

From the Cooke Committee to the Capital Accord of 1988

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The work on capital adequacy grew out of a different set of concerns. During the late 1970s and early 1980s, the capital ratios of large international banks declined steadily while their lending to developing countries expanded. When Mexico declared in August 1982 that it could no longer service its foreign debt, the exposures of the major US and European banks to Latin American sovereigns exceeded their capital in several cases. The debt crisis turned capital adequacy from a technical question into a political one.¹

Peter Cooke of the Bank of England chaired the Committee from 1977 to 1988, a period in which it was often called the "Cooke Committee" in those years. Under his chairmanship it began to compare the capital standards of its members and to develop a common definition of capital. Progress was slow until the United States Congress, when it approved an increase of the US quota in the International Monetary Fund in 1983, required the US supervisors to work towards international convergence of capital standards. The American authorities feared that their banks would be disadvantaged if they had to hold more capital than their Japanese and European competitors.²

The decisive impulse came in January 1987, when the Bank of England and the US supervisors announced a bilateral agreement on a common risk-based capital framework. Japan joined the discussions soon after. The prospect of an Anglo-American standard imposed on the rest of the world persuaded the other members to accelerate the work in Basel. The Japanese banks, which were then the largest in the world by assets, were operating with thin capital ratios but large unrealised gains on their equity holdings. Their treatment became one of the most contested points of the negotiation.³

The Committee published its "International Convergence of Capital Measurement and Capital Standards" in July 1988, a document that became known as the Basel Capital Accord or Basel I. It required internationally active banks to hold capital of at least 8 per cent of their risk-weighted assets, of which at least half had to consist of core capital, known as Tier 1. Tier 1 comprised mainly paid-up share capital and disclosed reserves, while Tier 2 could include undisclosed reserves, revaluation reserves, general provisions, hybrid instruments and subordinated debt within certain limits. Part of the unrealised gains on Japanese equity holdings was admitted to Tier 2 at a discount.⁴

The calculation of risk-weighted assets rested on a small number of weights. Claims on OECD governments and central banks received a weight of zero, claims on banks incorporated in the OECD a weight of 20 per cent, residential mortgages a weight of 50 per cent and most claims on the private sector a weight of 100 per cent. Off-balance-sheet items were converted into credit equivalents through conversion factors. The simplicity of the scheme, which allowed banks and supervisors of very different sophistication to apply it, was its strength as well as its weakness. A loan to a highly rated multinational received the same weight as a loan to a small and weak company.⁵

Although the Accord was addressed only to internationally active banks in the G10 countries and was to be fully implemented by the end of 1992, it soon became a global standard. More than a hundred countries adopted it in some form during the 1990s, frequently for all their banks. A ratio of 8 per cent became a signal of soundness that rating agencies and investors expected to see. The European Community transposed the Accord through the Own Funds Directive and the Solvency Ratio Directive of 1989, which applied the requirements to all credit institutions in the Community.⁶ The Committee had thereby set a pattern that would characterise its later work: a text agreed among a small group of supervisors became binding law for a far larger circle of banks through the legislative choices of others.

1 Notes

1. On the Latin American debt crisis and its effect on bank capital, see Kapstein (1994) and Goodhart (2011), chapters 5 and 6. To be verified. ↩
2. International Lending Supervision Act of 1983 (12 U.S.C. § 3901 et seq.), which directed US banking agencies to pursue international convergence of capital standards. To be verified. ↩

3. On the US–UK bilateral accord of January 1987 and its role as a catalyst, see Kapstein (1994), chapter 5, and Goodhart (2011), chapter 6. To be verified. ↩
4. Basel Committee, International Convergence of Capital Measurement and Capital Standards (July 1988), paragraphs 12–27 (constituents of capital) and paragraph 44 (target ratio of 8 per cent). To be verified. ↩
5. Basel Committee (1988), paragraphs 28–43 and Annex 2 (risk weights by category of on-balance-sheet asset). To be verified. ↩
6. Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions and Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions. To be verified. ↩

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