

# Regulating investment business in the Single Market

By Professor Richard Dale.<sup>(1)</sup>

*In this article, Richard Dale examines the regulatory framework for investment business put in place by the Capital Adequacy Directive (CAD) and other Directives, and focuses on the attempt to establish a 'level playing-field' for banks and other financial institutions conducting this business in the Single Market. He argues both that there is a general case for having differences in the regulatory approach towards banks and non-banks, and that—in attempting to establish a common treatment to apply to both types of institution—the CAD in fact introduces competitive distortions that favour securities financing at the expense of traditional bank lending.*

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As part of its single market programme, the European Union has adopted two sets of Directives covering banking and securities business. On the banking side, these consist of the Second Banking Co-ordination Directive (2BCD), which allows banks to engage in a wide range of financial activities throughout the European Union, and a number of other Directives aimed at providing a common regulatory framework. The Investment Services Directive (ISD) aims to give non-bank investment firms the same opportunities for conducting business in the European Union as banks already enjoy under the 2BCD, while the Capital Adequacy Directive (CAD) fulfils a similar function to the bank regulatory directives, by providing a common framework for the regulation of investment firms as well as the securities activities of banks (see Chart 1).

The purpose of this article<sup>(3)</sup> is to examine the new regulatory framework for European securities markets, focusing in particular on the capital adequacy requirements and the attempts of policy-makers to establish a 'level playing-field' between banks and non-bank investment firms. The issues to be addressed include: the appropriateness or otherwise of a regulatory objective of competitive equality; the extent to which the Directives are successful in achieving this objective; and the possibility that the mechanisms designed to achieve competitive equality may give rise to other market distortions. The first section deals with some general issues relating to the regulation of banks and investment firms, the second describes the CAD's 'trading book' concept, the third assesses the capital adequacy rules of the CAD and the final

**Chart 1**  
**The family of EU Directives**

	Banks:		Non-bank investment firms
	Banking book	Trading book	
Authorisation	Second Banking Co-ordination Directive		Investment Services Directive
Definition of capital	Own Funds Directive	Capital Adequacy Directive	Capital Adequacy Directive
Risk weights of assets	Solvency Ratio Directive	Capital Adequacy Directive	Capital Adequacy Directive
Large exposures	Large Exposure Directive	Capital Adequacy Directive	Capital Adequacy Directive
Consolidated supervision	Second Consolidated Supervision Directive/ Capital Adequacy Directive		
Protection of investors/depositors	Deposit Guarantee Directive		Nothing yet

section summarises the key policy issues arising out of the previous discussion.

## The regulation of banks and securities firms

Banks and securities firms have contrasting operational characteristics which underline the need for different regulatory regimes.<sup>(4)</sup> Traditional banking involves the acquisition of long-term non-marketable loans which are typically held on the bank's balance sheet until maturity. By contrast, investment firms experience rapid asset turnover as

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(2) The Houblon-Norman Fund, established by the Bank in 1944, finances academic research into subjects relevant to central banking. More details of the Fund were given in an article in the August 1993 *Quarterly Bulletin*.

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(3) An expanded version of this article is to be published in the *Journal of International Banking Law*.

(4) See Haberman, G. 'Capital requirements of commercial and investment banks: contrasts in regulation', *Federal Reserve Bank of New York Quarterly Review*, autumn 1987.

a result of their market-making, underwriting and trading activities. The main business risk for banks is credit risk (the risk of default by borrowers), whereas for investment firms it is market risk (the risk of fluctuations in the prices of securities held). Furthermore, securities firms are evaluated on a liquidation basis and their accounting is mark-to-market, while banks are evaluated as going concerns and their accounting is often based on original cost. Finally, banks rely largely on potentially volatile, unsecured short-term deposits for their non-capital funding, whereas securities firms have a much higher proportion of secured financing.

These differences in the business characteristics of banks and securities firms have important policy consequences when considering the *need* for regulation, the *objectives* of regulation and the appropriate *techniques* of regulation.

### *Need for regulation*

So far as the need for regulation is concerned, it is widely accepted among regulators, practitioners and academics that banks are uniquely vulnerable to contagious collapse. This inherent vulnerability arises out of the liquid nature of banks' liabilities (deposits) and the illiquid nature of their assets (commercial loans), as well as the fact that banks' assets are generally worth significantly less in liquidation than on a going-concern basis.<sup>(1)</sup> In order to prevent costly bank runs, national authorities provide protection to depositors through either formal deposit insurance schemes or less formal support operations. But because the prospect of such protection tends to undermine market discipline by making depositors less careful where they place their money (the so-called moral hazard problem), regulators seek to constrain risk-taking by banks in order to limit the claims on the deposit insurance fund and/or the taxpayer.

For investment firms, the case for official regulation is much less clear. The traditional approach has been to focus primarily on the risk to investors. However, investment firms can be (and often are) required to segregate investors' cash and securities in special accounts, so that in the event of a firm's insolvency its clients' assets are protected from the claims of general creditors. If that is done, it is difficult to see why additional protective measures are required in the form of capital adequacy requirements. The investor protection argument for regulatory controls becomes even less persuasive if investors also enjoy the benefits of an investor compensation scheme.

There is a second rationale for regulating investment firms, based on the need to reassure counterparties, including banks and other creditors, who might otherwise be reluctant to deal with such firms. Settlement procedures have an important role here because if settlement is on a delivery versus payment (DVP) basis, counterparty risk and associated regulatory concerns can be much reduced. Beyond this, it is worth pointing out that investment firms are well placed—because of their liquid assets—to arrange secured financing

which does not give rise to full counterparty risk exposure, and that in the absence of capital adequacy requirements this is no doubt how most of their borrowing would be arranged. Finally, concerns about counterparty risk do not provide a strong case for *official* regulation. If investment firms perceive it to be in their interests to reassure counterparties about their financial strength, they will presumably find means of doing so. Indeed, this has been the impetus behind the self-regulation of its member firms by the New York Stock Exchange since well before the US Securities and Exchange Commission was established in 1934. Credit rating agencies may also fulfil a self-regulatory function, as they do in the case of unregulated US holding companies that issue debt to fund their securities subsidiaries.

The third and most important argument for the regulation of investment firms is founded on the view that the default of unregulated investment firms could cause systemic problems. Official concerns over the potential for systemic disturbances were, for instance, reflected in a recent OECD study of risks in securities markets,<sup>(2)</sup> which noted that 'the extreme systemic threat arising from a collapse of securities prices is that default by one or more large securities dealers will lead to further defaults and that the failures will extend into the core of the banking system and cause a breakdown in the flow of payments in settlement of financial transactions throughout the world'.

This proposition, suggesting as it does that the default of an investment firm may involve social costs equivalent to the collapse of a bank, deserves careful scrutiny. The assets of a non-bank investment firm consist largely of marketable securities and there will therefore be little difference between their value on a going-concern basis and in liquidation, in marked contrast to banking assets—which are worth considerably less in liquidation. This means that a troubled investment firm will generally be able to wind down its business in an orderly manner, meeting its obligations by prompt asset disposals at close to book value. On the liabilities side too, investment firms are generally less vulnerable than banks, because much of their funding is secured and in any case cannot be immediately withdrawn, as can bank sight deposits. To the extent that funding is curtailed, an investment firm will generally be able to contract its way out of trouble. In short, investment firms are much less vulnerable to contagious liquidity and solvency crises than are banks.

The real problem is not the vulnerability of investment firms, but the vulnerability of banks within a financial market regime characterised by increasing integration of banking and securities business. Banks may be exposed to securities market risk because they have lent to investment firms, because they engage in securities business off their own balance sheets ('universal banking'), or because they have securities subsidiaries or affiliates. The risks associated with bank lending to non-related investment firms can in principle be dealt with through regulatory limits on large exposures:

(1) See Diamond, D. and Dybvig, P. 'Bank runs, deposit insurance and liquidity', *Journal of Political Economy*, June 1983, pages 401–19, and 'Banking theory, deposit insurance, and bank regulation', *Journal of Business*, January 1986, pages 55–68.

(2) *Systemic Risks in Securities Markets*, OECD, 1991, page 15.

once these are in place there is no reason why the failure of an investment firm should pose a greater solvency threat to banks than would the failure of any other firm. Of course, investment firms may experience industry-wide difficulties in times of extreme market volatility, but that is no different from industry-wide problems experienced by, for instance, the property sector.

Where, however, banks themselves undertake securities business, or belong to financial groups that include an investment firm, the solvency of the bank is inextricably linked to its securities operations. This is obviously the case if the bank itself engages in securities activities, but it is also true if it does so at one remove through a related investment firm, since it is inconceivable that the related entity could default without irreparably damaging the credit standing of the bank. In effect, therefore, the bank's capital stands behind its securities unit.

The evolution of mixed banking and securities businesses may therefore create a situation in which the heavy social costs associated with bank failures are carried over into the securities markets. Arguably, it is the mixing of banking and securities business within banking groups, rather than the special characteristics of investment firms, that provides a rationale for the regulation of the latter. This observation is particularly important in the European context, since it is the diversified banking model that has been adopted by the relevant EU financial market Directives.

### *Objectives of regulation and regulatory techniques*

While the case for regulation is clearly stronger for banks than for investment firms, it is also true that the regulation of the two kinds of financial institution has quite different *objectives*. One of the main purposes of bank regulation is to prevent failures and to sustain banks as going concerns—reflecting the fact that if a bank is forced to liquidate its (non-marketable) assets, it may do so (if at all) only at a heavy discount which could leave depositors, or the deposit insurance scheme, exposed to heavy losses. By contrast, an investment firm with impaired capital is expected to shrink its balance sheet immediately by selling marketable assets, and in the extreme may be required to wind down its business completely. In other words, contraction and ultimately closure may be the first priority for a securities regulator faced with a troubled investment firm.

Reflecting this important difference in regulatory objectives, banks and investment firms are also subject to different regulatory *techniques*. Both must conform to specified capital adequacy requirements, but the emphasis for banks is on solvency, whereas for investment firms it is on liquidity or 'liquid capital'. In the case of banks, capital is expected to be permanent, in order to support the institution as a going concern, whereas for securities firms it may be temporary, reflecting the latter's ability to scale down its activities as well as its fluctuating need for capital resources.

Furthermore, securities regulators—unlike bank regulators—do not regard consolidated supervision as indispensable, partly because investment firms are considered to be less vulnerable than banks to cross-infection from a troubled parent or affiliate.<sup>(1)</sup> Finally, because banks are inherently illiquid, they typically have access to a lender of last resort. Investment firms, on the other hand, do not have the need for a lender of last resort because they can generally contract their way out of funding troubles.

In summary, the regulatory needs of banks and non-bank investment firms are very different. Where, however, banking and investment business are mixed within financial conglomerates, regulators are faced with the difficult task of devising a regulatory framework that is compatible with these divergent needs.

### *Globalisation*

The globalisation of banking and securities markets adds a further dimension to the regulatory problem. Globalisation in this context means three things: the cross-border delivery of financial services to foreign residents; the penetration of foreign financial markets by branches and subsidiaries of multinational institutions; and transactions between banks and investment firms from different countries that give rise to inter-jurisdictional counterparty risk.

Banking and securities regulators are presented with a number of formidable difficulties associated with globalisation. Systemic risk may be increased by the risk of contagious financial disorders originating in poorly regulated financial centres. Depositors, investors or counterparties may be exposed to foreign jurisdiction risks which they are not in a position to monitor or control. And the co-existence of uneven national regulations and global markets may severely distort competition between financial institutions.

There are several possible approaches to dealing with these 'geographic interface' problems. One would be to allow—and perhaps even encourage—regulatory competition between rival financial centres, in the hope that regulatory standards would eventually converge around some socially optimal level.

The major weaknesses of such an approach are that it does not deal with the danger of cross-border financial contagion, that it may confuse depositors, counterparties or investors who have to deal with multifarious regulatory regimes, and that it leaves open the potential for serious competitive distortions associated with uneven regulation. Accordingly within the Single Market, regulatory competition has been rejected in favour of a regime that imposes minimum standards of prudential regulation on all banks and investment firms.

In formulating these minimum standards, however, European regulators have had to deal not only with the geographic interface problem—which presents itself in a particularly

(1) Thus while US bank holding companies are subject to consolidated supervision by the Federal Reserve Board, the Securities and Exchange Commission's regulatory mandate covers only registered broker-dealers and does not extend to holding companies or unregistered affiliates.

## Regulatory regimes for banking and securities business

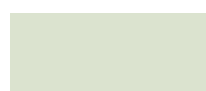
Four main structures of regulatory regime were available to those negotiating the CAD to deal with banking and securities business. At one extreme, there is the separation model, exemplified by the US arrangements under the Glass-Steagall Act. At the other, there is the traditional universal banking model. This box briefly outlines the four models:

- **Glass-Steagall model**



Under the separation model, banks are not permitted to undertake securities business or to own securities firms. The banking and securities industries are separately regulated in accordance with industry-specific capital adequacy rules (*functional regulation*).

- **Universal bank model**



Mixed banking and securities firm

Under the universal bank model, which has been the traditional banking regime in much of continental Europe, securities and banking business are freely combined within the banking entity. In this case, the risks involved in the two activities are pooled, and there is a single regulatory authority which applies a common capital adequacy regime to the combined business (*institutional regulation*).

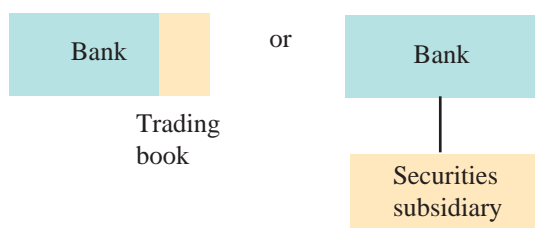
- **Firewall model**



Between the above extremes, there is a compromise option which seeks to segregate the risks associated with banking and securities business undertaken by financial conglomerates. The mechanism to achieve this is a requirement that the two businesses be conducted through different legal entities separated by ‘firewalls’ (restrictions on intra-group transactions), whose purpose is to prevent risk being transmitted from the securities unit to the banking unit.

The firewall approach has been applied to the so-called ‘Section 20’ subsidiaries of US banks—that is, subsidiaries that have limited powers to undertake securities business within the terms of the Glass-Steagall Act.

- **EU trading-book**



The trading-book approach permits banks to engage freely in securities activities either directly or through securities subsidiaries. In either case, securities activities, as defined by the trading book, are subject to a capital adequacy regime separate from that for the banking business.

acute form where all barriers to cross-border financial activity are removed—but also with two others: the ‘functional interface’ problem that exists where banks are free to undertake securities business either directly or through securities subsidiaries, and the ‘institutional interface’ problem that arises where mixed banking and securities businesses co-exist with specialist non-bank investment firms. The new European regulatory framework has therefore had to accommodate the different regulatory regimes and financial structures of individual Member States, as well as the divergent regulatory cultures of the banking and securities industries.

### The trading-book concept

The trading-book concept was devised by European policy-makers to resolve the various regulatory difficulties noted above. In order to appreciate the significance of this

central mechanism within the new regulatory framework, some reference to the negotiating background is necessary.

A key objective of those negotiating the CAD was to ensure competitive equality between banks and non-bank investment firms in respect of their securities activities. The main problem was that those countries with a long tradition of universal banking favoured a highly conservative capital adequacy regime designed to safeguard the solvency of banks, while other countries—including the United Kingdom—were concerned that if bank-type regulation were imposed on non-bank investment firms, the latter would be placed at a competitive disadvantage *vis-à-vis* their non-European rivals.

The options that were available to the CAD negotiators can be considered in the context of the main regulatory regimes used for banking and securities business (see the box above).

Originally it was intended that the CAD would apply to a particular class of financial institutions—namely, non-bank investment firms. But in order to meet the conflicting concerns of negotiating parties, it was agreed that the capital adequacy rules should be applied on a functional basis to cover certain types of risk taken on by both banks and investment firms. For this purpose, each institution would need to segregate its securities ‘trading book’ from the rest of its business, and the trading book alone would then be subject to the more permissive capital adequacy rules appropriate to securities trading. In this way, a level playing-field would be established between mixed banking and securities firms and non-bank investment firms.

Article 2(6) of the CAD defines the trading book to include the following positions, which must be marked to market daily: (a) proprietary positions in financial instruments held for the short term or for resale, whether this be for trading, arbitrage, market-making or hedging purposes; (b) exposures resulting from unsettled transactions, free deliveries and over-the-counter derivatives; and (c) exposures resulting from repurchase agreements and securities borrowing, subject to a number of conditions designed to draw a clear distinction between these trading activities and conventional secured lending by banks—which does not fall within the trading book.

Annex V of the CAD states that the capital of both banks and investment firms shall be defined in accordance with the Own Funds Directive (OFD)—that is, the banking definition of capital. However, national authorities are given the option of permitting banks and investment firms to use an alternative definition of capital in respect of their trading book. The alternative differs from the banking definition in the following key respects:

- A new class of short-term subordinated debt is eligible for inclusion in regulatory capital. This must have an initial maturity of at least two years (compared with a minimum of five years under the OFD). As an additional safeguard, such debt must incorporate a ‘lock-in’ clause, under which neither principal nor interest can be repaid if this would result in the institution’s regulatory capital falling below the required minimum.
- The ceiling on the amount of subordinated debt that can be included in regulatory capital is more generous than under the banking rules of the OFD. Whereas the OFD sets this ceiling at 50% of Tier 1 (essentially equity) capital and 25% of total regulatory capital, the CAD establishes a ceiling of 60% of total regulatory capital backing the trading book. However, for both banks and investment firms, the CAD ceiling on subordinated debt may be raised to over 70% (250% of Tier 1 capital) if the authorities judge this to be adequate prudentially and if—in the case of investment firms—specified ‘illiquid assets’ are deducted from capital.

Apart from allowing a more liberal use of subordinated debt in regulatory capital, the trading-book regime also includes less stringent capital adequacy requirements than those applicable to banks, as described below.

As a way of securing an agreed capital adequacy framework that meets the demand for a level playing-field between banks and investment firms, the trading-book concept is ingenious. On closer examination, however, this shift towards functional regulation is open to serious objection.

Most fundamentally, the idea of segregating one part of a bank’s business—its securities trading operations—and applying separate and distinct definitions of capital and capital adequacy to the different parts, appears to make little prudential sense. As explained above, the primary objective of bank regulation is to protect a bank’s solvency so as to sustain it as a going concern, but the primary purpose of securities regulators is to ensure that an investment firm can wind down its operations in an orderly manner if need be—hence the emphasis on liquid assets. The CAD’s alternative definition of capital allows more liberal use of subordinated debt to support a bank’s trading book, but to that extent the burden of absorbing losses on the trading book may have to be born by the equity capital that supports the rest of the bank’s business.

In this context, the mandatory ‘lock-in’ provision applicable to short-term subordinated debt does not provide the protection that is evidently intended: a bank which is forced to invoke this clause in respect of its trading book (in effect defaulting) would immediately become suspect in the eyes of the marketplace, thereby risking a deposit run. Accordingly, a bank would feel compelled to make good any capital shortfall arising on its trading book so as to prevent the triggering of the lock-in. The presence of ‘outside’ short-term subordinated debt to back the trading book therefore increases the solvency risk for the bank, because such debt cannot in practice be used to absorb losses on the trading book. On the other hand, a parent bank that provides ‘inside’ subordinated debt to its securities subsidiary would have to hold bank capital against this exposure. In short, there is little purpose in segregating a bank’s securities assets for capital adequacy purposes if the risks in this part of the business cannot also be segregated from the bank.

A second objection to the trading-book concept is that while it segregates *assets* used for trading purposes, as well as the regulatory capital used to back such assets, it does not segregate non-capital *liabilities*. This means that a mixed banking and securities business is free to use its deposit base to fund its securities trading book. The difficulty here is that because bank deposits (including wholesale deposits) generally benefit from deposit protection and/or other official safety net arrangements, deposit rates do not incorporate a risk premium that adequately reflects the risks a bank incurs. In a sense, banks’ risky activities are subsidised. This separation of risk-bearing from risk-taking is one reason why banks are subject to such extensive regulation.

If banks are permitted to use protected deposits to fund their trading book, then the trading operations are also being ‘subsidised’. That in turn provides incentives for excessive risk-taking within the trading book—risks that will eventually have to be borne, if not by the bank itself, then by the deposit insurance fund or the taxpayer. The moral hazard problem and the associated need for comprehensive regulation is then extended from the bank to its securities arm. It may be added that, from a quite different perspective, non-bank investment firms that do not have access to deposit funding are placed at a competitive disadvantage *vis-à-vis* banks.

These difficulties could in principle be avoided, or at least alleviated, by funding rules that prevented or limited the use of deposits to support a bank’s trading book and instead required funding in the form of outside ‘risk money’, the cost of which would depend on the perceived risk characteristics of the institution concerned. In this way, greater market discipline would be imposed on banks’ securities operations and the burden on regulators thereby reduced. However, for such a funding rule to be effective, it would be necessary to require banks’ securities activities to be conducted through separately incorporated entities.

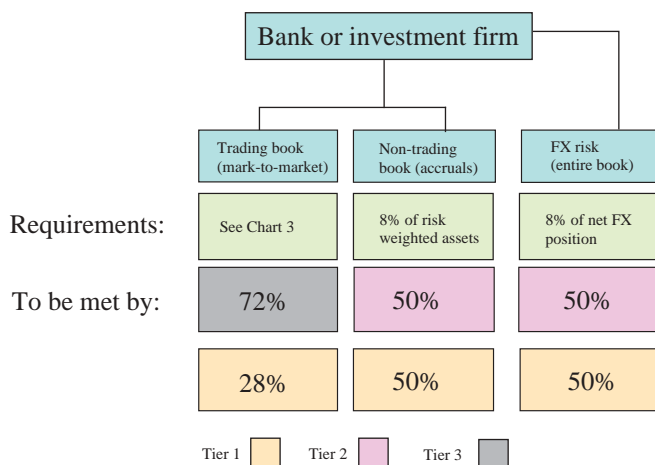
Finally, the trading-book concept can be criticised on the grounds that it is open to regulatory arbitrage in the form of switches between the banking and trading books. The authors of the CAD were clearly alert to this possibility, which is why such careful attention was given to the definition of trading-book assets, particularly reverse repurchase agreements. Nevertheless, given the existence of very large incentives because of the differential capital rules (see below), banks have a powerful inducement to present their longer-term investments as trading assets. It should be emphasised in this context that any financial instruments (defined in the ISD’s Annex B to include all ‘transferable securities’) that are held with the *intention* of ultimate resale or for short-term gains can be classified as trading-book assets. The subjective nature and generality of this definition suggests that policing the boundary between the banking and trading books will be both costly and difficult.

### Capital requirements under the CAD

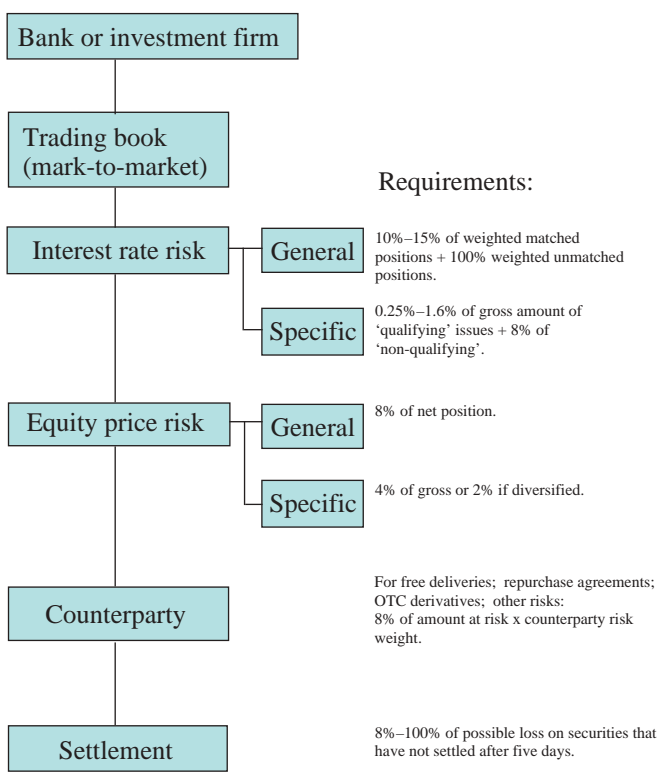
There are six categories of capital requirement imposed on investment firms by the CAD: initial capital (Article 3), position risk requirements for debt (Annex I) and for equities (Annex I), settlement and counterparty risk (Annex II), foreign exchange risk (Annex III), ‘other risks’ (Annex IV) and large exposures (Annex VI). Apart from the initial capital and other risks, these requirements are additive. However, whereas Annexes I, II and VI apply to the trading book only, the remaining requirements apply to the firm as a whole (see Charts 2 and 3). This section uses the example of the position risk requirements for debt to highlight the differing capital requirements applied to traditional bank lending and securities financing under the CAD.

The CAD divides the position—or market—risk on both debt and equity instruments into two components in order to

**Chart 2**  
Capital Adequacy Directive



**Chart 3**  
Capital Adequacy Directive



calculate the required capital. The first is *specific* risk, representing the risk of a price change in the instrument as a result of factors related to the issuer; and the second is *general* risk, representing the risk of a price change resulting (in the case of a debt instrument) from a change in the level of interest rates, or (in the case of equities) from a broad movement in the equity market unrelated to the specific attributes of individual securities. The requirements for specific and general risk are then added—this being the so-called ‘building-block’ approach.

The capital requirement for general market risk is intended to capture the risk of loss arising from changes in market

interest rates. For this purpose, positions in debt securities are slotted into one of 13 maturity bands, according to residual maturity for fixed-rate instruments and next repricing date for floating-rate instruments. These positions are then weighted by a factor designed to reflect their price sensitivity to changes in interest rates. Floating-rate instruments, which are the closest substitute for bank loans, have a very low or zero risk weighting, depending on the interest refixing period. Furthermore, the CAD allows substantial reductions in the capital requirement for general market risk where long and short positions are matched. In comparing the differential treatment of bank loans and debt securities, it is therefore more appropriate to focus on specific risk.

When calculating specific risk requirements for debt, securities are divided into three classes: central government, 'qualifying' and 'other'. Central government issues carry a zero risk weighting, qualifying securities carry a weighting of 0.25%, 1% or 1.6% depending on their residual maturity (since default risk is a function of time), while other securities are subject to a penal risk weighting of 8% regardless of residual maturity. These weighted positions (whether long or short) are then summed to arrive at the capital requirement for specific risk.

Given a range of risk-weightings from zero to 8%, the classification procedure for debt securities is of crucial importance to investment firms. Yet the most important distinction—that between 'qualifying' and 'other' items—is far from clear cut. Qualifying items must be: (a) listed; (b) considered by the lending institution to be 'sufficiently liquid'; and (c) carry a default risk 'comparable to or lower' than those assets specified in Article 6(1)(b) of the banking Solvency Ratio Directive (SRD) that carry a risk weighting (under that Directive) of 20%—a category which includes all claims on OECD commercial banks. The classification is subject to scrutiny by national supervisors; they may themselves classify securities as 'qualifying' if conditions (b) and (c), but not (a), are met, provided that the securities concerned have been rated at the required level by a recognised credit rating agency—*unless* this last requirement is judged inappropriate 'in the light of, for example, the characteristics of the market, the issuer, the issue or some combination of these characteristics'. (This waiver is designed to embrace large blue-chip borrowers whose debt is unrated.)

Taking the three primary criteria applied to qualifying items in turn: the first (ie listing) can be waived; the second ('sufficiently liquid') is subjective; and the third—a test of default risk—is highly elastic because the benchmark risk level used (Article 6(1)(b) of the SRD) embraces claims on the entire range of OECD banks whose credit ratings vary from sub-investment grade to AAA. Therefore, given both

the fuzziness and the importance of the definition of qualifying items, there exists considerable scope for competitive distortions arising from uneven treatment of similar instruments.

Much will depend on the manner in which these provisions of the CAD are implemented by the national authorities. The current UK plans for implementation, for instance, propose that any debt issue that is rated below investment grade by at least one 'relevant' credit rating agency should not be treated as qualifying.<sup>(1)</sup> The effect will be that an investment-grade debt security with a residual maturity of under six months will attract a capital charge of as little as 0.25% when carried on a bank's trading book, whereas a bank loan to the same borrower with the same maturity will attract a minimum capital charge of 8% (100% risk weighting x 8% capital charge under the SRD). For longer-term debt securities with over one year's residual maturity, the capital charge differential is somewhat less, at 1.6% versus 8%; but it is still large enough to have major consequences for the competitiveness of individual institutions, for the relative cost of funds of qualifying versus non-qualifying issuers and for the competitive position of different segments of the securities markets.<sup>(2)</sup>

More specifically, under the United Kingdom's application of the CAD rules, banks will have an overwhelming incentive to provide securitised loans that can be held in their trading books rather than conventional bank loans that are subject to the bank capital requirements of the SRD. Only if a debt issue has junk-bond (ie non-investment grade) status will a bank be indifferent on capital adequacy grounds between a purchase of bonds and a bank loan—the capital charge in both cases being 8%. An important qualification here is that, in order to be included within the trading book, a security must be held with the intention of resale or short-term gains.

One implication of the discrepancy between the capital adequacy regimes is that for most large borrowers (ie those of investment grade status) securities market financing will become cheaper relative to bank borrowing. Indeed, the difference in capital charges under the SRD and the CAD will give considerable added impetus to the process of securitisation that is already under way in European and global financial markets. In so far as securitisation reflects the greater competitiveness of securities as against bank financing, there need be no cause for concern; but to the extent that the process is due to arbitrary differences in the regulatory treatment of securitised versus bank debt issued by the same class of borrower, important inefficiencies and distortions are introduced into credit markets. In short, the CAD establishes a major regulatory bias in favour of securitised debt that could adversely affect traditional relationship banking.

(1) See, for example, the Securities and Futures Association's Board notice 200, 'The implementation in the UK of the EC Capital Adequacy Directive', Schedule 3, August 1994.

(2) Assume that 8% regulatory capital cover is required for loans and (say) 1% for securities. Assume further that 50% of this capital is provided in the form of equity and that the target return on equity is 10%. A universal bank will then need to earn 0.4% on its loan assets, but only 0.05% on its securities assets, in order to meet its target return on equity. From a borrower's point of view, the implied difference in funding costs between bank and securities financing is 35 basis points. To the extent that regulatory capital is more permissively defined for securities holdings than for bank loans, this disparity becomes larger still.

## Summary and conclusions

The liberalisation of trade in financial services has presented European regulators with two interrelated problems. First, host countries wish to be assured that foreign investment firms operating on their territory, or delivering cross-border services to their residents, are subject to minimum standards of prudential regulation in their home country. Second, the initiatives designed to achieve such minimum standards should not discriminate between different corporate structures: banks should be treated in the same way as non-bank investment firms, and securities subsidiaries of banks should be treated in the same way as banks that undertake securities activities on their own balance sheets.

The central difficulty with this negotiating agenda has been that banks and investment firms have traditionally been subject to very different regulatory regimes—and for good reasons (see the first section above). The CAD represents an attempt to square the circle by imposing functional regulation on similar activities of banks and investment firms, as defined by their trading books. This approach achieves broad competitive equality between banking and investment institutions—subject to one important exception—but it also creates a number of other problems.

First, the tug-of-war between bank and securities regulators has resulted in compromise capital requirements for the trading book that, in terms of the definition of capital, the treatment of underwriting, the large exposure rules and the position risk requirements, are much closer to the regulatory model of securities markets than of banking. Since banks must ultimately bear the risks associated with their own trading books or those of their securities subsidiaries, this could mean some dilution of the solvency protection afforded to banks. The CAD imposes only minimum capital adequacy requirements and it is, of course, open to national authorities to apply higher requirements where these are felt to be necessary.<sup>(1)</sup> Nevertheless, competitive concerns may tend to discourage unilateral prudence of this kind.

Second, because banks are free to use their deposit base to fund securities operations—whether undertaken on their own balance sheets or through subsidiaries—the moral hazard problems associated with banking are carried over into securities markets. Deposit funding of securities business

also gives banks an important competitive advantage over non-bank investment firms—a major source of unevenness in an otherwise level playing-field.

Third, by conferring on investment firms the same privileged credit standing as that accorded to banks—automatic ‘qualifying’ status for their debt issues and concessionary risk weightings for institutions incurring counterparty risk or large exposures to them—the message may be conveyed to financial markets that investment firms enjoy the support of the official safety net and lender of last resort arrangements that traditionally have been confined to banks.

Finally, it is a remarkable paradox that in seeking to establish a level playing-field between banks and investment *firms*, the CAD severely tilts the playing-field when it comes to banking and securities *business*. The capital requirements applicable to bank loans are much higher than those applicable to debt securities of equivalent default risk and maturity held on the trading book (by a factor of no less than 32 times in the case of short-term qualifying securities). And while it is true that in countries such as the United Kingdom a differential capital requirement has existed previously in favour of securities business when undertaken by investment firms, under the CAD regime banks will have a powerful incentive to shift their business from traditional banking to securitised lending. This added impetus to securitisation may or may not be a desirable outcome, but it is surely unsatisfactory that such an important market development should be the unintended by-product of a new regulatory framework, rather than the result of a conscious policy decision.

In conclusion, several consequences will follow from the introduction of the CAD regulatory regime. Banks will become somewhat riskier on account of their securities activities—not because securities business is itself inherently riskier than banking, but because it involves greater reliance on subordinated debt as capital. Second, securities activities will tend to expand relative to conventional banking business because of the preferential capital requirements applied to the trading book. Third, mixed banking and securities businesses will tend to displace non-bank investment firms, reflecting the former’s funding advantage. Finally, as banks increase the scale of their securities activities it will become more difficult for national authorities to separate banking from securities business in fulfilling the lender of last resort function.

(1) In this context, the Bank of England, for instance, applies target risk-based capital ratios to individual banks within a broad range whose lower bound is above the Basle and SRD minimum requirement of 8%.