The New Basel Capital Accord

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Almost all bank regulation is reactive; it is proposed and imposed in response to operational problems and crises that are perceived as unacceptable.

No less true of Basel I than of Basel II.

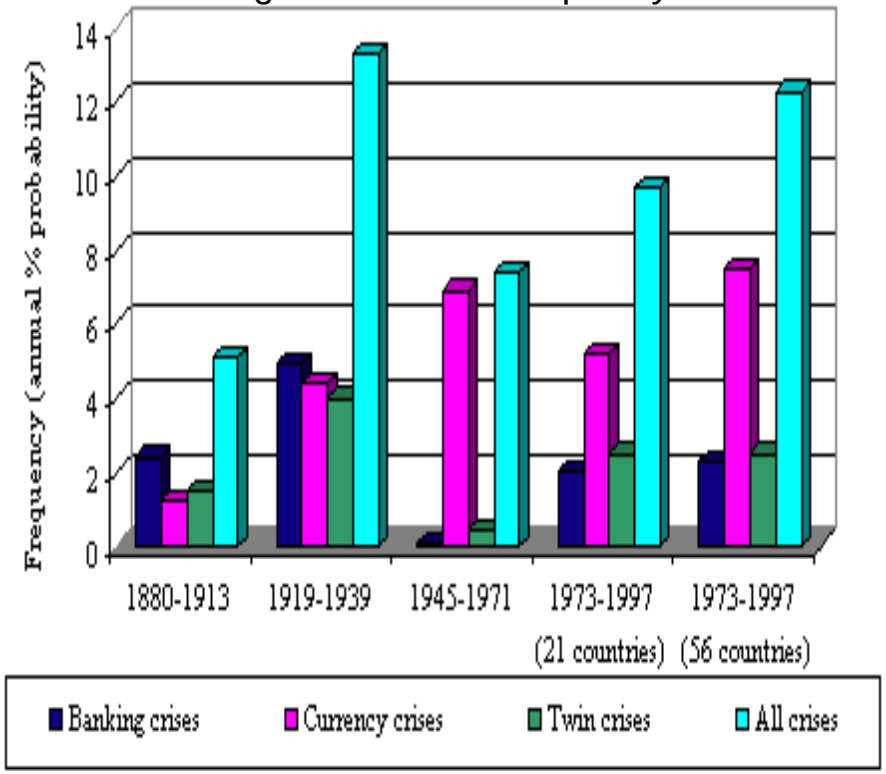
Before about 1970 few bank crises. Strict credit controls on bank lending to private sector; weak capital markets. Bank assets mainly public sector debt, plus large industrial borrowers. Banks organised into oligopolies. Secure profitability, franchise value. Acted almost as public utilities.

Table 1: Crisis frequency

Year	Banking crises	Currency crises	Twin crises	All crises
1880-1913	2.30	1.23	1.38	4.90
1919-1939	4.84	4.30	4.03	13.17
1945-1971	0.00	6.85	0.19	7.04
1973-1997 (21 countries)	2.03	5.18	2.48	9.68
1973-1997 (56 countries)	2.29	7.48	2.38	12.15

Source: Eichengreen and Bordo (2003, Table 3.5)

Figure 1. Crisis Frequency



Source: Bordo *et al.* (2001, Figure 1, p. 56).

But inefficient and uncompetitive. Deregulation, International competition, Information technology; Abolition of exchange controls. All these led to greater competition both internationally, especially in wholesale markets, and also within countries. Blurring of distinctions between different intermediation functions (e.g. commercial banking, investment banking, insurance, securities market activities, fund management, etc.). Rise of universal banks.

Competition led to reduced spreads, lower profits, shift to higher risk borrowers, (plus loans to individuals), falls in capital adequacy ratios. Large (safe) private sector borrowers migrate to capital markets, leaving a lower quality of bank borrowers. Greater systemic risk. Cannot be handled nationally because of international competition, especially from Japan (cross-shareholding) and France (public sector owned).

Rationale for Basel I, 1988 Capital Adequacy Requirement Accord. Considerable success, reverses downwards trend in capital ratios. Basel I took the, apparently reasonable, view that capital should be required in relationship to the relative riskiness of the individual bank. But relative riskiness was measured very roughly, simply adding up the absolute riskiness, the prospective variances, of individual classes of assets; not to the overall riskiness of the portfolio as a whole; and the categorisation of the individual classes, or buckets of assets was extremely rough.

Meanwhile the assets of the large international banks are commonly divided into two separable books, the trading book and the banking book. At this time the large commercial banks, e.g. JPM, were developing a simplified model, or algorithm, for assessing the riskiness of their investment, or trading book, i.e. VaR; and regulators have sought to piggy-back on that to apply VaR models to the trading book, although a model well-suited to commercial use, as is VaR, is poorly suited for regulatory use, (mainly because of fat-tails (kurtosis) in the distributions).

The position is worse with the banking book. Credit-metrics, though developing, is much more complex, (partly because of lack of data on PD and LGD). Meanwhile regulatory arbitrage. All bank loans to private sector (except mortgages) under Basel I had same 100% weight. Hence cost of high quality loan artificially raised by Basel I, relative to low quality loan. Response: shift of high quality borrowers to capital markets, and securitisation. Makes banks into `bad banks'.

So Basel II aiming to make required capital more closely related to economic capital which a bank would want to hold on its own to avoid risk. How do you do this? Internal risk-rating basis for estimating PD, and, if sufficiently advanced, LGD. Most banks outside the major international banks in the most developed countries, however, will continue to use standardised approach.

In order to encourage banks to move onto IRB, capital requirements for such banks will generally decline, but regulators do not want CARs for main international banks to fall. Hence supplemented by Operational Capital, a new category.

Certainly operational risks exist, but a mixture of smallish, predictable problems, e.g. credit card fraud, trading errors; operational issues, e.g. IT failures; and unpredictable events, e.g. massive insider fraud. Requiring more capital will not prevent fraud or most other operational risks. Not clear what is the justification, (e.g. in terms of overcoming market failures), for requiring minimum capital to be held against such risks.

Reduced in extent, but still will raise CARs in most developing countries.

Advantages of Basel II:

(1) Risk awareness and measurement.

(2) Does tie economic and regulatory capital closer together.

Disadvantages:

(1) Procyclicality. Endogenous Risk and Common responses.

(2) Complexity

(3) Still crude measures of riskiness, i.e. does not properly account for diversification and co-variance.

(4) Will not avoid regulatory arbitrage, e.g. securitisation.

(5) Imposes external assessments of how to handle risk.

Financial Regulation aiming,

(1) to reduce systemic risk

(2) to protect depositors (asymmetric information).

Does Basel II really help in either case?

It involves a trade-off between the beneficial effects of greater individual risk awareness and management, against the unfortunate systemic side-effects of greater procyclicality. Which will be greater? Cannot tell in advance.

Where do we go from here?

Almost everyone is agreed that Basel II is <u>not</u> the final resting place for the regulation of credit (or operational) risk. There is a widespread desire by regulators to be less prescriptive, complex and intrusive, and to be able to rely more on banks' own credit-risk control mechanisms, (than under Basel II).

But not yet. Moreover in the meantime there will be a need to let the new system become tried and tested. How long should the bedding-down period be? Uncertain.