to lower their capital reserves in economic expansion, but requires an increase in capital requirements in economic downturns. This is precisely the opposite of what financial economists suggest to be the optimal approach for capital standards. This problem is one of the consequences of grafting a market mechanism into a regulatory standard that the mechanism was not initially designed to serve.

An additional and deeper problem with the Basel Committee's reliance on rating agencies is the fact that the proposal builds on the original and simplistic approach that the Committee's earlier standards established for setting capital requirements for credit risks. The approach entails establishing capital standards for each category of asset held by a particular institution and then adding the individual requirements together to arrive at a total capital requirement for the institution. As numerous commentators have recognised, this additive approach to capital requirements ignores the fact that the risks of individual assets may be correlated with other assets in a firm's portfolio in different ways.<sup>21</sup> A bank with all its loans committed to the highly-rated firms in the oil

<sup>19</sup> See, e.g., Shadow Committee Comment, n. 13 above, 12.

<sup>20</sup> Indeed, critics have interpreted the current proposal as an effort on the part of the Basel Committee to enlist the support of countries where few commercial issuers are rated: *ibid.*

<sup>21</sup> See Altman and Saunders, n. 14 above, 6-8.

<sup>22</sup> See, e.g., Shadow Committee Comment, n. 13 above, 12.

and gas industry is exposed to more risk than a firm with loans extended to a diversity of highly-rated borrowers; yet the Basel Committee proposal—being sensitive only to the credit rating of individual borrowers—would impose the same capital requirement on both institutions. By incorporating the credit rating of individual institutions, the Basel Committee would add precision to the capital charges for certain kinds of credit risk, but it would do nothing to measure inter-relationships among risks across an institution's total portfolio. A number of critics have faulted the Basel Committee's reliance on credit rating agencies because this approach holds little promise of providing an accurate measure of an institution's overall risk.

#### ALTERNATIVE APPROACHES TO SETTING CAPITAL *REQUIREMENTS* FOR CREDIT RISKS

While the criticisms of the Basel Committee's 1999 proposal are substantial, the problem confronting regulatory authorities such as the Basel Committee and national supervisory units is that there is no obviously superior approach currently available. So perhaps the best way to evaluate the Committee's proposal is to compare it with other alternative approaches to the problem of setting capital standards for loans and other credit risks borne by commercial banks and other financial institutions.<sup>22</sup>

As summarised in Figure 19.4, there are three basic approaches to setting capital standards for credit risks currently under active consideration by regulatory authorities. The Basel proposal is illustrative of the first and most traditional approach—setting capital requirements based on the volume of an individual institution's assets (and associated credit risks). Before the Basel Accord of 1988, national authorities typically relied on simple leverage requirements, such as 6 per cent capital reserves for all assets.

In 1988, the Basel Committee improved on this simplistic approach by, among other things, establishing risk-based capital requirements that crudely distinguished among a rank of credit risks.<sup>23</sup> Although all commercial loans had the same risk rating, distinctions were made among cash reserves, credits to other banking institutions, sovereign credits and a few other general categories. The 1999 proposals constitute an extension of this effort by further classifying the commercial credits of lending institutions into three different categories (or perhaps four or more if the analysis of Altman and Saunders is followed).

<sup>22</sup> To assist in future comparative evaluations of the efficacy of regulatory incorporation of rating agencies, the Basel Committee's working group has collected extensive empirical evidence about the past performance of credit ratings and also comparable information about complementary sources of credit information. See Credit Rating Working Paper, n. 4 above, 55-180.

<sup>23</sup> The Basel Committee subsequently added components to reflect market risk and interest rate risk.

- I. Requirements based on Volume of Bank Loans
  - Simple Leverage Requirements (pre-1988 regimes)
  - Crude Risk-Based (1988 Basel Accord)
  - Risk-Based Measures with Ratings (1999 Basel Proposal)
- II. Requirements Based on Portfolio Models
  - Standard Models
  - Internal Models
- III. Market Discipline Models
  - Subordinated Debt Proposals

Fig. 19.4. *Alternatives approaches to setting capital requirements for credit risks*

Within this progression of gradual improvement in asset-based capital requirements, the June 1999 proposals seem a sensible refinement. While vulnerable to the technical criticisms outlined above, the 1999 proposals are probably best understood as a continuation of the incremental improvements of asset-based requirements that has been under way for the past two decades. While there are various ways in which the proposals might be tweaked-to increase the number of classifications or adjust the capital requirements for various categories-there are limits to how far these enhancements can go. In particular, as outlined above, revisions of the 1999 approach are unlikely to address the more fundamental criticisms that have been levelled at the proposals.

To address these deeper concerns, one must seek alternative approaches to capital setting standards. And, indeed, there is afoot a movement towards new capital standards based on overall portfolio risks. Already in the area of market risks-that is risks on assets held in trading accounts-regulators have developed various portfolio approaches to the establishment of capital requirements.<sup>24</sup> And, in its 1999 proposal, the Basel Committee intimated that a similar approach might eventually be developed for credit risks, thus providing an alternative to the additive asset-based approach upon which the Committee has hitherto relied for dealing with credit risks. Unfortunately, the development of capital standards based on portfolio models is extraordinarily complex. It relies on detailed analyses of the correlations in performance of many different types of assets. In some areas, historical data can provide the basis of such analyses; but often-particularly for new types of credits-such historical information is not available. In addition, it is possible that the appropriate way to measure credit risk will vary from institution to institution. To date, regulatory authorities have relied upon two different approaches to portfolio models: standard models which can be used by a wide range of institutions and internal models, which depend on individual models

<sup>24</sup> See Basel Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (January 1996, as amended in September 1997) <<http://www.bis.org/publ/bcbas24.pdf>>.

developed for individual institutions (subject to general standards and review by regulatory authorities).

In the area of credit risks, capital standards based on portfolio models are in an early stage of development. Experts differ on how soon practical applications of these models will be possible.<sup>25</sup> Whether it will be possible to develop standard models that generate more appropriate capital requirements for a wide range of institutions than the Basel proposal of 1999 would provide is open to debate. Reliance on internal models of larger and more sophisticated financial intermediaries appears to offer more promise in the near term. This approach, however, raises the difficult question of how much regulatory authorities should delegate the establishment of capital standards to bank management.<sup>26</sup> After all, the reason we regulate bank capital requirements in the first place is the belief that left to their own devices banks will maintain less capital than is socially desirable.<sup>27</sup> Thus, the more fundamental criticisms of the Basel Committee's 1999 proposal must be balanced against problems that might arise if regulatory authorities were to move to a more theoretically pleasing, portfolio based model for setting capital standards.<sup>28</sup>

A final approach to setting capital requirements is to rely more on market mechanisms and less on formulaic capital requirements. Illustrative of this technique are proposals to require commercial banks to issue publicly traded subordinated debt on a periodic basis.<sup>29</sup> Like any other form of capital, this subordinated debt would insulate depositors and deposit insurance funds from losses, but regulatory authorities could also use the market values of a bank's subordinated debt to obtain an independent assessment of the solvency of the bank. Under this approach, regulators would monitor fluctuations in the market valuation of subordinated debt and in the event of sudden downturns in value take appropriate supervisory action with respect to the issuing

<sup>25</sup> In connection with its capital reform proposals, the Basel Committee solicited comments on credit risk modelling. See Basel Committee on Banking Supervision, *Summary of Responses Received on the Report "Credit Risk Modeling: Current Practices and Applications"* (May 2000). <<http://www.bis.org/publ/bchb71.htm>>. See also Shadow Committee Comment, n. 13 above, 12 (expressing skepticism as to the reliability of existing credit risk models).

<sup>26</sup> Cf. European Shadow Financial Regulatory Committee, *Internal Ratings Capital Standards and Subordinated Debt*, (Statement No 7, February 2000) <<http://www.esfrc.org/shdw/shdweuro7.htm>> ("[S]ince banks face a degree of protection, they have the incentive to take excessive risk and, therefore, to manipulate the ratings used to allocate capital").

<sup>27</sup> As discussed above, it is possible that the final Basel Committee proposal will allow at least some banks to use internal rating systems for capital measures. See Speech by William J. McDonough, n. 16 above. See also Overview of the New Basel Capital Accord, n. 1 above (proposing greater reliance on internal models). Such an approach falls short of full-blown credit modelling, because the capital requirements are not based on overall portfolio risk. It does, however, allow for more tailored capital requirements based on individualised models.

<sup>28</sup> To be fair, internal models typically must comply with regulatory standards and are also subject to periodic back testing. Notwithstanding these safeguards, internal standards increase the ability of individual institutions to influence their own capital standards.

<sup>29</sup> See, e.g., Shadow Committee Comment, n. 13 above, 16-17. See also M. E. Van Der Weide and S. M.-Kini, "Subordinated Debt: A Capital Markets Approach to Bank Regulation", (2000) *41 B C L Rev.* 195; R. Dhumale, ch. 5, above.

bank.<sup>30</sup> Subordinated debt proposals of this sort have been under consideration in the United States for a number of years, and Congress recently authorised a full scale study of the technique. In academic circles, there is considerable support for the approach, and one group of commentators recently proposed that the Basel Committee drop its proposal with regard to private rating agencies and recommended instead a subordinated debt requirement as part of its next version of bank capital adequacy standards.<sup>31</sup>

This is not the place for a full discussion of the merits (and potential problems) of subordinated debt proposals. What is important to recognise here is that this reliance on market discipline offers another alternative to setting capital standards. It finesses the shortcomings of requirements tied solely to bank assets and the complexities of portfolio models by harnessing market forces for regulatory purposes. In a sense these proposals are distant cousins of the Basel Committee's 1999 proposal. Whereas the Basel Committee seeks to incorporate discrete assessments of individual borrowers (as reflected in the views of private credit rating agencies), proponents of mandatory subordinated debt incorporate market values of securities issued by the banks themselves.

#### IMPLICATIONS FOR THE BASEL PROPOSALS FOR REGULATORY POLICY

I would like to close with a few comments about the regulatory implications of the Basel Proposals. Let me start by returning for a moment to Schwartz's discussion of the question whether additional oversight of credit rating agencies is necessary. While I would agree with Schwartz that the market has, to date, worked relatively well in this area, I think it also important to recognise that the regulatory incorporation of credit ratings in bank capital requirements puts greater pressure on the system. Currently, an issuer's credit rating affects only its access to capital markets; under the Basel proposal, a rating will also affect the borrower's cost of commercial loans from regulated entities (since the cost of higher capital charges will likely be passed on to borrowers, at least in part). As the importance of credit ratings increases, the pressure to get better ratings will also increase. This change could increase the need for governmental oversight of rating agencies.

Another important point to note about the Basel proposals is that it somewhat changes the structure of the market for credit ratings. In the past—as Schwartz explains—the real consumer of credit ratings was individual investors, and the reason the market has worked is that rating agencies need to preserve their reputation for accurate assessors of credit risk. Under the Basel proposal, bank regulators will also "consume" credit ratings and use those ratings to set capital standards for regulated institutions. One wonders whether

<sup>30</sup> In a similar spirit, one critic of regulatory incorporation of credit ratings has suggested that regulators rely instead in market movements of interest rates on debt. See Partnoy, n. 3 above.

<sup>31</sup> Shadow Committee Comment, n. 13 above, 16-17.

centralised regulators will be as good monitors of credit rating agencies as have decentralised market forces in the past.

In addition, when one recalls that one of the goals of the Basel Capital Accords was to encourage national regulators to raise capital requirements for local banks, one can appreciate the potential problem of this new use of credit rating agencies. If banking officials in a particular country are reluctant to force local banks to raise capital to the standards set by the Basel Committee, one way to subvert compliance is to accept higher-than-appropriate ratings from local rating agencies. In other words, as the Basel Committee's 1999 proposal allows national regulators latitude for setting capital requirements for commercial credits, the goal of maintaining uniform capital standards across national boundaries may be jeopardised.

Collectively the foregoing concerns raise the possibility that the Basel Committee's recent proposal and other regulatory incorporations of rating agencies at the national level could undermine the quality of credit ratings, thereby generating a form of credit rating inflation. This is, it should be noted, the inverse of the principal concern over rating agencies that Schwarcz raises in his chapter—that rating agencies might issue credit ratings that were inappropriately stringent.<sup>32</sup> My fear is that market forces will lead agencies in the other direction.<sup>33</sup>

A final question to be posed about the Basel Committee's incorporation of credit rating agencies is its implications for developing countries. In many parts of the world, few private borrowers have privately rated debt. Indeed, the credit rating industry is largely a phenomenon of the United States and other advanced economies.<sup>34</sup> Accordingly, this aspect of the Basel 1999 proposal will have little impact on banks in many parts of the worlds. For these institutions, the effective capital requirement for commercial loans will remain the 8 per cent set under the original Basel Accord. Viewed in this light, the primary effect of this aspect of the Basel Committee's 1999 proposal will benefit only banks in industrialised nations—allowing them to lower capital reserves for loans to borrowers with top credit ratings. In isolation this effect might not be disturbing, but it turns out that several recent and proposed reforms to the Basel Committee's capital requirements apply, in practice, only to institutions in advanced nations: for example, internal models for market risks and analogous proposals for credit risk modelling discussed above. What seems to be emerging from the Basel Committee is a two-track system of capital standards: one relatively simple but rigid standardised system for banks in developing nations and a second, more flexible regime for sophisticated institutions in advanced economies. Whether this division threatens the considerable success that the Basel Committee has enjoyed over the past two decades is an open question for future debate.

<sup>32</sup> See S. L. Schwarcz, 305-7.

<sup>33</sup> For additional views that credit rating agencies might be tempted to devalue the quality of their ratings, see Shadow Committee Comment, n. 13 above, 12. See also R. Cantor and F. Packer, "The Great Rating Industry", *Fed Res Bank of NY Quarterly Rev* (Summer/Fall 1994), 1; Partnoy, n. 3 above.

<sup>34</sup> For a review of rating agency coverage in various countries see Credit Ratings Working Paper, n. 4 above, at 21-39.