General Discussion*

Claudio Borio emphasized the importance of research on the interaction between monetary policy and capital standards, especially now that new capital standards will change the cyclical properties of bank capital and have a larger impact on the way banks price risk. He underlined the view of the discussant, Césaire Meh, that the maturity mismatch effect might not be very strong, and cited work done at the Bank for International Settlements by William English that suggested there is only a small impact of monetary policy on bank profits through this channel. Skander Van den Heuvel responded that the importance of the maturity mismatch channel for bank profits is an empirical question. He argued that empirical studies need to consider how profits respond to properly identified monetary policy shocks rather than to changes in interest rates, since the latter do not control for economic conditions more generally.

Borio thought that research on the links between monetary policy and bank capital should explore other channels, such as the impact of rising interest rates on loan charge-off rates. In addition, he noted that the implementation of Basel II will make capital charges more sensitive to interest rates owing to the interaction between changes in interest rates and changes in asset values and collateral values.

Césaire Meh asked why unconstrained banks lend more when a financial friction is added to Van den Heuvel's model. In a standard model, adding a financial friction would result in less investment, and the analogue in this model would be lower bank lending. The author argued that the reason

* Prepared by Ian Christensen.

highly capitalized banks lend more when a financial friction is present is because of a tax distortion. In his model, if unconstrained banks want to hold a "buffer" stock of capital to insure against the risk of future capital inadequacy, it is more efficient for banks to make a few more loans than to put the funds into securities.

Kevin Clinton argued that the reduced frequency of bank crises in the early 2000s relative to the early 1990s suggested that capital-adequacy ratios, and a greater willingness to enforce them, played a role in the strengthening of the financial system. He noted that in the case of Japan, where there have been severe banking problems, many question whether capital regulations have ever been enforced. He argued that the impact of capital regulation is evident since the decline of capital-adequacy ratios in the 1980s was reversed. Georges Dionne agreed that the Basel Accord was responsible for the higher capital ratios, but argued that there is little evidence that bank risk has changed or that the current level of bank capital is the appropriate one.

John Chant wondered if competition and the stability of the banking sector are incompatible. He highlighted two arguments in this vein. Some argue that the franchise value under monopoly is greater and so a bank will not want to jeopardize this value, making the banking sector more stable. Others argue that preventing competition on interest rates, as did Regulation Q, is a source of banking sector stability.

Raphael Solomon asked whether it is not a good thing that multinational banks face standard capital regulation in different countries. Dionne noted that capital-adequacy ratios were originally designed for multinational banks, but that these regulations have now been applied to domestic banks in countries with very different banking systems. He argued that domestic differences in deposit insurance or the structure of the banking sector may make universal regulations inappropriate.

David Longworth pointed out that much of this discussion was about the search for the appropriate way to regulate. He felt that regulators need to look at a large set of information when assessing bank risk. At various times this set has included such things as CAMEL ratings, the quality of bank management and internal controls, and the degree of geographical diversification. He argued that Dionne's paper should place greater emphasis on early intervention, which decreases the probability that depositors or the Canadian Deposit Insurance Corporation are left holding what he called a "very large bag." Dionne responded that he prefers the Canadian approach of the separation of regulators, which forces any conflict between them to be public. He also noted that early intervention should only be undertaken when there is a clear risk of a systemically important event, but this is difficult for a regulator to know. He thought one institution should have a

clear responsibility to take early intervention measures, though this should not be public information because of the moral-hazard problem that would result.

Borio felt that deposit insurance received too much emphasis in Dionne's paper. In his opinion, deposit insurance will not stop bank runs because the behaviour of large depositors is not affected. If deposit insurance is supposed to deal with bank runs, it provides excessive protection because it pays out in bankruptcy regardless of whether the cause is insolvency or a liquidity problem. He argued that for these reasons, liquidity provision, perhaps by a central bank, dominates deposit insurance as a means to prevent bank runs. Deposit insurance, however, does make the orderly resolution of bank insolvency more likely, since it reduces political pressure for regulatory action, and has the added benefit of being pre-funded. Borio argued that capital ratios were put in place to prevent bank failures, not to cure the incentive problems caused by deposit insurance, and as such are part of a package meant to improve the resilience of the banking system.

Dionne responded that some banks believe that capital ratios are enough and there is no need for deposit insurance because there is no systemic risk in Canada. These banks argue that capital regulation is efficient because of the strength of the Office of the Supervisor of Financial Institutions. They contrast Canada's situation with that of Japan, where regulators are not strong enough and there is too much political intervention. He thought the appropriate regulatory framework is still open for debate, but reiterated that the international experience is different and regulation should be based on individual country characteristics and not on universal international regulation.