

# Basel II failures highlight need for regulatory rethink

## Barbara C Matthews



The Bracken column is named after Brendan Bracken, the founding editor of *The Banker* in 1926 and chairman of the modern-day *Financial Times* from 1945 to 1958. This column reflects his enormous contribution to the open discussion and understanding of international finance and banking. It focuses on providing views and perspectives on how to improve the global financial system.

FOR THE PAST 20 OR SO YEARS, the global financial community has tried to craft a common minimum regulatory capital standard for banks. The result has been a complicated framework that is not enforced consistently, is constantly under revision, and failed to contain contagion during the 2008 market meltdown. The time is right to consider whether this path continues to make sense.

The Basel I framework (still used today in the US and elsewhere) established a common, risk-weighted minimum capital cushion for assets held on bank balance sheets and a definition of capital. The 8% risk-based calibration was chosen arbitrarily.

In the 1990s, as banks moved into trading, global regulatory capital requirements were crafted to cover general/systematic market risk and specific/issuer risk. Assessing risks specific to individual issuers proved to be similar to credit risk analysis.

Following the east Asian financial crisis, the credit risk measurement system was updated and new requirements to cover operational risk (which is neither market nor credit in orientation) were created (Basel II).

### THREE ASSUMPTIONS

All these revisions shared three assumptions. First, the regulatory capital framework should not serve as the first line of defence for banks, nor should it protect banks from market meltdowns. Second, the amount of capital generated by Basel I is more or less sufficient to protect the banking system. Third, regulators should use the same methodologies as financial firms to measure risk and set regulatory capital requirements. These assumptions are no longer valid.

*Purpose of regulatory capital:* regulators, spurred on by the G-20, are creating new global capital requirements to cover liquidity risk, incremental risk and leverage. Capital cushions will certainly increase as a consequence. Policy-makers have been clear about their goals: increase financial system stability and protect banks from future market meltdowns. Regulatory capital is now seen as a primary line of defence.

*Calibration:* when the Basel Committee initiated the Basel II process, it stated clearly that the new framework would generate roughly the same amount of capital as Basel I. Thus, Basel II's assumptions and parameters were designed to establish a floor based on Basel I's arbitrary 8% requirement. Last year, the Basel I cushion in the US proved to be as inadequate as the Basel II cushion in Europe.

Now regulators talking in Basel and in the EU are busy revising upwards the risk weights applicable to

securitisation and finding ways to incorporate through-the-cycle ratings and stress loss given default values within the Basel II framework. In addition, Basel II stress tests and data validation processes will ensure that the market meltdown data will hard-wire higher regulatory capital than might otherwise have been the case if the original calibration to the baseline 8% were still in operation. Today, calibration to the original 8% is not a public policy priority.

*Methodology:* reliance on bank internal models, stress tests, and quantitative finance are discredited as highly procyclical and prone to abuse. Policy-makers now seek simpler, conservative capital standards that can serve as check against sophisticated internal risk measurement models. As a practical matter, banks will not manage to meet the Basel II requirements when binding regulatory capital constraints arise from other measures.

### FACING REALITY

The days when Basel II could be seen as defining the regulatory minimum standard for capital globally are thus gone. However, technocrats and bankers that have sunk substantial political capital, compliance and IT costs into Basel II continue to cling to the framework.

A common global language for assessing credit and operational risks based on actual data is certainly a valuable risk management tool and can provide supervisors with helpful insight into the calibre of a bank's business and risk management systems. But public policy priorities are moving away from Basel II quickly.

Acknowledging this reality will facilitate progress on crafting regulatory capital tools that address new public policy priorities while permitting banks to intermediate risks. Acknowledging this reality would also facilitate opening an important discussion about the likely impact that higher regulatory capital requirements will have on credit-worthy customer access to credit and banks' maturity transformation functions, both of which will likely be adversely impacted by the full range of regulatory capital adjustments currently under consideration. **FB**

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