Essays on the Economics of Banking and the Prudential Regulation of Banks

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This thesis consists of four independent chapters on bank capital regulation and the issue of unsolicited ratings. The first chapter is introductory and reviews the motivation for regulating banks and credit rating agencies while providing a detailed overview of the thesis.

The second chapter uses a simultaneous equations model to analyze how banks from six G10 countries adjusted their capital to assets ratios and risk-weighted assets to assets ratio between 1988 and 1995, i.e., just after passage of the 1988 Basel Accord. The results suggest that regulatory pressure brought about by the 1988 capital standards had little effect on both ratios for weakly capitalized banks, except in the US. In addition, the relation between the capital to assets ratios and the risk-weighted assets to assets ratio appears to depend not only on the level of capitalization of banks, but also on the countries or groups of countries considered.

The third chapter provides Monte Carlo estimates of the amount of regulatory capital that EMU banks must hold for their corporate, bank, and sovereign exposures both under Basel I and the standardized approach to credit risk in Basel II. In the latter case, Monte Carlo estimates are presented for different combinations of external credit assessment institutions (ECAIs) that banks may choose to risk weight their exposures. Three main results emerge from the analysis. First, although the use of different ECAIs leads to significant differences in minimum capital requirements, these differences never exceed, on average, 10% of EMU banks’ capital requirements for corporate, bank, and sovereign exposures. Second, the standardized approach to credit risk provides a small regulatory capital incentive for banks to use several ECAIs to risk weight their exposures. Third, the minimum capital requirements for the corporate, bank, and sovereign exposures of EMU banks will be higher in Basel II than in Basel I. I also show that the incentive for banks to engage in regulatory arbitrage in the standardized approach to credit risk is limited.

The fourth and final chapter analyses the effect of soliciting a rating on the rating outcome of banks. Using a sample of Asian banks rated by Fitch Ratings, I find evidence that unsolicited ratings tend to be lower than solicited ones, after accounting for differences in observed bank characteristics. This downward bias does not seem to be explained by the fact that better-quality banks self-select into the solicited group. Rather, unsolicited ratings appear to be lower because they are based on public information. As a result, they tend to be more conservative than solicited ratings, which incorporate both public and non-public information.