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Comment on Thakor and Wilson

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Under the Basle Accord of 1988, banks in the major industrialized countries are required to ensure that their ratios of capital to lending are kept above a specified level. For many banks the introduction of this agreement meant that an increase in these ratios was necessary. A number of papers have analyzed the effect of such changes in ratios on the *supply* of bank credit. Thakor and Wilson (henceforth TW) take a rather different approach by looking at the *demand* for bank loans.

In their model, firms have a choice between borrowing from banks or through the capital markets. The advantage of bank debt is that it can be easily renegotiated whereas publicly-issued debt cannot because of coordination problems among the large number of holders. The disadvantage of bank debt is that the capital requirements make it more costly than direct borrowing. A rise in capital requirements can not only lead to a reduction in demand for bank debt because interest rates are increased but may also lead to *substitution* towards publicly-issued debt. Small changes in bank capital requirements can have a large effect on the amount of borrowing from banks because this substitution effect can be large. In addition, their model predicts that firms with higher growth prospects and hence larger borrowing requirements will tend to prefer market finance because of the higher costs of bank finance caused by capital requirements.

TW's paper is a novel and interesting contribution to the literature. The notion that increased capital requirements will lead to more borrowing through financial markets is potentially very important in practice. The analysis is theoretical and they do not investigate their thesis empirically. Such an empirical study would add to our understanding of the role of bank capital requirements. Given the Basle Accord was adopted by many countries, it should be possible to observe a variety of experiences. Before undertaking such a study, however, a number of extensions of their framework would be helpful.

A crucial assumption of TW's analysis is that borrowing occurs with debt contracts. In practice, of course, a wide range of other types of security such as equity and preferred stock are used. One issue is whether an increase in the range of securities that can be used in the market increases or decreases substitution away from bank lending. In the U.S. banks are restricted in the type of loan contracts they can use and they are unable to take equity, for example. In countries with universal banks, such as Germany and Switzerland, this is not the case. A second issue is how banks' ability to use a wide range of instruments affects borrowing substitution.

The ease of market-based borrowing differs significantly across countries. At one extreme is the U.S. where it is relatively easy for companies to raise funds in the market while at the other is Germany where this is relatively difficult. Another important extension of TW's theory is to consider the differential effect of bank capital requirements when ease of access to markets is varied. It is natural to conjecture that when access to markets is more difficult there will be less substitution. If banks have significant fixed costs, then in countries where access to markets is limited banks will be able to spread these costs over a wider base and will be at an advantage competing internationally.

An empirical analysis could compare the different effects of capital requirements in different countries and investigate the extent to which there was substitution between bank-based lending and market-based lending. With the extensions outlined above, it would be possible, among other things, to consider the extent to which the recent spate of IPOs in the U.S. and the switch from bank borrowing to publicly-issued debt in Japan could be attributed to increases in capital ratios. It would also be possible to see whether banks in countries with easy access to markets, such as the U.S., had been put at a disadvantage compared to banks in countries with restricted access, such as Germany.

In conclusion, TW address an important practical issue, namely the extent to which bank capital requirements lead to an increase in the role of direct finance through markets. It will hopefully stimulate a literature investigating how the Basle Accord has affected the relative importance of banks and markets as sources of finance in the countries where it was adopted.