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Research
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RESEARCH AND MARKET ANALYSIS GROUP

What Course Should Capital Regulation Take in the Next Century?

A conference hosted by the Federal Reserve Bank of New York considers strategies for improving the current system of bank capital standards.

On February 26-27, 1998, bank supervisors, researchers, and financial industry practitioners from more than fifteen countries gathered at the Federal Reserve Bank of New York for the conference "Financial Services at the Crossroads: Capital Regulation in the Twenty-First Century." The conference, which was held in partnership with the Bank of England, the Bank of Japan, and the Board of Governors of the Federal Reserve System, took stock of the existing system of capital rules and identified key objectives for the future development of capital regulation.

The proceedings of the conference, published in a special issue of the Bank's ***Economic Policy Review*** (vol. 4, no. 3), include nineteen papers on a wide range of topics—the impact of capital rules on bank risk taking, industry approaches to monitoring risk, the role of capital regulation in bank supervision, and proposals for reforming the regulatory framework put in place by the Basle Accord of 1988. Also included in the volume are speeches by Federal Reserve Chairman Alan Greenspan, Deutsche Bundesbank Board Member Edgar Meister, and Tom de Swaan, who at the time of the conference was the Chairman of the Basle Committee on Banking Supervision and Executive Director of De Nederlandsche Bank.

Conference participants expressed conflicting views on some issues, but a consensus did emerge on two important points. First, participants agreed that the increasing sophistication of financial institutions' risk management procedures requires corresponding refinements in supervisory practice. Regulatory capital requirements, several speakers noted, must evolve in line with advances in industry methods of quantifying risk and allocating capital. Second, there was a shared perception that the growing specialization of financial institutions is making "one-size-fits-all" capital requirements increasingly ineffective. Participants suggested that the existing structure of rules should be modified to take into account the differing risk profiles and characteristics of individual institutions. Indeed, the difficulty of devising uniform requirements for diverse institutions led some speakers to predict that the regulatory community would in the future move away from specific rules toward a system of general principles for prudent risk management.

Although the conference did not establish a formal agenda for capital regulation in the next century, it did outline the challenges that will face supervisors and the financial industry in coming years. For financial institutions, a key objective will be identifying the best methods of measuring the various risks they encounter—including credit, operational, and legal risks. For supervisors, the central task will be devising a regulatory framework that is flexible enough to apply to the complex operations and rapidly changing risk exposures of financial institutions.

Publications and Papers

The Research and Market Analysis Group produces a wide range of publications and discussion papers:

- The ***Economic Policy Review***—a policy-oriented research journal focusing on macroeconomic, banking, and financial market topics. **http://www.ny.frb.org/rmaghome/econ_pol/1998.htm**
- ***Current Issues in Economics and Finance***—a newsletter-style publication offering concise and timely analyses of economic and financial topics. **http://www.ny.frb.org/rmaghome/curr_iss/1998.htm**
- ***Second District Highlights***—a regional supplement to ***Current Issues*** covering financial and economic developments in the Federal Reserve System's Second District. **http://www.ny.frb.org/rmaghome/curr_iss/sec_dis**
- ***Staff Reports***—technical papers presenting research findings, designed to stimulate discussion and elicit comments. These papers are intended for publication in leading economic and finance journals. **http://www.ny.frb.org/rmaghome/staff_rp/1998.htm**
- ***Research Papers***—discussion papers reporting preliminary research findings. **http://www.ny.frb.org/rmaghome/rsch_pap/1998.htm**
- ***Publications & Other Research***—a brochure spotlighting the Group's research output for the year. **http://www.ny.frb.org/rmaghome/otherres**

Fall in Bank Capital Ratios Linked to Bank Strategy of Boosting Payouts to Shareholders

The sharp decline in U.S. bank holding companies' capital ratios in 1997 largely reflected efforts by the institutions to return earnings to shareholders, according to Beverly Hirtle in "Bank Holding Company Capital Ratios and Shareholder Payouts" (***Current Issues in Economics and Finance***, vol. 4, no. 9).

Hirtle explains that since the late 1980s and early 1990s, bank holding companies have greatly increased their capital ratios—the measures used by regulatory agencies to gauge bank capital strength. Although nearly all institutions now have capital ratios that comfortably exceed the regulatory minimums, average ratios did fall considerably in 1997, especially among the largest banks.

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Such drops "could cast doubt on these institutions' future capital strength," Hirtle notes, "particularly if their credit quality were to deteriorate significantly or if profitability were otherwise to weaken." She adds that, in the extreme, such capital constraints could undermine banks' ability to expand their lending activities or participate fully in other key financial services.

Hirtle assesses the seriousness of these concerns by examining the reasons for 1997's fall in bank capital ratios. She concludes that "concerns of this type may be premature," finding that the drop in average ratios is due mainly to large banking companies' strategy of managing their capital positions by returning earnings to shareholders, rather than to an unusually large elevation in risk-weighted exposures.

Following a period of strong, sustained profitability, bank holding companies were also found to have significantly increased their payouts to shareholders in 1997, in the form of dividend payments and stock repurchases. The author reveals that most of the rise in payouts came from a surge in stock repurchases. Significantly, banking companies can cut back on repurchases more easily than they can reduce dividends if earnings begin to fall. "Should the companies' future income deteriorate, the repurchases would provide a large cushion before equity holdings were affected," says Hirtle.

Economists Win Award for Best Article

Paolo Pesenti and Eric van Wincoop, economists in our International Research area, recently won the Hicks-Tinbergen medal, awarded by the European Economic Association for the best article published in the ***European Economic Review*** in the past two years. Their paper—"Wages, Profits, and the International Portfolio Puzzle"—investigates the impact of fluctuations in the return to human capital on the composition of international asset portfolios. The paper was cowritten with Laura Bottazzi of Bocconi University, Milan. See ***European Economic Review*** 40, no. 2 (February 1996): 219-54.

For Countries Coping with Unfair Foreign Competition, Antidumping Tariffs Are a Questionable Remedy

As the international trade agreements of the 1990s weaken or eliminate many barriers to trade, countries are increasingly resorting to antidumping tariffs—tariffs imposed on imports judged to be unfairly priced. In "Free versus Fair Trade: The Dumping Issue" (***Current Issues in Economics and Finance***, vol. 4, no. 8), Thomas Klitgaard and Karen Schiele examine the economics of antidumping actions and conclude that this form of protection—both in concept and in application—is largely unsound.

Supporters of antidumping tariffs claim that the tariffs prevent foreign producers from radically underpricing their exports as part of a scheme to drive domestic producers out of business. Klitgaard and Schiele show that countries have, in fact, little economic incentive to engage in such "predatory pricing."

The authors also call into question the way in which allegations of dumping are investigated. Pricing practices that are a normal part of domestic commerce, they note, are regarded as evidence of illegal behavior, and the standard used to establish that domestic industries have been injured by imports is exceedingly weak.

The authors conclude their discussion by pointing out that industries hurt by import competition have alternative remedies—an appeal to the antitrust authorities or a petition for temporary relief under a so-called safeguard action.

The Earnings Gap in the New York–New Jersey Region Parallels National Gap

Much has been written about the growing gap in income between workers at the top and bottom of the earnings distribution—a trend that is evident across the United States. How large is that gap in the New York–New Jersey region, and how has it changed over the years?

In "Earnings Inequality: New York–New Jersey Region," David Brauer, Beethika Khan, and Elizabeth Miranda review earnings inequality over the 1979-96 period (***Second District Highlights***, July). They find that in 1996, year-round, full-time male workers at the top of the income spectrum earned about five times what workers near the bottom earned ($80,000 compared with $15,000, measured in 1996 dollars). In 1979, that gap in earnings was much smaller: high-income workers took home less than three and one-half times as much as low-income workers ($63,700 compared with $19,000).

Although significant, the regional rise in earnings inequality is not out of step with the U.S. trend, report the authors. Both regionally and nationally, income inequality has widened about 50 percent in the past two decades.

Structural Change in the Mortgage Market Leads to Greater Refinancing Activity in the 1990s

In the past two decades, the home mortgage market has undergone two major refinancing episodes, first in 1986 and 1987 and then in 1992 and 1993. Although both episodes were prompted by similarly steep declines in long-term interest rates, refinancing activity in the 1992-93 period was significantly more intense.

What explains the increased intensity of refinancing in the 1990s? In "Structural Change in the Mortgage Market and the Propensity to Refinance," Paul Bennett, Richard Peach, and Stavros Peristiani use duration analysis to show that a combination of technological, regulatory, and structural changes has lowered the explicit financial transaction costs associated with obtaining a mortgage (***Staff Reports***, no. 45). Points and fees fell from 2.5 percent of the average conventional loan amount in 1983 to about 1 percent at the end of 1995.

Lower transaction costs, however, cannot explain all of the increase in refinancing activity. Even after controlling for interest rate differentials, points and fees, and other measurable costs, the authors find that refinancing probabilities were considerably higher in the 1990s than in the 1980s. They attribute this additional increase to developments that may have reduced the nonfinancial costs of refinancing a mortgage, including more aggressive solicitations by lenders, the streamlining of the refinancing application and approval processes, and increased financial sophistication among homeowners.

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Research Group Holds Intranational Macroeconomics Conference

This summer, the Research and Market Analysis Group hosted an Intranational Macroeconomics Conference at the New York Fed. The two-day conference was organized in conjunction with the publication of ***Intranational Macroeconomics***, a book currently being coedited by Eric van Wincoop, an economist in the Group's International Research area.

The conference drew thirty-five researchers from universities in the United States and Europe as well as economists in the Federal Reserve System. Stephen G. Cecchetti, Director of Research at the New York Fed, delivered the opening remarks.

van Wincoop explains that intranational macroeconomics, a relatively new field, has grown rapidly in recent years as economists investigate what the interaction of regions within a country can teach us about countries' global interaction. The economic significance of national borders, he adds, has been blurred by such factors as the worldwide removal of capital controls, the reduction of tariffs and other trade barriers, and the adoption of a single European currency. The papers presented by the book's contributing authors and the ensuing discussions addressed the implications of these and other factors for the future of the world economy.

For more information, please contact Mr. van Wincoop at **eric.vanwincoop@ny.frb.org**.

Recently Published

Richard Deitz. "A Joint Model of Residential and Employment Location in Urban Areas." *Journal of Urban Economics* 44, no. 2 (September): 197-215.

Erica Groshen. "Analyzing Firms, Workers, and Wages." *Monthly Labor Review* 121, no. 7 (July): 54-5.

Sydney Ludvigson. "The Channel of Monetary Transmission to Demand: Evidence from the Market for Automobile Credit." *Journal of Money, Credit, and Banking* 30, no. 3 (August, Part 1): 365-83.

Carol Osler. "Short-Term Speculators and the Puzzling Behavior of Exchange Rates." *Journal of International Economics* 43, no. 1 (June): 37-58.

Sangkyun Park. "Can Credit Derivatives Be Widely Applied to Bank Loans?" *ABA Banking Journal* 90, no. 8 (August): 30-4.

Sangkyun Park and Stavros Peristiani. "Market Discipline by Thrift Depositors." *Journal of Money, Credit, and Banking* 30, no. 3 (August, Part 1): 347-64.

Eli Remolona and Rama Seth. "Modeling Foreign Bank Performance and Lending Behavior," with Philip Molyneux. *Financial Markets, Institutions and Instruments* 7, no. 4.

Robert Rich. "Disagreement as a Measure of Uncertainty: A Comment on Bomberger," with J. S. Butler. *Journal of Money, Credit, and Banking* 30, no. 3 (August, Part 1): 411-8.

Rama Seth. "Do Banks Follow Their Customers Abroad?" with Daniel E. Nolle and Sunil K. Mohanty. *Financial Markets, Institutions and Instruments* 7, no. 4.

Egon Zakrajšek. "The Importance of Credit for Macroeconomic Activity: Identification Through Heterogeneity," with Simon Gilchrist. In S. Brakman, H. van Ees, and S. K. Kuipers, eds., *Market Behaviour and Macroeconomic Modelling*, 129-57. New York: St. Martin's Press.

Papers Presented by Economists in the Research and Market Analysis Group

Kenneth Kuttner. "Does Talk Matter After All? Inflation Targeting and Central Bank Behavior," with Adam Posen. Implementation of Price Stability Conference, Center for Financial Studies, Johann Wolfgang University, Frankfurt, September 11.

Looking at the experience of Canada, New Zealand, and the United Kingdom after they have adopted inflation targets, Kuttner and Posen seek to discern changes in the way in which central banks and financial markets respond to inflation. They conclude that the behavior of the banks and markets does appear to change with the adoption of inflation targets, but in ways that differ across the three countries.

Sydney Ludvigson. "Can We Explain the Consumption Excesses Yet? Aggregate Consumption Implications of Buffer Stock Saving Behavior," with Alexander Michaelides. NBER Aggregate Implications of Microeconomic Consumption Behavior Summer Meeting, Cambridge, Massachusetts, July 21.

Ludvigson and Michaelides examine the aggregate consumption implications of a standard buffer stock model of precautionary saving. They also investigate whether the model can explain the well-known smoothness of aggregate consumption growth or its correlation with lagged income. Ludvigson and Michaelides find that although the model partially explains the "consumption excesses," it does not match the data well in magnitude: aggregate consumption growth is determined to be both too volatile and too highly correlated with lagged income.

Paolo Pesenti. "Paper Tigers? A Preliminary Assessment of the Asian Crisis," with Giancarlo Corsetti and Nouriel Roubini. NBER International Macroeconomics and Finance Summer Institute, Cambridge, Massachusetts, July 15.

The authors develop an interpretation of the Asian meltdown that focuses on moral hazard as the common source of overinvestment, excessive external borrowing, and current account deficits in the region. They present evidence supporting the thesis that weak cyclical performances, low foreign exchange reserves, and financial deficiencies resulting in high shares of nonperforming loans were at the core of the Asian crisis.

Lawrence Radecki. "The Expanding Geographic Reach of Retail Banking Markets." Seminar sponsored by the Financial Markets and Institutions Committee of the Antitrust Section of the American Bar Association, Washington, D.C., September 17.

Countering the prevailing view that competition in retail banking markets occurs in local markets, Radecki argues that banking competition has in recent years shifted to larger geographic arenas. Radecki finds that many banks set uniform rates for both retail loans and deposits across an entire state or broad regions of a large state. His analysis of the relationship between retail deposit rates and measures of market concentration provides further evidence of an expansion in market size.

Individual copies of these papers can be obtained by e-mailing the authors at **firstname.lastname@ny.frb.org.**

RESEARCH AND MARKET ANALYSIS GROUP PUBLICATIONS AND PAPERS: JULY–SEPTEMBER 1998

Economic Policy Review

Volume 4, Number 3

This issue is dedicated to the proceedings of the February 26-27 conference "Financial Services at the Crossroads: Capital Regulation in the Twenty-First Century," cosponsored by the Bank of England, the Bank of Japan, the Board of Governors of the Federal Reserve System, and the Federal Reserve Bank of New York.

Current Issues in Economics and Finance

Earnings Inequality: New York–New Jersey Region, *by David Brauer, Beethika Khan, and Elizabeth Miranda*
Volume 4, Number 7 (July)
Second District Highlights

Free versus Fair Trade: The Dumping Issue, *by Thomas Klitgaard and Karen Schiele*
Volume 4, Number 8 (August)

Bank Holding Company Capital Ratios and Shareholder Payouts, *by Beverly Hirtle*
Volume 4, Number 9 (September)

Staff Reports

Identifying Noise Traders: The Head-and-Shoulders Pattern in U.S. Equities, *by C.L. Osler*
Number 42 (July)

Soft Exchange Rate Bands and Speculative Attacks: Theory and Evidence from the ERM since August 1993, *by Leonardo Bartolini and Alessandro Prati*
Number 43 (August)

The Dual Nature of Trade: Measuring Its Impact on Imitation and Growth, *by Michelle P. Connolly*
Number 44 (August)

Structural Change in the Mortgage Market and the Propensity to Refinance, *by Paul Bennett, Richard Peach, and Stavros Peristiani*
Number 45 (September)

International Trade and American Wages in General Equilibrium, 1967-1995, *by James Harrigan*
Number 46 (September)

Research Papers

What Inventory Behavior Tells Us about Business Cycles, *by Mark Bils and James A. Kahn*
Number 9817 (July)

Does Exchange Rate Stability Increase Trade and Capital Flows? *by Philippe Bacchetta and Eric van Wincoop*
Number 9818 (July)

The Rise and Decline (?) of U.S. Internal Labor Markets, *by Erica L. Groshen and David I. Levine*
Number 9819 (July)

Information Asymmetry, Market Segmentation, and the Pricing of Cross-Listed Shares: Theory and Evidence from Chinese A and B Shares, *by Sugato Chakravarty, Asani Sarkar, and Lifan Wu*
Number 9820 (August)

How Important Is the Stock Market Effect on Consumption? *by Sydney Ludvigson and Charles Steindel*
Number 9821 (September)

Paper Tigers? A Model of the Asian Crisis, *by Giancarlo Corsetti, Paolo Pesenti, and Nouriel Roubini*
Number 9822 (September)