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If **Basel II** was controversial before its launch in 2004, that was nothing compared with today. Now, there is even talk of getting rid of the capital accord completely, but a major overhaul may be the answer. **William Rhode** investigates

On the scrap heap?

Basel II is in the firing line. Everyone from Jamie Dimon, CEO of JPMorgan Chase, to Josef Ackermann, chief executive of Deutsche Bank, to Ben Bernanke, Federal Reserve chairman, has been voicing strong criticism of the banking accord. Even though some of the best minds in finance worked on the capital adequacy framework for several years before it was published in June 2004, there is now talk of tearing it up and starting over.

“Should Basel II be scrapped? I think a lot of people would probably say ‘yes’,” says Dean Buckner, London-based head of market risk at Daiwa Securities SMBC Europe. “I am not sure, although, if I had the chance to rewrite

the accord, it would look somewhat different to how it does today.”

One of the main difficulties for any capital adequacy framework is that it is difficult to come up with a regulatory capital provisioning system that can accommodate new products and operate in a dynamic, innovative financial world.

Christopher Laursen, a Washington DC-based senior consultant at NERA Economic Consulting, who until recently was head of risk policy and guidance at the Federal Reserve and member of the Basel Committee's Trading Book Group, says: “A lot of bank risk managers want to do a good job of assigning the right risk weightings and meeting capital adequacy requirements. The problem comes when a new product is invented.



Dean Buckner, head of market risk, Daiwa Securities SMBC Europe

There's usually a range of possible answers, anywhere from one to 100 for what the risk-weighting should be; it could be 60 or it could be 10."

And when it comes to considering the economic viability of a product, it may be that a risk weighting of 60 would make a product too expensive to market and sell – this is where people start to think about lowering the risk allocation.

"It's not that it's an unsupported or wrong weighting, in the strictest sense," says Laursen. "But it does mean that banks, compelled by the business function and competition, can become overly aggressive with each individual estimate and thereby sacrifice the spirit of the accord and the self-regulating environment it promotes."

There is currently a knee-jerk reaction towards structured products and their capital provisioning requirements. A proposal made by Pervenche Berès, the French MEP, which would have limited any regulatory capital benefits of credit default swaps (CDS) in Europe to those cleared via a central counterparty in the EU, was narrowly voted down by the Economic and Monetary Affairs Committee in March.

But some say that when it comes to the future, it would be better for a new regime to err on the side of caution than worry too much about maintaining a dynamically innovative financial market.

"The main lesson to learn from the crisis is the need for a level playing field: the same risk should be treated in the same way regardless of the regime or industry, and the corresponding capital requirement should be commensurate to that risk," says Buckner. "One of the main difficulties that Basel II was unable to address was that fundamentally different approaches to risk measurement (actuarial, ratings-based, VAR, probability of default), some of which resulted in very different estimates of the same risk, were allowed to coexist."

Breaking the cycle

Patricia Jackson, head of the Prudential Advisory Practice at consultancy Ernst & Young in London and a former member of the Basel Committee, says that it is the pro-cyclical element of the accord that needs to be addressed. The risk-sensitive nature of the accord means capital requirements fall in a boom, yet rise in a downturn – forcing banks facing severe capital constraints to cut back lending in a recession, further aggravating a slump.

"The Basel Accord should absolutely not be scrapped," she says. "But there are adjustments that need to be made. The degree of pro-cyclicality can be extremely large."

Under Pillar I, which covers minimum capital requirements, banks set risk weightings according to credit quality – this means that as the creditworthiness of borrowers declines in a recession, banks have to hold more capital. But this can be dealt with using mechanisms that scale default likelihood into a through-the-cycle measure.

In a speech to the Council on Foreign Relations in Washington DC on March 10, Bernanke said: "Capital standards, accounting rules and other regulations have made the financial sector excessively pro-cyclical. We should review capital regulations to ensure they are appropri-



Christopher Laursen, senior consultant, NERA Economic Consulting

ately forward-looking, and that capital is allowed to serve its intended role as a buffer."

In April, the question of pro-cyclicality was backed up by a paper by the Financial Stability Forum (FSF) – "Recommendations for Addressing Procyclicality in the Financial System".

Following the G20 meeting, the FSF, a body of central bankers and regulators established in 1999 and based in Basel, will be re-established as the Financial Stability Board with a new and expanded brief.

The FSF's paper, which breaks the problem of pro-cyclicality into capital requirements, leverage and the provisioning of credit losses, recommends as a top priority that the Basel Committee on Banking Supervision overhauls the regulatory capital framework so that banks are forced to strengthen both the quality and level of their capital during strong economic conditions.

It also calls for a reassessment of risk management models, the adoption of simplified capital ratios and risk-based measures, wider use of tougher stress-testing, a reassessment of closer monitoring of leverage and an overhaul

of the speed and manner with which banks are required to record actual and potential credit losses.

In March, the Basel Committee said it would also introduce rules to promote the build-up of capital buffers that can be drawn down in periods of stress.

“The level of capital in the banking system needs to be strengthened to raise its resilience to future episodes of economic and financial stress. This will be achieved by a combination of measures, such as introducing standards to promote the build-up of capital buffers that can be drawn down in periods of stress, strengthening the quality of bank capital, improving the risk coverage of the capital framework and introducing a non-risk-based supplementary measure,” the committee wrote.

This view was echoed by the UK’s Financial Services Authority (FSA) on March 18 in the Turner Review, a report on banking regulation in the light of the financial crisis, conducted by FSA chairman Adair Turner. The review identified pro-cyclicality as an inherent problem in the banking system that worsened the impact of the financial crisis. In spite of the initiatives to damp pro-cyclicality in the Basel II framework, Turner emphasised that overtly counter-cyclical measures were also needed.

“The banking system of the future should operate with more and higher quality capital than demanded in the past, reducing its vulnerability to shocks,” Turner said. “A crucial priority is to make the banking system an economic shock absorber, not itself a source of shocks. That requires actions to ensure that the introduction of Basel II does not introduce unnecessary pro-cyclicality. But we must go further and introduce a countercyclical element to the capital regime, with capital buffers built up in good times to be drawn on in economic downturns.”

Turner suggests a similar approach be introduced, with capital increasing in good years when loan losses are below long-run averages, creating capital buffers that could be drawn on as losses increase.

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In an effort to avert pro-cyclicality, the FSA announced on January 19 that it expects banks to hold minimum core tier-one capital of just 4 per cent in the bad times, while advocating they build up a capital cushion when economic conditions ease. “We believe that it would be preferable for the capital regime to incorporate counter-cyclical measures which lead to banks building up capital buffers in good years which they can draw down during economic downturn,” the FSA said.

But critics say that it is dangerous to lower capital levels in a period when bank losses could deteriorate further. They argue that it appears counter-productive for the FSA to allow banks to lower capital at a time when there are already concerns that reserves are insufficient.

The Spanish experience

Turner points to the Spanish market as an example of somewhere that introduced a dynamic provisioning regime in 2000 to build up a capital buffer for losses that have not yet been incurred. The provision is calculated based on the difference between the average losses on loans over the business cycle, using a standard or internal model, and the amount of specific provisions already deducted.

If the difference is positive, it is charged into the profit and loss (P&L)

account. If it is negative, it is written as income in the P&L statement and deducted from the dynamic provision fund. In other words, when the economy is booming, the requirement for provisions increases, and this can be eaten into during downturns.

While the Spanish economy is in a deep recession, its banking system appears to have weathered the storm better than others – a fact some attribute to the dynamic provisioning.

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Patricia Jackson, head of prudential advisory practice, Ernst & Young

increasing in good years when loan losses are below long-run averages, creating capital buffers that could be drawn on as losses increase.

He suggests two possible approaches for the calculation of the size of the buffer. In the first, the size would be determined by regulators, who would judge the appropriate level of capital using a discretionary system based on macro-economic and macro-prudential concerns. The alternative is to use a formula based on the growth of the balance sheet or estimates of average loan losses through-the-cycle.

Accounting face-off

In doing so, however, regulators are potentially facing off with the accounting standards bodies. Currently, loan loss provision rules stipulate there must be objective evidence of impairment before a provision can be made. General provisions or reserves are not allowed, unless these attempt to estimate loan losses after a triggering event has actually occurred.

Regulators argue this is pro-cyclical thinking – in good times, provisions will be low, even though banks may recognise losses are likely to increase in future, but in bad times, banks have to throw money into mushrooming loan loss provisions to cope with rising impairments.

The counter argument from accountants is that financial statements should reflect the current condition of a company. As the behaviour of borrowers is cyclical, accounting models must also, by their nature, be cyclical. Any attempt to smooth the effects of the cycle through a buffer or an additional provision would mean that resulting financial statements would not properly reflect the economic characteristics of loans in the portfolio.

The reasons for this are straightforward. If management was allowed to provision in advance for future loss, the bank would have a cushion to hide the impact of subsequent losses caused by poor management decisions. Accountants argue that building up buffers in the good times could significantly reduce transparency.



John Tattersall, partner, financial services regulatory practice, PricewaterhouseCoopers

This argument between regulators and accountants is not new. But the difference now is that political pressure to strengthen bank capital has reached fever pitch. Something has to give and the consensus is that it will be the accounting industry that will be forced to bow to the political will.

“I imagine that accounting standard setters, particularly International Financial Reporting Standards, will have to make a concession of some kind,” says John Tattersall, partner in the financial services regulatory practice at PricewaterhouseCoopers (PwC), the consultancy firm. “Given the public interest, it is not impossible to imagine strong political pressure being placed on them to change the rules.”

The credit rating agencies

Another key focus of any overhaul is the role of the credit rating agencies, which, before the crisis, were given a pre-eminent position within Basel II and the allocation of capital reserves.

Under the Basel II agreement, banks can choose to use the ratings assigned to assets by credit rating agencies when calculating their capital requirements, or they can use their own risk models via the internal ratings-based, or IRB, approach.

The UK's FSA, in its blueprint for overhauling financial regulation, has called for regulating credit rating agencies to limit conflicts of interest and “inappropriate” use of rating techniques. Specifically, the FSA said that it believed “there should be a fundamental review of the use of structured finance ratings” within the Basel II framework.

The inability of ratings agencies to rate reliably those securities has been identified as one of the key factors in causing the financial crisis, as the price of some highly-rated bonds backed by riskier assets collapsed.

The FSA's review said that credit ratings for structured credit products “proved far less robust predictors of future developments” than ratings assigned to specific loans and bonds, and that this had contributed to the financial crisis because some investors had wrongly assumed that high credit ratings also denoted high liquidity and market price stability.

The FSA said it supported the aims of planned EU legislation on rating agency governance and conflicts of interest, under which the FSA and other regulators take a supervisory role.

VAR

Another important element of the debate on Basel II, focuses on value-at-risk (VAR). The crisis highlighted that VAR models did not capture many of the risks in bank trading books, which were hit by credit migrations, credit spread widening and liquidity shortages. The losses sustained by banks on structured credit exposures far outweighed anything their VAR models suggested they could lose. By building requirements for VAR measures into Basel II, regulators were arguably responsible for giving an official stamp of approval to the use of such imperfect models.

It has also been said that the use of historical data within VAR models has been skewed far too heavily towards the positive. By only drawing on historical data from the good years prior to 2007, VAR measures were misleading and unable to predict the losses that would

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occur in the stressed market conditions of 2008.

NERA's Laursen of NERA says: “VAR is always going to be an important tool measuring risk on a portfolio of positions on a mark to market basis. But it is limited by the data used for input. The current VAR regime has pro-cyclical effects because it only looks at the market data of a fairly recent past. That has proved to be insufficient.”

As a consequence, the Basel committee has proposed to supplement its VAR framework with a new incremental risk charge, designed to measure losses due to default and migrations. On top of that, banks will need to calculate a stressed VAR measure, using historical data from a one-year period of significant loss. These changes, scheduled for implementation from December 31 2010, should significantly increase the market risk capital charge for trading books, even in benign market conditions.

But critics of the plan say the new proposal may more than double the market risk capital requirement in normal times. “I don't think there's yet been a thorough assessment of what the capital impact will be of adding in this stressed VAR. It is likely to be quite high,” suggests Laursen.

Buckner of Daiwa SMBC says: “The stressed VAR requirement has little merit as it stands because it provides the wrong kinds of incentives. It effectively

rewards banks with poor risk models and punishes those with good ones.”

Buckner argues that it was not trading books that suffered during the crisis – rather it was exposures not covered by VAR (such as retail and commercial loan books, special investment vehicles and securitisations and other illiquid and hard to price assets) that presented the biggest risk to banks and caused the largest losses.

“Suggestions that the VAR regimes should be radically overhauled are misplaced. There is evidence, both from anecdotal and in published sources, that trading books with appropriate VAR-based controls did not fare too badly in the crisis,” Buckner adds. Banks that had sufficiently reactive VAR models in place during the crisis did not suffer a significant number or size of backtesting exceptions.

Buckner is favourable to the idea of “stress VAR” in principle, but simply taking the VAR given by a bank's standard model during a historical crisis period does not make sense.

“This approach appears to penalise banks with models that correctly estimated the magnitude of risk in crisis periods, and rewards banks that underestimated it during the same period. Mathematically and statistically, it makes little sense,” Buckner comments. “Predicting cyclicalities is not a precise science, and is in any case concerned

with predicting market direction, which is traditionally not part of a market risk manager's job description. A market risk manager is concerned with estimating the size of possible losses, with a specified degree of confidence.”

Instead, the Basel Committee should emphasise more the segregation between what is friendly to the trading book and friendly to VAR and what is not. It would then, arguably, be wise to levy penal capital charges on those products that are not friendly to VAR, Buckner argues.

The one thing people do tend to agree on is that the latest proposals by the Basel Committee represent a fundamental shift in its approach towards capital adequacy regulation.

“The regulators are really under pressure to make sure they are using the correct look-back period and the correct VAR methodologies to get appropriate levels of capital,” says Laursen of NERA. “Before, the onus was on the banks to get it right. But now, the responsibility will be with the regulators to make sure that the banks get it right. Regulators will want to assess and agree with virtually every detail of what's being done in the models. That's a sea change from the previous approach where trading book capital models were often completely excluded from the exam process by inexpert managers.”

A sea change indeed. ■