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This collection of essays stems from a seminar on Basel 2, held at the Financial Services Authority on September 27, 2001, that was organised jointly by the CSFI and the Société Universitaire Européenne de Recherches Financières (SUERF) – a pan-European association of academics, central bankers and financial practitioners.

What struck us very forcibly at that meeting was the fundamental and deeply-held nature of many of the objections to the Basel Committee’s proposals for revisions to the 1988 Accord that were being advanced. Until then, I suppose, I had assumed that a combination of two things – a general realisation that the original Accord was increasingly flawed, and the powerful personality of the Committee’s chairman, William McDonough – would ensure that the proposals would go through, albeit perhaps with some slippage from the very ambitious schedule that had been put forward. After the seminar, I was not so sure; with regulators themselves expressing some sympathy with many of the concerns being raised, maybe Basel 2 was not quite a done deal. The latest revisions to the Committee’s own schedule, announced in mid-December, reinforce this feeling that many of the issues that we thought were closed are once again up for debate.

In light of this, it seemed to SUERF’s President, David Llewellyn, and myself that it would make sense to cajole those who had spoken at the seminar (including some of those who had intervened from the floor) to put down their concerns in as concise and pithy a form as possible – no more than 1,500 words was the brief (though one or two have gone a bit beyond this). To our surprise, almost everyone we approached was willing to write – and we quickly discovered that quite a few others were keen to have their views represented as well. The result is a collection of 16 views of Basel, most from very different perspectives, plus an introductory piece from David Llewellyn that both summarises some of the main themes in the anthology and adds his own interpretation of Basel’s shortcomings. And - thanks to the cooperation of Oliver Page (one of the speakers at the original seminar) - we also have an extremely important response from the FSA itself.

What are the main concerns about Basel put forward by our writers?

Well, for David Llewellyn, it is probably a potentially dangerous confusion between \textit{precision} and \textit{accuracy}. The new proposals are, as he says, “more detailed, sophisticated, prescriptive and precise” than what they will replace. But will they actually produce a more accurate assessment of risk? Or is there a danger that regulators, supervisors and bank managements would constitute a genuine step-level change in how risk is measured and monitored, and in the role of regulators and supervisors.
themselves will be seduced by a largely spurious precision into believing that they have a much better handle on risk than is really the case?

Beyond that, I would like to emphasise half a dozen (or so) themes:

- **The “pro-cyclicality” issue:** I put this first because there is some evidence that, in the UK at least, regulators (including Oliver Page) are sympathetic to this criticism about Basel 2 – and hope to do something about it. The problem is posed succinctly by Charles Goodhart, who notes that there is a “psychological and practical tendency for risk management to lead to cyclical exaggeration”. In my opinion, it is awfully late in the day for regulators to realise that any form of risk-weighted capital regime will tend to exacerbate the business cycle; surely it is obvious that credit risk (in particular) increases in a downturn and decreases in an upturn? Any deliberate attempt to offset this (eg by setting capital requirements on the basis of average risk calculated over an entire business cycle), no matter how well-intentioned, risks introducing a new form of instability. The problem is bad enough; the cure could be even worse.

- **The “good versus best” problem:** I think that this dilemma is captured exceptionally well by Brandon Davies, who points out that, while Basel 2 may actually force some banks greatly to improve their risk management practices, it will pose a serious dilemma for those (and he obviously includes his own institution) who are already well ahead of the curve. Will they run two risk management systems in parallel? Or will they abandon their own (possibly better) way of managing risk in favour of that which is mandated by the regulators? And what will that do to the risk management profession? If the regulator tells you how to measure and manage risk, why spend a lot of money to do it any other way?

- **Regression to a single view of risk:** Brandon Davies’s contribution is important, not just for identifying the “good/best” problem. It is also important because it identifies a potentially devastating systemic risk if – thanks to Basel 2 – we lose diversity of view when it comes to risk. As he rightly says, nature’s best protection against systemic risk comes from diversity. What Basel 2 will do is drive diversity out of the risk management area. With the same rules and the same models, institutions that are subject to Basel will increasingly come to share the same view of risk – and, as Brandon points out, a single view of risk is a concentration of risk with important systemic implications.

- **Excessive emphasis on regulatory capital:** This is a concern that probably comes through most strongly in the contribution by Alistair Milne, who points out that Basel 2 appears to be based on a fallacy: that regulatory capital should be equal to economic capital. In his view, this is almost never the case: “a bank needs to hold the regulatory minimum level of capital plus some buffer”. For him, the key is not regulatory capital but total capital – and Basel’s emphasis is therefore wrong. (It is worth comparing Alistair’s analysis with that of Ray Soifer – who, as a long-time Wall St. analyst, points out that what is important to analysts and fund managers is not the accuracy of a bank’s risk model, but whether it satisfies the regulators and the rating agencies. Whether the regulators are right or wrong, it is their seal of approval that matters.)

- **The “collateral damage” issue:** This is a concern that, as she acknowledges, Angela Knight has banged on about for years – with very little success until recently. It stems from the fact (in my opinion) that the chairman of the Basel Committee is an American, who carries in his head a US-based definition of what constitutes “a bank”. The problem is that the US defines a bank much more narrowly than does the EU – particularly under the Investment Services Directive. Hence, when Basel 2 is introduced into the US, it will not apply to (say) securities or asset management firms. When it is finally introduced, via EU directives, into national European legislation however, it will apply to any entity that is subject to the ISD regime – which, as Angela points out, would include her APCIMS membership,
who will be liable for a potentially crippling operational risk change. Again, as Oliver Page indicates, UK regulators (at least) are generally sympathetic, and maybe something can be done – but it will take time.

- **The “black hole of Brussels”:** As Angela Knight highlights, Basel 2 has no impact on any UK financial institution until (a) it is written into EU directives, and (b) those directives are written into national UK legislation. The problem is that, as Karel Lannoo points out, it is going to be very hard to get the Commission, the Parliament and the Council to agree on any directives – either new or amended. The row over the “framework” approach to financial legislation, proposed by the Lamfalussy Committee, has not been resolved, and the European Parliament seems unlikely to roll over and play dead on any piece of European legislation as important as this. As Karel says, getting Basel through Brussels could be a “nightmare” – and the legislation that eventually comes out (which, remember, would still have to be written into national law) could be even more complex than Basel intended. Again, there are important competitive issues *vis-à-vis* the US which need to be explored.

- **The general issue of excessive complexity:** This is a theme that permeates many of the contributions. Robin Monro-Davies, in particular, who is not unsympathetic to Basel 2, acknowledges that it will greatly raise the cost of regulation by adding new levels of complexity – which Brandon Davies worries will mean a further barrier to entry. As Robin points out, “the cost of developing and implementing new risk management systems will clearly be significant” – and the benefits may turn out to be illusory. This is a difficult (and dangerous) area, but it is worth emphasising that, for Fitch at least, initial calculations suggest that “most banks using the IRB approach (for operational risk) will probably end up with a higher capital charge than those using the standardised approach” – in other words, not only is the most advanced approach extremely complex, it may also not deliver all the benefits that are generally expected. (Based on Shirley Beglinger’s contribution, this is also a conclusion that Swiss Re has reached.)

- **Pillar 2 may ask too much of many regulators:** Most of the contributions in the present anthology are focussed on the risk-adjusted capital charge under Pillar 1, but John Heimann’s note concentrates on the discretionary element in Pillar 2 – which, he points out, will require lots of very sensitive judgement calls from regulators who may well be ill-equipped to make them. This is going to be a particular problem for the developing country regulators that John has been working with at the Financial Stability Institute. As he puts it, if Pillar 2 is to be taken seriously, supervisors will be opened up to “a lot of heat that most would rather avoid” – and they will be required to “make judgements that will not always be clear on their face”. Stephany Griffiths-Jones and Stephen Spratt, and Andrew Cornford, put forward a number of other concerns that developing countries have about Basel; but perhaps the most telling in the end is the very tough demands it makes on local regulators and supervisors.

- **The defensibility of an operational risk charge:** Charles Goodhart suggests that the Basel Committee may have got itself into a bit of a twist over the rationale for an op risk charge. In his view, there is no reason for regulators to concern themselves with a risk that ought properly to remain with a bank’s shareholders – *unless* they are really only concerned with boosting the capital of those banks that are systemically important. Put more bluntly, what Charles suggests is that regulators have no business setting a capital charge against operational risk at banks whose failure would not jeopardise systemic stability; for those (relatively few) institutions who do pose a systemic threat, why not be honest and explain that the supplemental capital charge is a protection against that systemic risk?

Those aren’t the only points made in the following contributions. Shirley Beglinger, for instance, makes a powerful case that the Committee’s approach to insurance as a risk mitigator is inherently flawed. Larry White argues that Basel 2 will raise the barriers to entering the bond rating business (already too high) to an utterly unacceptable level. And several authors argue that particular types of financing are being treated unfairly – developing country lending (Stephany Griffiths-Jones and Stephen Spratt), asset-backed finance (Craig Pickering), SME lending (Robert Laslett). Finally, Harald Benink makes a heartfelt cry (echoed in the US by, among others, Charles Calomiris and Bert Ely) for “market-based supervision” built around the mandatory issue of “credibly-uninsured” subordinated debt by all big banks – an idea that has, so far, only been tried in a couple of countries (notably, and unfortunately, Argentina).
All in all, we feel that this collection of brief essays brings together most of the serious concerns about Basel 2 – concerns that, in some cases, strike to the heart of what the Committee is trying to achieve. We don’t know how many of these issues will be addressed in the “final final” version that is still scheduled to come out this year once the latest (and, hopefully, final) qualitative impact study has been completed; Oliver Page’s response certainly suggests that the Committee is well-briefed on the industry’s concerns, and that it intends to address as many as it possibly can. Nevertheless, the stakes are high; if the Committee gets it wrong, implementation of Basel 2 could be exceptionally disruptive.

Andrew Hilton
Director, CSFI
January 2002
A response from the FSA...

"On reading this stimulating series of papers, one is struck, as a member of the Basel Committee, by the familiarity of many of the issues discussed. They mirror, very closely, discussions we have had both internally within the FSA in considering the Basel proposals ourselves, and with industry representatives. Many of them are also being wrestled with by the Committee itself in its deliberations.

"It is pleasing that there is overall industry support for the aims of Basel 2. It is also pleasing that there is apparently increasing consensus within the industry and among academic commentators on where the problems lie with the proposals as they were at the stage of CP2. The external input to our thinking and to the Basel process has been invaluable; the arguments put forth are well understood, both by ourselves and by the Committee as a whole. Nothing demonstrates this more tangibly than the Committee’s decision in December to reprioritise its work plan for the next few months – to give time to finalise the remaining key areas; to allow the opportunity then to stand back and view the proposals as a whole; and to allow time to undertake the final quantitative impact study in order to ensure that the new Accord delivers the right amount of capital for the system and between different banks. It was agreed that it was crucial to do these before publishing a final version of the new Accord for consultation. Put simply, it is more important to get it right, than to get it out. But there are limits.

"To be clear, CP3 when it comes out will be materially different from CP2 – as already flagged to some extent in the consultative papers produced over last summer and early autumn. Further dialogue with the industry, based on our most recent thinking, should enable the Committee to arrive at an Accord which gains consensus from representatives – banks, supervisors and economists – from many different countries with many different traditions. By definition, it cannot please all of the people all of the time; but we remain optimistic that it will be agreed to represent a materially more risk-sensitive framework which, in the round, will deliver a more appropriate level of capital requirement for the risks being run by banks. It will also serve as a solid basis for the EU legislation to be proposed by the Commission.

"Whilst, intellectually, it is tempting to continue to analyse all these issues and to enjoy reading and digesting the kind of paper presented here, we cannot now allow the perfect to become the enemy of the good. The existing accord is outmoded; there is broad agreement that Basel 2 is the way to go – so we must get on and produce it. But in doing so we must ensure, as Charles Goodhart emphasises, that the Accord (and indeed the ensuing European legislation) is flexible and able to reflect the evolving financial services markets and practices.

"Various leitmotifs run through these papers. One is that the new Accord will increase the cost of capital for lending to certain sectors of the economy. It is inevitable if we are to produce a more risk-sensitive approach to capital, that the amount of regulatory capital required against some lending (to risky enterprises or on risky structures) will rise – and, equally, that for other, less risky, lending it will fall. But the extent of this should not be exaggerated, as the main driver of costs for riskier lending will continue to be credit perception rather than capital, particularly regulatory capital. If we are successful, Basel 2 will produce regulatory capital largely in line with the judgements that core banks are already making on the economic capital which they are already allocating, and on which they will be basing their current pricing. Economic and regulatory capital in line with the economic risks would seem a pretty sensible outcome.

"That said, we cannot operate in a vacuum and must take account of the broader economic implications. Robert Laslett sets out the challenges of finding a solution to the SME issue admirably. Here, the Committee will need to find a solution which not only leads to an appropriate treatment of credit to small and medium sized enterprises, but which is seen by interested politicians, both at national and European level, to do so. And also, of course, one which looks sensible to us as supervisors. A specific asset class is impossible to define – there is simply no consensus on criteria – and treatment as part of the retail portfolio is only really appropriate to the smallest of SMEs. So the outlook for solving this conundrum might seem
bleak – but we remain optimistic that we will be able to make adjustments to the IRB approach for corporates and retail to deliver a good answer.

"An issue we regard also of major importance to be addressed is procyclicality. As, in particular, Charles Goodhart points out, we cannot have an Accord which reinforces the tendency to assume risk during upturns and realise it in downturns. Clearly, banks will have to hold enough of a buffer of capital in good times against the effects of bad times – and the Accord will need to reflect this, and place an obligation on supervisors to deliver it.

"In this regard, Pillar 2 comes into its own - as John Heimann says, it will likely be seen as the most far reaching of the three pillars. But he also explains how much of a challenge it will be to ensure that a process, which cannot avoid involving a large degree of subjectivity on the part of supervisors, is deliverable by the supervisors and acceptable to the supervised. And most importantly, from a level playing field point of view, to ensure that it helps deliver, rather than undermines, consistency of implementation across different countries. Much valuable work has been done already by the Groupe de Contacte at the European level; the recently announced Accord Implementation Group will provide an opportunity for similar work to be done in the Basel context.

"Pillar 3 is also crucial, but it is a support for the other two pillars, not a substitute. It is designed to increase transparency and to allow investors and others to make an assessment of a bank’s risk management practices. The crucial issue here is to make sure that we do not create a second set of disclosure requirements, very close to, but subtly different from, existing or future accounting standards approaches, which would be cumbersome for the industry. I should note that we also believe in transparency for supervisors.

"We see separating out capital for operational risks as a key element of producing a risk-sensitive Accord. But there are some real issues to address. As Angela Knight points out, the operational risk requirements devised in Basel for banks may not have direct application to investment firms, particularly some of the smaller ones, where the role of capital in achieving regulatory objectives differs. As one commentator put it, why put a Ferrari engine in a Fiat cinquecento? It might just about work; but it might not have the effect you expected or intended. One of the challenges for the European process – which, as Karel Lannoo points out, is very different from the Basel process, involving as it does Commission, Council and Parliament in co-decision - will be to find appropriate and well-founded capital treatments for investment firms generally, since many of the pertinent issues will not have been addressed by the Basel Committee.

"These contributions to the Basel debate are greatly to be welcomed. It is only with continuing dialogue of this nature that Basel and Europe will succeed in delivering an appropriate, risk-based and durable capital adequacy framework."

Oliver Page, director, complex groups, Financial Services Authority
My initial purpose here is to suggest a framework for assessing the proposed Basel 2 Accord by establishing a set of criteria. I will then look at the new Accord in terms of these criteria, many of which are also addressed by the other contributors to this anthology.

When judging the effectiveness of any capital adequacy regime, it is useful to establish the criteria by which it is to be judged. The following twelve tests are suggested:

1. Does it have the effect of aligning regulatory and economic capital, i.e. do the regulatory requirements correspond to the amount of capital a bank really needs, given the risks in its business?
2. Does it create incentives for effective and efficient risk analysis, management and control mechanisms?
3. Does it create appropriate incentives for the correct pricing of risk?
4. Does it create incentives for an efficient allocation of capital within the bank across different business areas and asset classes?
5. Does it create perverse incentives for regulatory arbitrage - business structures that lower capital requirements without any corresponding reduction in the risk profile of the bank?
6. Does it create unwarranted entry barriers?
7. Are the capital requirements competitively neutral as between countries and competing banks?
8. Are the requirements such that the amount of capital is appropriate for overall portfolio risk (i.e. the risk of the bank overall), as opposed to the sum of project risks (i.e. the risks attached to each component of the business)?
9. Does it have the effect of impairing competition in banking markets?
10. Does it have unwarranted effects on the macro-economy?
11. Is the new Accord unnecessarily complicated and prescriptive, in that the same effect could be achieved with a simpler approach?
12. Does it create or reinforce incentives for stakeholders other than official supervisors to monitor the risks of banks and for market discipline to be exercised.

Judged by these criteria, there are pluses and minuses in the proposed Accord.

**Basel’s present approach to capital**

Capital serves as an internal insurance fund to cover risks (most especially credit risks) that cannot be insured externally. It follows that the amount of capital a bank needs is determined by the nature of its risks. The objective of regulation and supervision should ultimately be to equate regulatory and economic capital, although this is an extremely complicated issue.
The problems with the current Basel regime are well-established. In particular:

- The risk weights applied to different assets are not based on precise measures of absolute or relative risk. This creates incentives for banks to misallocate the internal distribution of capital. It is also liable to produce a mis-pricing of risk. The distortion arises, not because of differences in risk weights per se, but to the extent that differentials between regulatory and economic risk weights vary across different asset classes.

- All corporate loans currently carry a risk weight of 100%, ignoring the fact that the major differences within a bank’s overall portfolio exist within its loan book.

- Basel’s current methodology involves the summing of risk-weighted assets, and does not adequately take into account the extent to which assets and risks are efficiently diversified.

- No allowance is made for risk-mitigating factors such as hedging strategies within the banking book, though some allowance is now made for risk mitigation in the trading book.

- Banks are able to arbitrage their regulatory capital requirements in a way that lowers capital costs without any corresponding reduction in risk.

It can also be argued that the current Accord does not give sufficient scope for market-based mechanisms of monitoring and for market discipline (Lannoo; Benink).

**What will Basel 2 mean?**

Let me turn now to some aspects of the new Basel proposals, in the context of the criteria established at the outset, and in the light of what the authors represented in this anthology consider to be the key characteristics of the new proposals:

1. **Alignment of regulatory and economic capital:** In an attempt to bring regulatory capital more into line with economic capital, Basel 2 proposes to widen the range of risk weights and to introduce weights greater than 100%. The weights to be applied will be refined by reference to a rating provided by an external credit assessment institution (such as a rating agency) that meets strict standards. Some writers (eg Griffith-Jones and Spratt; Cornford) have criticised this aspect of Basel 2 with reference to the excessive risk weights applied to loans to some developing countries. A similar critique has been suggested with respect to loans to SMEs (Laslett; Pickering), though this is currently under review by the Committee.

2. **Risk analysis, management and control systems:** New emphasis is to be given to banks developing their own risk analysis, management and control systems, and it is envisaged that incentives will be strengthened for this. In the case of banks with sophisticated risk analysis systems, this may enable them to calculate their own risk and the required capital backing.

The European Central Bank has focused on the choice of risk methodologies offered by Basel, since the range of risk weights is considerably wider in the IRB approach than in the standardised approach. As observed by the ECB, “banks with a loan portfolio concentrated on lower-risk borrowers may have the strongest incentives to use the IRB approach, as it gives a lower capital requirement”. Equally, banks with higher-risk loans might opt for the standardised approach. There is also a maturity dimension in that, as risk weights can increase with the maturity of loans in the IRB approach (whereas there is no such adjustment in the standardised approach), this is an additional incentive to opt for the standardised approach. The bottom line for the ECB is that “those banks that would benefit most from more advanced internal credit risk management techniques could actually have the weakest incentives to develop them”.
(3) **Correct pricing of risk:** The key here is whether the risk weights applied to different categories of assets are true reflections of risk. If a risk weight applied to a particular class of assets, or a particular loan, is low relative to true economic risk, there is an incentive for that asset to be under-priced as the full (capital) cost is not incorporated in the pricing structure. The distortion becomes even more significant if mis-specifications of risk weights relative to true risks vary between different classes of assets. In this respect, the test for Basel 2 is whether risk categories are correctly defined. Clearly, *precision* should not be mistaken for *accuracy*, in that while the proposed capital regime is considerably more precise than its predecessor, this does not in itself make it more accurate. In one area (loans to some developing countries), several of the present authors suggest that the proposed weights are too high, and that this will reduce the volume of bank lending.

(4)/(5) **Internal allocation of capital, and regulatory arbitrage:** The same arguments that are relevant to the correct pricing of risk apply equally to these two criteria. This again reinforces the importance of the risk weights being a true reflection of risk.

(6) **Entry barriers:** That capital, or any other form of regulation, might create entry barriers is not in itself a legitimate criticism, as one purpose of regulation is precisely to exclude hazardous firms. The real issue is whether unwarranted or unintended entry barriers are created. It is suggested in the present collection of papers that Basel 2 will create such entry barriers because it ties capital requirements very closely to risk, and because it implies a uniform methodology of how risk is calibrated (*Davies*).

(7) **Competitive neutrality:** It is axiomatic that similar banks (in terms of their risk profile, etc.) should be treated in the same way, and that particular institutions should not have excessive regulatory burdens imposed on them that are not equally applied to all similar institutions. Competitive non-neutrality can arise through two routes: the rules themselves may not be competitively neutral, or discretion may be applied in a non-neutral manner. This can arise both within a jurisdiction, and (most especially) between jurisdictions.

Basel 2 implies substantially more supervisory discretion in assessing banks’ capital adequacy than before – and, within this, there is ample scope for discretion to be applied in different ways in different countries. This is emphasised by several authors (*Monro-Davis; Heimann*), who worry that the Accord’s objective of creating a level playing-field may be undermined.

More controversial is the question of whether different types of institutions that conduct the same business should be subject to the same capital and other regulatory requirements. One area of dispute relates to the capital requirements imposed on the securities business of banks *vis-à-vis* those imposed on specialist securities traders. If banks have different systemic implications than securities firms, it is not unreasonable that they should be regulated differently - even though they may be conducting business similar to other institutions which are not systemically significant. This is particularly important in the EU, since whatever Basel decides will eventually become binding on all firms (banks or non-banks) that are subject to the Investment Services Directive regime. There is real concern that the resulting capital charge for operational risk that will apply to non-bank financial firms (such as fund managers) will jeopardise many such firms (*Knight; Goodhart*). This may represent a misplaced concern with “competitive neutrality”: the ultimate rationale of imposing capital requirements on banks is the nature of the (debt) contracts they write on both sides of the balance sheet; the contracts of securities (or asset management) firms are different in kind.

(8) **Portfolio v project risk:** Under Basel 2, capital requirements are supposed to take into account both the volatility of risks and the extent to which risks are diversified. Allowance is also to be made for risk-mitigating factors, such as the use of derivatives contracts. That is progress. Nevertheless, the ECB has recently argued that “full recognition of portfolio diversification is not yet present in the new framework” – though it also accepts that “the IRB is an ‘intermediate step’ towards the regulatory acceptance of fully-fledged internal risk models, which explicitly recognise this aspect”. 
(9) **Competition:** One of the important contributions to the present anthology (*Davies*) suggests that the single view about the riskiness of different types of assets that is implied in Basel 2 will itself have the effect of reducing competition, since “it will not be as competitive as it otherwise would have been had banks been able to compete on their view of risk”.

(10) **Macro-economic effects:** Several adverse macro-economic properties of Basel 2 have been highlighted in public debate, and are reflected in the present anthology: (i) its “pro-cyclical” nature (*Goodhart*); (ii) the impact on lending to developing countries (*Griffith-Jones and Spratt; Cornford*); and (iii) the tendency of banks to give too much weight to current economic conditions when assessing risk (*Goodhart*).

The pro-cyclicality argument is particularly serious, and is especially actue in the IRB approach where the effect of banks revising their internal ratings over the business cycle may be to exacerbate pro-cyclicality. Under some circumstances, this can be destabilising to a degree that could make the banks themselves more risky. The European Central Bank also focuses on the pro-cyclicality problem, and notes three aspects in particular: the changing risk characteristics of assets over the cycle; the fact that some risk mitigants (e.g. collateral) may also be pro-cyclical; and the volatility of external ratings over the business cycle.

(11) **Complexity:** A key issue is whether Basel 2 is unnecessarily complex, in that its objectives could be achieved with a simpler (and less costly) system. Maybe complexity is the price of increased sophistication (*Monro-Davis*); but equally the new proposals may be too complex. As it stands, the demands that Basel imposes on supervisors will be heavy – particularly as they attempt to assess the complex risk models proposed by banks who apply the IRB approach. Perversely, this could divert supervisory attention away from banks with weaker risk analysis and management systems (and who could therefore pose greater threats to systemic stability) towards banks with more sophisticated models.

Two issues arise: increased sophistication does not in itself imply increased accuracy, and the same objectives might be achievable with a less complex (or costly) system. Again, there is a danger of mistaking precision for accuracy. This is hazardous for two reasons: it may impose unnecessary costs, and it may create the illusion that, because a regime is precise, it must be accurate. A third issue is that complexity reduces transparency, and makes the evaluation of capital adequacy more difficult (*Lannoo*). This causes one to wonder whether an equally effective approach would be to have a simple capital adequacy framework (perhaps not greatly different from the current Accord), but bolstered by a more demanding supervisory structure and a greater role for market discipline. This would imply a reduced role for Pillar 1, but an enhanced role for Pillars 2 and 3 (*Heimann*).

An even more fundamental critique of the new Accord holds that Basel’s goal of increasing the risk-sensitivity of regulatory capital requirements is itself misplaced (*Milne*). What matters when it comes to maintaining the safety and soundness of banks, it can be argued, is the total level of capital that is held – and fine-tuning regulatory capital to bank risks is not of huge importance in reducing the probability of bank failure. Indeed, a crude capital-assets ratio might be equally effective in cost-benefit terms. What really matters is the effectiveness of banks’ internal risk analysis and management systems, and “capital regulation is only an adjunct (to this)”.

An alternative approach to reducing complexity, which would at the same time create incentives for the adoption of effective risk analysis and management systems, would be to establish a simple capital adequacy charge for credit risks – but for there to be discretion to lower the charge for those banks which have demonstrably superior systems. Incentives for the establishment of effective risk analysis and management systems do not require complex formulae.

(12) **Market monitoring and discipline:** Greater emphasis is to be given to the role of market discipline – Pillar 3. This should encourage higher standards of transparency and disclosure. It is envisaged by Basel that market discipline will play a greater role in the monitoring of banks and the creation of appropriate incentives. That sounds fine; however, at least one author (*Soifer*) is sceptical. His argument is that market analysts and fund
managers are more focused on whether a bank satisfies the regulator (who is presumed to have inside information) than on the public information that the regulator might require to be disclosed. For them, “assessing a bank’s capital adequacy and the accuracy of its risk models are of only marginal relevance, at best, to their investment decisions”.

There is another issue. While regulation may be a response to market failures, weak market discipline and inadequate corporate governance, causation may also operate in the other direction - with regulation weakening these mechanisms. For instance, the more emphasis that is given to detailed, extensive and prescriptive rules, the weaker might be the role of incentive structures, market discipline and corporate governance within financial firms. In other words, excessive reliance on detailed and prescriptive rules (such as is implied in Basel 2) may actually have the effect of weakening incentive structures and market discipline. Similarly, an excessive focus on detailed and prescriptive rules may weaken corporate governance within firms, and may blunt the incentive of others to monitor and control the behaviour of banks. The presumption may be that regulators have more information than do non-executive directors and shareholders, and that their own monitoring would, therefore, only be wastefully duplicating that being conducted by official supervisors.

On balance...

There is no doubt that the proposed new Accord is considerably more detailed, sophisticated, prescriptive and precise than its predecessor. That is borne out by every contribution to this anthology. However, that in itself is not the point, and cannot be the justification for such a radical change. In the final analysis, the value of Basel 2 depends on its accuracy - and, to the extent that it is more accurate, whether this is bought at an acceptable cost both to banks and to regulatory/supervisory agencies.

There are areas of doubt here. Above all, where is the cost-benefit analysis in these proposals, bearing in mind that in many countries (including the UK) new regulatory requirements are subject to at least a rudimentary cost-benefit analysis? Overall, there must be some doubt, on cost-benefit grounds, as to whether the benefits of a complex set of capital adequacy requirements, designed to make capital requirements more risk-sensitive are substantial enough to offset the higher compliance and monitoring costs that they will inevitably entail.

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Silly me. The Basel Committee has stated that one of its goals in the new Capital Accord is to promote sound practices in the management of operational risk. I’ve always understood “promote” to include both instruction and motivation – stick and carrot. In CP 2 ½, I can see the Stick – but I’m still looking for the Carrot.

It certainly isn’t the treatment of operational risk. True, the Pillar 1 charge for op risk has been reduced from 20% of Minimum Regulatory Capital (MRC) to 12%, citing “the ... use of [such] insurance products”. The Committee’s paper doesn’t say so, but the inherent assumption seems to be that a bank which buys no insurance will have its capital charge increased by its national regulator back up to the 20% mark. No Carrot there.

The problem is that national regulators are stuck with two conflicting goals:
- the promotion of sound prudential standards; and
- ensuring the competitiveness of their own national financial centres.

The result is that national regulators may end up applying a supplemental capital charge of 800 basis points to their non-insurance-purchasing banks, in addition to any other Pillar 2 charge which may be felt necessary. Consumers will then be up in arms because the cost of that additional capital will be passed on to them in the form of higher banking charges. And politicians will be up in arms because the competitiveness of national financial centres may be undermined. Nevertheless, the courageous regulatory men and women will prevail. The result may well be the lumpiest playing field in the history of European finance.

The formulae for calculation of the Pillar 1 capital charge move along a continuum from the very simple basic indicator approach (gross income x alpha) to the mildly complicated standardised approach (gross income per business line x beta) to the very complicated advanced measurement approach (calculate your own – and then satisfy the regulator that your result is correct). The intention apparently is for G10 banks to move along this continuum at a fairly brisk trot. Enter Stick and Carrot. Except that only the Stick appears.

Getting from the basic indicator to the standardised approach would seem to entail shoe-horning a bank’s businesses into the matrix provided – which will be no mean data-mapping feat. The resulting symbolic reduction in the capital charge doesn’t look worth the effort.

Getting from the standardised approach to the advanced measurement approach (AMA) requires a herculean effort involving data collection, scenario development, benchmarking, calculating, back-testing – and five years’ worth of data. The cost of this mighty endeavour can only be guessed at. The result – if the calculation is favourable – will be to reduce the capital charge by a maximum of 25%. But assume for a moment that the bank’s calculation shows that its own charge should be not 9% but 20%. The bank is not rewarded for its hard work; rather it is punished. Now assume that the calculation shows that the charge should be only 2%. Tough luck: the floor is fixed at 75% of the capital requirement calculated under the standardised approach. Either way, the bank runs the risk of spending ten pounds to save one pound.

The good news though is that insurance may be taken into account in calculating the charge...
under the AMA – always subject to the floor of 9%. However, there is still no Carrot in sight, since the Basel Committee anticipates that only about 40-60 banks worldwide will qualify for the AMA. The majority of G10 banks are likely to fall under the standardised approach, and may well elect to stay there.

Insurers are being encouraged by Basel to develop new products offering longer coverage periods, more timely loss payment and greater certainty. Insurance, however, lives from the law of large numbers: the premiums of the many pay for the losses of the few. Forty to 60 AMA-eligible banks worldwide do not qualify as “many”. In other words, the development of those new products may simply not be viable for insurers.

There are also a number of issues surrounding “timeliness of payment following loss events”, as well as “certainty of coverage”:

- The first is a fundamental attribute of insurance: insurance is about indemnity. Indemnity requires that there be a loss, and that the value of that loss should be unquestionably established. Indemnity then puts the insured [the bank] back in the position that would have existed if the loss had not occurred. Establishing this theoretical “loss-free” position often requires considerable time, thought and investigation.

- Second, discovery and reporting: there may be a considerable time-lag between the occurrence of a loss and its discovery by the bank. There is then a further delay while the bank investigates whether it really has a loss. Once the existence of a loss is ascertained, it may take a while before someone in the bank says “but isn’t there insurance for this?”. Notification then wends its way through the channels of a large organisation to the insurer. Going back to the indemnity question above, the insurer then requires proof of loss. This again may take some time to compile. Even in straightforward cases, the lag between occurrence and indemnification may be very long.

- The third point concerns certainty of coverage – and here regulators may join the courts in levelling justified criticism at both the sellers and the buyers of insurance. Contracts of insurance tend to be shrouded in obscure language and crowded with outdated phrases which do nothing to convey the intent of the parties. Instead, both parties look to the vast body of case law which has arisen as courts over the centuries have struggled to interpret clearly the murky intentions of underwriters and the underwritten.

All of this aside, there is ample proof that insurance works. The obvious proof is that insurance is still bought several centuries after Mr. Lloyd’s coffee house became an established venue for the transaction of insurance. People wouldn’t buy it if it didn’t work. More specifically, the Basel Committee has reviewed statistics showing the number of losses paid for by insurance. It seems, therefore, that there is a good case for accepting existing insurance products as a mitigant of the operational risk capital charge.

If one accepts that existing insurance products mitigate op risk, then the mitigation must apply to all banks – whether on the basic indicator approach to op risk, the standardised approach or the AMA. After all, if two banks buy the same insurance policy, suffer the same loss and receive the same indemnification, then surely the mitigation must be the same. It doesn’t seem logical to grant mitigation to the AMA-eligible bank but not to the standardised
approach bank. The difference between the institutions' risk management is already implicit in the initial charge calculation.

Bearing in mind that the Committee seeks to promote sound risk management, it might make sense to vary the amount of mitigation that a bank can take for insurance that it has purchased. Thus, a bank might calculate its operational risk capital charge as \(\text{gross income} \times \alpha\), then deduct from that number the value of standard insurance policies purchased multiplied by a factor (\(\delta\)). Delta could vary along a continuum, being quite small at the basic indicator level, larger for the standardised approach, and largest at AMA.

The next question is how to calculate the mitigation of standard insurance policies. One seemingly easy answer would be to calculate mitigation as a function of premium charged. The argument in favour of this approach is that premium is a reasonable proxy for the inherent riskiness of the bank. However, this ignores the fact that insurance markets expand and contract just as financial markets do. In times of contraction, a bank might be disproportionately penalised by the higher premiums charged. Conversely, in times of expansion, “bad” banks might be disproportionately benefited by the lower premiums charged.

A more logical method might be to combine both insurance limit and premium in a single calculation. The argument here is that the premium reflects:

- the relative riskiness of the bank;
- the applicable deductible (being the converse of the amount of mitigation); and
- the supply and demand of insurance capacity.

A simple approach then would be to deduct the premium from the amount of insurance purchased, and then multiply the result by the delta factor. Delta could be fixed as a fairly simple figure for each standard type of insurance policy, then varied according to the bank’s capital calculation approach. The resulting mitigation would be far less volatile than the premium approach, and would serve as a “reward” for the bank’s progress along the continuum of risk management excellence.

AMA-eligible banks should be able to negotiate an even greater degree of mitigation than delta if they arrange “new and better” forms of insurance. If a floor must be applied, it should be well below the 75% currently mentioned in the paper. Enter Carrot, stage left.

Turning to counterparty risk, another question arises in connection with the Committee’s statement that mitigation will only be granted for insurance purchased from an insurer whose rating is an entire notch above that of the purchasing bank.

It’s certainly sensible to insist that banks should not exchange an operational risk for a counterparty risk. But the counterparty risk argument should surely be satisfied by an insurer whose rating is equal to that of the bank. After all – and for all the same reasons - insurers cling to their ratings as tenaciously as any bank.

The Committee also appears to be considering a ban on the use of reinsurance (reinsurance is the process whereby an insurance company syndicates or lays off a percentage of the total risk it assumes under a policy). Apparently, reinsurance leads to a lack of counterparty transparency since a bank can never know who is really carrying its risk. There are two responses to this:
- **The first is legal**: A bank’s contract of insurance is with its primary insurer(s). They have a contractual obligation to perform irrespective of the success or failure of their back-door arrangements. Thus, if the reinsurer failed, the insurer would still have to pay out 100% of what is due.

- **The second is commercial**: Given the size and concentration of risks in financial markets, insurers have rapidly moved up the learning curve. Realising that it would be foolish to pay a premium to lay off a risk and then find themselves stuck with the risk and minus the premium, insurers are paying ever closer attention to the quality of their own trading partners.

In summary, the Pillar 1 charge is a very big Stick. Permitting insurance as mitigation is a small (but potentially perfectly formed) Carrot. Banning reinsurance would render the Carrot so small that it would be invisible to the naked eye.

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In late June, the Basel Committee delayed (unexpectedly, but rightly) for a year the launch of new rules on the amount of capital banks are required to hold. Delay of the proposed new Capital Accord became necessary owing to more than 250 submissions that were prompted by the Committee’s January 2001 proposal. The Committee is now expected to issue a further set of proposals in early 2002, which are to be finalized by the end of 2002 and implemented at the beginning of 2005.

Most of the comments have been submitted by banks, consultants, rating agencies and other finance professionals. But what is still lacking is a fundamental analysis of the approach proposed by the Basel Committee. To fill this gap, the Shadow Financial Regulatory Committees from Europe, Japan, Latin America and the US recently issued a joint statement entitled “Reforming Bank Capital Regulation”. (The shadow committees consist of professors and other independent experts affiliated with leading universities, business schools and think tanks.) In their statement, the shadow committees present a fundamental criticism of the Basel proposals and put forward recommendations that would significantly improve capital regulation.

Capital standards for banks are intended to ensure that banks maintain a sufficient level of capital relative to their risk exposures. In order to quantify credit risk and to determine the regulatory capital requirement, the Basel Committee proposes two possible approaches, both of which are more “refined” than the 1988 Accord. The first would be to use the credit risk assessment of external rating agencies. The second approach, only to be used by “sophisticated” banks, would be to use a bank’s internal ratings system to assess credit risk. Although it is positive that the two approaches imply a more refined measurement of credit risk, they are unlikely to meet the fundamental objective of ensuring that banks hold sufficient capital relative to their risk exposures. There are two reasons for this:

- Rating agencies cannot be counted on to measure adequately the risks associated with bank loans. First, rating agencies have little experience in risk-rating bank borrowers; second, rating each and every bank borrower would be very costly; and third, the agencies’ track record suggests that they have been better at risk confirmation than risk diagnosis (e.g. during the 1997 Asian crisis, ratings were only revised after the start of the crisis). Furthermore, many new ratings agencies would have to be established in a short period, creating the risk that some would provide overoptimistic ratings in order to maximize their market share.

- Use of a bank’s internal ratings model provides many opportunities to “game” the rules, since banks have an obvious incentive to minimize regulatory capital for a given level of economic risk. This could take the form of banks designing internal ratings systems that systematically underestimate credit risk - and, hence, lower the regulatory capital requirement. If this happened, it could threaten the stability of the financial system.

Internal ratings are expected to be the preferred option for most large banks in industrialized countries, since they enable banks to use their own risk systems as a basis for calculating the amount of regulatory capital. Given the potential dangers of the internal ratings approach for...
financial stability, however, it is essential to supplement these internal ratings with something that can counterbalance the perverse incentive effect of underestimating credit risk. The solution is to enhance the role of financial markets in disciplining banks.

Although the Basel Committee tries to enhance market discipline by increasing requirements for disclosure and transparency, its proposal does not go far enough. Real market discipline requires not only that information is made available to the market, but also that market participants have an incentive to act on it. As long as depositors (and other bank creditors) are explicitly or implicitly protected against loss, they will be less inclined to demand relevant disclosure concerning risks or losses, and to act on the information that is disclosed.

In order to strengthen market discipline, banks in industrialized countries should issue a minimum amount of credibly uninsured subordinated debt. Holders of such debt have a real incentive to monitor default risk. The risk premium on a bank’s subordinated debt could then serve as an indicator of a bank’s risk profile - to be used by supervisors alongside a bank’s own assessment based on internal ratings. The result will be to reduce a bank’s incentive to underestimate credit risk.

This subordinated debt proposal could be implemented experimentally in phases so as to minimize cost and permit review of its effectiveness. Initially, the requirement could be limited to large institutions whose debt is actively traded. In addition, at the outset, market signals from subordinated debt need not trigger any particular supervisory action; however, the yields at which such debt traded would provide helpful information to both the markets and supervisors.

Harald Benink is a professor at the Rotterdam School of Management of Erasmus University, and chairman of the European Shadow Financial Regulatory Committee.
Brandon Davies:

**Basel lags behind the banks**

I was asked to write this note based on a discussion that evolved from a CSFI round-table on Basel. CSFI discussion groups are always strict on application of the Chatham House rule. As, however, this is to be published, I should make it clear that these are my personal views and do not represent in any way those of the organisation for which I work.

The core of my argument at that discussion was that, while it is easy to see that bankers and regulators may have different incentives when it comes to regulation of the banking industry, and that while we may assume that regulators pursue the ‘public good’, the results of regulation may not be in the ‘public good’.

However, I would like to make clear at the beginning of what I concluded at the end of my argument - which is that, when in five years time the industry looks back at the effects of Basel 2, it will, I am sure, be judged a success. Banks will be fully aware that they are in the risk management business, and many who are today are far behind the risk management ‘curve’ will have caught up with those we regard as leading practitioners. This is surely a good thing.

What we will not see is at what cost this has been achieved.

Regulation is a very effective barrier to entry to any industry; the higher the barrier, the less competitive the industry will be.

We, as consumers of financial services, are schizophrenic in this regard. We want low prices and high service, but we don’t want the concern that our banks may fail. Regulation, such as is encompassed in Basel 2, is potentially very effective in ensuring that banks compete on level terms. But, in choosing to achieve this by tying capital so closely to risk and, indeed to a prescriptive view (as far as credit risk is concerned) of how this risk is to be calibrated as capital, Basel is in danger of creating a barrier to entry that is high and the effect of which is to protect bank shareholders - not simply bank customers. This will come about because, given one prescriptive view of risk and capital, the pricing of banking products will inevitably be driven to a high degree of uniformity.

I am not saying banking will not be a competitive industry. It will, for all sorts of reasons concerned with globalisation of certain markets (notably capital and investment markets), the economies of scale and scope that service specialists can bring and the ability of banks to innovate new products and services and to become more customer-focussed. But it will not be as competitive as it otherwise would have been had banks been better able to compete based on their view of risk.

Is there room for more than one view on risk? The simple answer is Yes. Institutions can (and, in my view, should) take a different view on risk depending (amongst other things) upon their ‘holding period of returns’. This itself is likely to be driven by the stability of a bank’s funding base. One bank highly dependent on market funding and another with a low exposure to market funding are unlikely to have the same attitude to the desired holding period of returns.
of their assets.

Moreover, banks may take a very different attitude to their target asset portfolio. A bank with a high degree of market sector or geographic concentration could be expected to manage risks differently from a bank with a target asset portfolio that was more widespread. Put simply, does one put all one's eggs in one basket “and watch the basket”? Or does one spread risks by not putting all the eggs in one basket? Neither strategy seems to me to be right or wrong - just alternative risk strategies that require quite different management policies and actions.

Some banks already have a well-developed understanding of the risks of their business, and have equally well-developed management structures for risk across credit market and (increasingly) operational risk.

In the area of credit risk, Basel 2 (through Pillar 1) is prescriptive whether the standard, foundation or advanced approach is used. To implement the Basel 2 proposals, and particularly the Advanced Measurement Approach (AMA), will require significant resources to be diverted to data management and credit modelling. This will create a dilemma for a number of banks with methods for measuring and managing credit risk that are already advanced. Clearly, they could handle this by implementing Basel 2 in addition to their current methodology. In practice, however, this is likely to be expensive as resources in this area are scarce. The more probable result is that many banks already using advanced credit-modelling techniques will divert resources from the development and maintenance of their existing credit modelling to build a Basel 2 AMA-compliant system.

The dilemma for management does not end with the resource issue. Of more importance is another management dilemma it brings in its wake. If management believes its original modelling to be correct, then is Basel 2 compliance to be an expensive overlay of its existing methodology? Or should the Basel 2-compliant methodology replace its existing methodology, despite management feeling Basel 2 to be a sub-optimal solution?

The results of Basel 2-based regulation may therefore be to raise the standard for some banks, but to lower it for others. Moreover, if in general the reaction of bank management, when faced with this dilemma, is to use Basel 2, we will get very close to a single view of credit across the industry; this will not be good for competition.

What I characterise here as a dilemma for bank management should be a dilemma for regulators as well - but not simply for reasons concerned with competition.

While Basel 2 may represent received wisdom, and is in my view not a bad system (though it clearly has serious limitations in respect of both the holding period of returns issue and portfolio effects), its problem - above all for regulators - is its prescriptive nature and what this implies for systemic risk.

With much of the world’s bank-related credit risk being subject to analysis through one prescribed methodology, we will create risk.

As Maynard Keynes pointed out long ago, the future is not simply unknown; it is unknowable. But how should we deal with the unknowable? The temptation is to say we can’t, but nature provides an excellent example of how to do it - by encouraging diversity. Populations are at risk...
of extinction when they concentrate - be it a physical concentration (putting them at risk of some natural disaster such as flood or earthquake) or when they have genetic concentration (putting them at risk of disease or environmental change). To encourage concentration in risk analysis and management is to create risk to extreme events.

My contention is that under Basel 2, Pillar 1 creates two dangers:

- **First**, it is in danger of reducing competition in banking because it will limit diversity of view about credit risk and return – and, in doing so, it will also discourage markets from emerging to trade credit based on these differences, thus restricting banks’ ability to manage these risks.
- **Second**, the reduction in diversity of views of credit risk may make the whole system more at risk from some shock we cannot foresee.

Both of these unintended consequences of Basel 2 are, I would suggest, against the “public good”.

I am not questioning the good intent of regulators, nor the good intentions behind Basel 2. But, in practice, I am concerned that it will discourage competition within the banking industry from banks that would otherwise use advanced credit management as a competitive advantage. It will also discourage the growth of markets that could make their credit risk management more effective.

While the Basel process will undoubtedly raise the level of understanding by banks of their risks, and will therefore lead to better risk management across the board, the very homogeneity it will create may itself cause the whole system to be more at risk from extreme events.

If this is our problem, where should we look for a solution? The simple answer is back to Basel 2 - **but this time to Pillar 2**.

In contrast to the way in which Basel 2 attempts to deal with credit risk, look at the way it seeks to deal with market risk in the banking book. Here, the approach is quite different to that for credit risk - though the nature of retail market risk is every bit as difficult to understand as credit risk. (Indeed, I would claim even more so, given the amount of optionality now commonly incorporated in retail products.)

Moreover, the approach to the management of these risks differs greatly across banks - not least because of the way in which these risks offset one another in different banks under differing scenarios of, most notably, interest rates (though the issue is far from confined to simply interest rate scenarios). The differing deposit structure of banks also produces different transfer prices for ‘free funds’, as banks seek to mitigate the volatile P&L effect of these balances - which are subject to a substantial degree of assumptions as to volume, duration and interest rate re-set.

Basel 2, through Pillar 2, deals with this in an altogether different way from credit risk under Pillar 1. In place of a prescriptive set of rules, we find a set of statements of best practice which can be briefly summed up as:

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1 See Basel 2 consultative document, “Principles for the Management and Supervision of Interest Rate Risk”.

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- a requirement for banks to be able to measure product balances that are subject to retail market risk to auditable standard;
- a requirement for banks to model these risks and to stress-test such models;
- an obligation to have clear statements of policy for the management of these risks; and
- a requirement to have clear reporting of their economic value in accordance with policy.

The regulator is required to assess policy and process and to appraise the bank’s own models for managing such risks. The existence of diversity of strategy and management technique is recognised and not discouraged.

The question I have is why such an approach should not also be the foundation for credit risk management. If it were, I would contend that the problems of competition and potential risk concentration under Pillar 1 would be mitigated and an active market in credit risk would be encouraged.

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The Basel Committee’s latest proposals have already attracted a great deal of comment from developing and transition economies – particularly from central bankers and regulators. This note summarises the substance of these, indicating which appear to be the most important for financial institutions outside the G-10.

Perhaps the most important theme that recurs in many developing-country submissions to the Committee is concern about the impact of the new Accord on supervisory regimes for developing country banks and on banks’ management and internal controls.

Many developing country comments emphasise that the proposals would increase the complexity of responsibilities for both supervisors and banks, and would impose additional costs. This has led to proposals for a more gradual phasing-in of the Accord’s implementation.

A special problem is implementation of the IRB approach – particularly for banks that are not obviously “internationally active” – given the likelihood that historical data required for the IRB approach will be unavailable in many developing countries. There is also concern about problems posed for supervisors in developing countries where most (or all) domestic banks will use the standardised approach to credit risk, but where foreign entities may use the IRB approach. This could complicate not only domestic bank supervision, but also cross-border supervisory cooperation. Moreover, where foreign entities use the IRB approach and domestic banks use the standardised approach, there could be a cost advantage to the former from lower capital charges – and consequent allegations by the latter of unfair competition.

Generally, submissions to Basel suggest that there is recognition among developing countries of the advantages of the IRB approach, but (as noted) this is combined with a belief that its introduction will be more difficult for developing country banks owing to weaker managerial and supervisory capacity and the non-availability of historical data. It has, therefore, been suggested that Basel’s requirement that a banking group using the “foundation” IRB approach for some exposures must adopt it across all exposure classes and significant business units should be relaxed. Instead, it is proposed that national supervisors be allowed to approve a more selective application of the “foundation” IRB approach, areas not covered being subject to the standardised approach.

Many comments from developing countries are critical of the way the proposed Accord aggregates expected and unexpected losses, as well as of the way in which part (but typically not all) loan-loss provisions are included in regulatory capital. This reflects a widespread preference for treating expected losses as a cost of doing business to be covered by provisions, while reserving capital for unexpected losses.

Various points are raised here: for example, the inclusion of only part of provisions in regulatory capital could be a disincentive to banks to carry adequate provisions. Equally, the lack of guidelines on provisioning could mean that some credit risks may be covered both by regulatory capital and by provisions that are not recognised as part of capital (so-called “double counting”).
The point has also been made that inadequate provisioning could contribute to excessive cyclical in bank lending since the increased provisions following a deterioration in loan quality in a cyclical downturn will lead to less new lending. Another potential source of more pro-cyclical bank lending is the Accord’s reliance on credit ratings in setting risk weights under the standardised approach. Other developing country reservations about reliance on rating agencies include:

- the limited national coverage of most rating agencies;
- the possibility that new, less reliable, agencies will emerge; and
- the problem of unsolicited ratings.

Some developing countries have suggested that a different way of setting risk weights under the standardised approach is needed, since dependence on rating agencies is so unsatisfactory for developing countries. One country (India) has made a detailed proposal: under its simplified standardised approach for banks that are “not internationally active”, risk weights of 20 to 150 per cent would be applied to different exposures on the basis of benchmark probabilities of default estimated by supervisors from pooled data for selected banks.

Beyond these general concerns, developing countries have put forward many more specific points. Some of these concern the risk weights under the standardised and IRB approaches to credit risk:

- In the standardised approach, there is widespread concern among developing countries that inadequate account is taken of diversification in reducing banks’ credit risks. The calibration of risk weights is also considered insufficiently discriminating – and as being asymmetric in part of its range. In the case of loans to sovereigns, for example, an intermediate risk weight of 50-100 per cent has been proposed for borrowers rated between BB+ and BB-. For corporates, the single risk weight of 100 per cent for those rated between BBB+ and BB- is viewed as insufficiently discriminating between “investment” and “non-investment” grades. Some countries have also pointed out the perverse incentive under the standardised approach for borrowers to avoid being rated at all, since the risk weight for unrated entities is less than for entities with low ratings.

A number of comments concerning the standardised approach have been directed at the preferential risk weight for claims on banks with an original maturity of three months or less; this, it is argued, would act as an incentive to lend on inappropriately short terms.

- Regarding the IRB approach, there is concern about the sharp rise in risk weights for borrowers with probabilities of default above a specified threshold – which could lead to levels of capital for exposures to borrowers of below investment grade substantially higher than under the standardised approach. This could mean that banks with large concentrations of low-rated borrowers would stick with the standardised approach to keep down capital requirements; equally, low-rated borrowers would have an incentive to stick with banks using the standardised (as opposed to the IRB) approach.
Collateral...

Many comments from developing countries have taken the view that the new Accord is too restrictive about the recognition of collateral, particularly in the form of commercial real property. Commercial real estate tends to be a more important form of collateral in developing than in developed countries, given the absence of alternatives. It has, therefore, been proposed that commercial real estate should be recognised as allowable collateral, alongside eligible financial instruments, under the standardised approach.

Equity exposure...

A number of comments have been directed at proposed capital requirements for equity exposures. Of special interest in the context of the restructuring of banks’ balance sheets after financial crises is the attention drawn by Thailand to consequences of the rule that minority-owned, non-controlling equity investments should be deducted from capital (or be subject to consolidation on a pro rata basis). In countries which have experienced financial crises, such investments may be a high proportion of total bank exposure (owing to debt-equity swaps as part of debt restructurings), but are not intended to be long-term holdings.

Op risk...

The proposed approach to operational risk has also been the subject of a large number of developing countries comments.

Their major focus is the “basic indicator” approach, which is likely to be most widely used in developing countries. The capital charges which would result from this approach are felt to be too high given the less complex nature of banking in developing countries. The point is also made that gross income (to which the capital charge would be proportional) is frequently not closely correlated with risk in a simple way (if at all). There is also criticism of the proposed floor for the capital charge in the most sophisticated approach. This, it is argued, would be a disincentive to its adoption – and more generally to improved risk management.

Other recurring concerns for developing countries involve disclosure and definitional issues:

- The reservations about enhanced disclosure (a subject covered under Pillar 3 and under proposals for operational risk) focus on the way financial markets in developing countries would respond to greater disclosure, and on competitive effects. There is scepticism about market participants’ capacity to interpret the increased information from enhanced disclosure, some countries even suggesting that such disclosure could create financial instability. Concern has also been expressed that disclosure of proprietary information could unfavourably affect a bank’s competitive position.
- Many comments have been directed at terminology used in the proposed Accord. For example, what does “internationally active” really mean in the classification of banks? Equally, there is concern about the fleshed-out definition of “default”, which is still felt to lack clarity in that it leaves room for supervisory interpretation of the likelihood that an entity will meet its debt obligations.

Since most of the comments are from developing countries with more developed financial sectors and more sophisticated regulators, unsurprisingly they echo many themes also found in those of developed countries (though with differences in emphasis). Even so, the concerns expressed underline the difficulties now confronting Basel owing to its assumption of the role
of setter of global banking standards, not just of standards for major G-10 banks, and to the resulting need to encompass an enormous range of both banking and supervisory practice.

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Charles Goodhart:

**Basel and pro-cyclicality**

It is widely agreed that the treatment of credit risk in the original Basel Accord led to some highly undesirable consequences.

Because almost all credit risk to the private sector (bar mortgages) was lumped together in one undifferentiated risk “bucket”, it had the effect of relatively overpricing better risks, and underpricing worse risks. Naturally, banks responded by securitising, and selling into the capital markets, better risks, while keeping worse risks on their own books. Thus, regulators induced banks to become “bad banks” - hardly what they wanted!

One of the main aims of Basel 2 is to rectify that by treating credit risk in a more sophisticated and differentiated manner (though the issues of portfolio diversification and covariance are still hardly touched upon), and in a fashion that comes much closer, indeed relies upon, the internal risk-based assessments of the major banks themselves.

Who could possibly object to a measure that leads to a better (and finer) assessment of credit risk?

Yet some of us do. There are two aspects to the basic problem. The first arises from the fact that no one can foresee the future, and hence one tends to extrapolate from the recent past. It has, for example, been demonstrated that downwards shifts in ratings by specialised ratings agencies tend to follow, not to precede, adverse shocks. There is no reason to believe that internal bank risk managers will have better foresight. Indeed, the need to justify figures (which are inevitably somewhat arbitrary) to suspicious accountants and tax authorities puts further pressure on risk managers inside banks to base their estimates of the risk of default, and of loss-given-default, on current, tangible data, rather than on a more shaky and challenging prognostication of future outcomes.

Thus, there is a tendency - incorporated directly into many of the risk-metrics actually used by the larger banks - to place excessive weight on current and recent developments in measuring risk. This means that when the economy is booming, and actual defaults are low (and collateral values high), this tends to be extrapolated forward, for example by applying high ratings to new loans. Similarly, during a recession, confidence is depressed, almost by definition. Loans, which were previously taken on with enthusiasm, will have unexpectedly gone bad. Given that, in a recession, outcomes tend to be worse than expected, who is going to get kudos for suggesting that the present state will in due course reverse, with outcomes better than immediately foreseen?

So, there is both a psychological and a practical tendency for risk measurement to lead to cyclical exaggeration. Moreover, the finer and more “sophisticated” the risk measurement methods, the greater such a tendency often becomes. The greater the number of risk “buckets”, the more the likelihood that, during a downturn, the credit rating of a given loan in the portfolio will migrate downwards - thereby raising capital adequacy requirements for the lending bank.

Whether or not this argument about inherent myopia is accepted, there is a second, and even more powerful, leg to the pro-cyclicality concern. This is the observation that what may be correct (indeed, desirable) at the micro-level may still make no sense at all at the macro-level. Individual banks are undoubtedly stronger in booms, and more fragile in slumps – and, therefore, need less (more) capital to survive in a boom (recession). The problem is that there is a macro-
level externality. Increased credit expansion during booms raises asset prices, incomes and profits - which further encourages credit expansion, in a well-known dynamic cycle. And *vice versa* during downturns. From the macro, and systemic, viewpoint, the need is to place downwards pressure on bank lending during booms, and to encourage additional lending during recessions. The effect of Basel 2 will be in the opposite direction.

As Andrew Crockett, the general manager of the Bank for International Settlements (BIS), and his colleagues have noted on numerous occasions, risk is assumed during upturns and is realized during downturns. That tendency will be reinforced by the latest proposals emanating from Basel.

What can, or should, be done about this? One response is that there is no call to do anything. On this view, the duty of the regulator is to prevent individual, micro-level insolvency; and if that should, perhaps, lead to an exaggeration of the macro-level cycle (especially by restraining bank lending in a recession), then it is the responsibility of others, notably those deciding monetary policy within the central bank, to use contra-cyclical measures to stabilize the cycle.

One sees the point. But the responsibility of the regulator is primarily to prevent systemic, or highly-correlated, banking failure *not* to ensure the solvency of all individual banks. The latter is the responsibility of management. If regulation is leading in the direction of making the system as a whole subject to more extreme fluctuations, it is tending in the wrong direction. Moreover, the idea that contra-cyclical stabilization can safely be left to monetary policy committees, against the adverse headwinds of a more pro-cyclical regulatory system, is wishful thinking. As recent events have shown, monetary policy cannot (at least not quickly) offset all adverse shocks; and monetary policy-makers have no more ability to divine future events than lesser mortals.

So, the view that the (extra) pro-cyclical impetus arising from Basel 2 is a regrettable necessity, is not one that many of us share.

However, the question of how to mitigate this is not easy, especially since it is hard ever to discern accurately either where one might be in the economic cycle, or the extent to which asset prices are diverging from their “fundamental” values (whatever that might be). Nevertheless there are some possible approaches:

- The first is to encourage the use of much longer historical time periods, preferably covering several cycles and extreme events, in risk measurement methodologies.

- The second is to encourage the conditioning of capital requirements on the rate of growth of bank lending to the private sector (relative to long term trends). The rate of growth of such lending has been one of the best indicators, at both the micro and the macro-level, of solvency problems some years ahead.

Of course, any such regulation will also be subject to those “laws” which suggest that regulatory (policy) change will result in reactions which change the way that the system works. But that is a generic problem for regulators; and certainly one implication is that regulation must be a dynamic exercise open to continuous reconsideration and review. Once Basel 2 is adopted
(in whatever shape), we look forward to Basel 3, 4, 5 and so on *ad infinitum*.

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Charles Goodhart:

The operational risk issue

All life is risky. There was recently a splendid story about the number of people who had seriously injured themselves with a loofah; the mind boggles. Many risks are clear, quite common and serious; for example a computer crash. The obvious (albeit partial) answer is a back-up facility. Most individual (and corporate) computer users will put in place back-up facilities to the point where the perceived extra gain in security is matched by the extra cost to those at risk. The loss, when it occurs, usually falls on those who did not take precautions. There appears to be no room for regulation here, since each decision-maker can (and should) assess the risk and bear the loss if he or she gets it wrong.

There may, however, be some qualification. There are conventionally three main justifications for regulation. One, *monopoly control*, is clearly not relevant here. But the problems of *asymmetric information* (or customer protection) may be raised to support operational regulation. We will discuss how this might be done shortly. More likely, however, is the case in which operational failures in the financial field may have *externalities*, i.e. systemic effects.

For example, in the case of network systems (e.g. payments systems), the failure of one participant may have widespread adverse effects on others. But in many cases, for example in the case of the computer failure mentioned above, the proper response is to review the adequacy of the back-up system directly, e.g. that it should not be housed four blocks away (as was apparently the case with the Bank of New York on September 11). Equally, the appropriate response in the case of the payments system itself might be to move towards real-time gross payments – thereby sharply reducing the potential for systemic disruption.

The same actually applies in the case of asymmetric information: customers can usually be better protected from operational risk by targeted practical methods, e.g. by requiring the segregation of client monies, than by a blunderbuss approach of requiring a general capital charge for operational risk.

The cases of op risk that are infamous, and that stick in our minds, almost all relate to rogue traders (e.g. Nick Leeson) and to cases of fraud and illegal activity. There are measures that can, and should, be taken to address these risks by better internal control systems. These usually involve trying to adjust the incentive systems for management. It is far from clear whether, or how, a new op risk capital charge could have any useful effect on either the frequency or the *impact of fraud*. Indeed, in so far as higher capital requirements might increase pressure to make profits (to maintain a firm’s ROE), they could actually reduce the incentive to look closely into apparently profit-making sectors.

Of course, the links between banks (for example via the payments system and the interbank market) mean that the failure of any large bank – and perhaps also the failure of a systemically-important non-bank financial intermediary – might have significant external overspill effects. That might suggest that large, systemically-important banks ought to have sufficient capital to reduce the probability of their failure to an acceptable minimum.

There is at least a suspicion that the new concept of op risk capital requirements was introduced
into the Basel 2 proposals with this in mind. In order to induce banks to move towards the more sophisticated internal risk rating approach (which the Basel Committee wants to promote), there had to be a carrot – a potential lowering of capital requirements for such banks. At the same time, however, these are precisely the banks for which the regulators would want a quite high minimum capital requirement on general systemic grounds. Perhaps an extra operational risk requirement would meet this need - and, anyhow, most sensible banks would already hold capital for operational purposes.

But, as I argued at the outset, where the loss falls on the individual bank shareholder, bondholder, or manager, it is for them to choose the optimal level of capital, not the regulators. Where the concern is about wider externalities or systemic failure, the response ought to be to require adequate overall minimum levels of capital, not to require the application of such capital to individual functional operations, employing coefficients the justification of which is dubious in the extreme.

The current proposal is, moreover, likely to have the effect of distorting the conduct of certain kinds of business, e.g. fund management, between banks and non-banks. Attempts to create a level playing-field between banks and non-banks by applying the same operational capital requirements to non-banks, again for example in fund management, would impose a costly burden on the non-banks the rationale for which is difficult to see.

Finally, the data base, upon which the operational regulatory requirement is calculated, is insufficient and tenuous. As a result, the coefficients proposed by Basel are more than a little arbitrary - and the second-round effects of consequential distortion will be even more unpredictable.

But even if the data base was much better, what would be the rationale for interfering with individual bank decisions on how to handle operational risk by the imposition of capital requirements? The case that Basel’s proposals provide customer protection (that cannot be better achieved by other means) has not been properly made. Nor are they a useful protection against fraud or rogue traders. If the intention is to impose a back-door extra minimum capital requirement on large, systemically-important banks, then that is better done directly than through such a general and complex artifice.

The introduction of this new capital requirement will add a further layer of complexity and bureaucracy to the regulatory process in the financial field. The positive case why it should be introduced at all has yet to be convincingly made.
Stephany Griffith-Jones & Stephen Spratt:

**Basel 2 and the developing countries**

Since the Asian crisis, bank lending to developing countries has fallen very sharply. In June 1998, loans outstanding to developing countries totalled US$924 billion; by December 2000, they had fallen to US$753 billion. It is in this context that the implications of the new Capital Accord for developing countries should be assessed. In particular, the fear that the new Accord may further discourage lending is of great concern.

It is clear that banks have become highly risk averse vis-à-vis developing economies. This reflects a more general trend towards ever-greater appreciation of the need for accurate risk assessment. This trend has been a response to competition from non-bank financial institutions which are not subject to the same regulatory constraints as banks. Consequently, given the fear that business will migrate from the regulated (bank) sector to the unregulated (non-bank) sector, banking regulators have come under pressure to act.

It has been argued that the 1988 Accord forced banks to hold levels of regulatory capital that did not correspond to actual risks, as measured by the banks’ own internal models. This created perverse incentives, leading to distortions in lending practices. Recognising this, the Basel Committee has now proposed a new Accord, with a stronger focus on aligning regulatory capital requirements with actual risks.

While the effects on developing countries are clearly not central to the new proposals, it seems likely that, as with the 1988 Accord, significant impacts will be felt – both positive and negative. The key is to maximise the former, minimise the latter and avoid a net negative impact.

Although the proposed Accord is to be built on “three mutually reinforcing pillars”, it is likely that the changes proposed to the measurement of credit risk (under Pillar 1) will have the most far-reaching implications for both developed and developing countries.

The proposals envisage three approaches to credit risk, with increasing degrees of complexity. These are the standardised approach, and the foundation and advanced internal ratings-based (IRB) approaches. The new system proposed for the standardised approach addresses many of the concerns raised by developing countries about the 1988 Accord. In particular, the removal of the OECD/non-OECD distinction and the reduction in the incentive towards short-term lending are positive proposals. Also, the removal of the sovereign ceiling will be of benefit to highly-rated banks and corporates in less highly-rated countries, regardless of OECD membership. Overall, therefore, the proposals should, as envisaged, more closely align capital requirements with actual risk.

The proposed use of external credit assessment institutions has, however, been criticised. While we have some misgivings, these are primarily of a practical nature and need not prove insurmountable. Therefore, on balance, the proposals contained in the standardised approach are to be broadly welcomed. Unfortunately, however, the standardised approach cannot be viewed in isolation: in our judgement, the IRB approach, if implemented in its current form, would have negative implications for developing countries. Consequently, the net impact of the
The IRB approach may not be...

new Accord on developing countries is likely to be determined by the extent to which the IRB approach comes to dominate the banking industry’s relations with the developing world.

Perhaps the most significant changes proposed in the IRB approach relate to the greater use of banks’ internal risk management systems. The rationale is that greater sensitivity to the measurement of actual risk will enable banks to more accurately price and provision for risk. The result, it is hoped, will be a sounder, more efficient banking system that functions better for the benefit of all. Unfortunately, from the perspective of developing countries, there are two major areas of concern:

- **Cost and quantity of lending**: One impact of the new Accord will probably be an increase in the quantity of loans to borrowers rated above BBB and a fall in loans to borrowers rated below BBB. Given that the majority of the latter are in the developing world, they are likely to see a reduction in lending from internationally active banks. What lending does occur would be concentrated in highly rated sovereigns, corporates and banks. The Bank of England’s Patricia Jackson puts it thus:

  “For any bank, the effect of the internal ratings approach on required capital will depend on the risk profile of its particular book - high risk books will demand more capital than currently and low risk books less.”

A number of studies have attempted to assess the impact on the cost of borrowing for low-rated borrowers. Some have suggested alarming increases, to the extent that developing countries would be effectively excluded from international bank lending. Other research has not found increases of the same magnitude. The different approaches, however, all point to a significant rise in the cost of lending to low-rated borrowers. Indeed, this is also cited in recent submissions to Basel by a number of major banks, some of which argue that the calibrations used by the Committee are too conservative and therefore produce capital requirements, particularly for low-rated borrowers, that are in excess of those produced by their own, internal models. For example, Citigroup argues that:

  “…under the new Accord, the calibration of capital causes regulatory minimum capital requirements to increase to inappropriately high levels when compared to existing rules or internal risk models.”

Similarly, Credit Suisse contends that:

  “The calibration of high-risk grades in the IRB sanctions SMEs and emerging markets. Their access to capital from large institutions will be made significantly more difficult.”

The Committee appears to have accepted this point. Work is attempting to ensure that the regulatory capital curve is flattened sufficiently to align it with the economic capital models employed by the major banks. However, two issues arise here. First, some have argued that concerns over the impact of the new proposals on the cost of bank lending are misplaced. While it is not disputed that capital requirements for lending to lower-rated borrowers will rise under the IRB approach, the suggestion is that banks price loans off their own internal models, rather than on the basis of regulatory
capital requirements. Consequently all the new Accord will do is bring regulatory requirements into line with existing practice. However, while this may be so when the regulatory capital required is below that which banks would choose to hold, if the regulatory requirements are above those indicated by the banks’ own models, it might force them to increase the cost (and/or reduce the quantity) of lending to lower-rated borrowers.

Second, even if the IRB curve is brought into line with banks’ internal models, is this a realistic assessment of the risk posed by developing country borrowers? In the absence of robust, long-term historical default data for all classes of borrower (certainly an issue in developing countries), ‘risk’ can be viewed as the quantification of expectations. The high levels of uncertainty that this produces create strong incentives to herd, with developing countries periodically going in and out of ‘fashion’. Thus, market perceptions of the risk posed by developing countries are often overstated, sometimes understated, and rarely objectively justifiable. Given that this is very different from the treatment of OECD borrowers, there would appear to be a case for developing a distinct developing country approach to regulatory capital. The Committee has apparently conceded that there may be a case for devising a separate curve for SMEs: a similar argument could be made for developing countries.

- **Pro-cyclicality:** One of the charges levelled at the new proposals is that they will exacerbate pro-cyclical tendencies within the banking system. The drive for risk-weights to more accurately reflect the probability of default (PD) is inherently pro-cyclical in that, during an upturn, average PD will fall - and thus incentives to lend will increase. Conversely, during a downturn, average PD will increase (due to more difficult economic circumstances). Deteriorating economic conditions would cause existing loans to ‘migrate’ to higher risk categories, therefore raising overall capital requirements; given the difficulty of raising capital in a downturn, this may lead to a credit crunch, which would further deepen the downturn. The Committee has recognised this concern, but argues:

  “The Committee has also considered the argument that a more risk-sensitive framework has the potential to amplify business cycles. The Committee believes that the benefits of a risk-sensitive capital framework outweigh this concern.”

However, as is the case with much of the new Accord, the trade-offs are viewed primarily in terms of their impact on the major banks. For the developing countries, it is likely that they will feel the costs disproportionately (reduced lending, coupled with increased frequency and scale of crises), while simultaneously attracting few of the benefits. If we assume that financial crises are connected with the business cycle, and accept that developing countries are disproportionately affected by such crises, it becomes clear that developing countries have more to fear from an amplified business cycle than the developed world.

The Committee seems to have also accepted the validity of this criticism. The next consultative document is likely to include a variety of measures to combat pro-cyclicality. However, the important question is whether the concrete measures will offset the potentially negative effects of increased pro-cyclicality.
While the proposals contained in the standardised approach are broadly to be welcomed by developing countries, the introduction of IRB approaches is very problematic. The new Accord may merely serve to give with one hand only to take (more) with the other. Equally, although the systemic implications of greater risk sensitivity in lending patterns will impact upon both developed and developing countries, the latter will be hit harder given the smaller size of their economies vis-à-vis international capital flows. It is therefore crucial that the trade off between microeconomic allocative efficiency and macroeconomic systemic stability is more clearly thought through. Specifically, it is not clear that what is good for individual banks is necessarily good for the stability of the international financial system, nor the economic prospects of the developing world in particular.

Our policy proposals can be summarised as follows.

- Early adoption of the IRB approach is likely to have significant, and possibly unintended, consequences, particularly for developing countries, and we therefore recommend further postponing its implementation to allow for further research.
- If, despite this, the IRB approach is to be implemented in something like its current form, it is essential that regulatory requirements are lowered for low-rated borrowers to at most the levels suggested by the banks’ own models. That is, the IRB curve should be flattened significantly.
- The possibility of a separate curve for developing countries, similar to that under consideration for SMEs, should be fully investigated. From a global perspective, developing countries could be as much an ‘engine of growth’ as SMEs are at the national level. Also, the risk profile of developing countries is distinct from that of developed world borrowers, and this difference could be recognised in a different approach to capital requirements.
- The improvements contained within the standardised approach should be developed to further reduce, if not eliminate, incentives towards short-term lending, and the number of risk buckets expanded to reduce regulatory biases towards lending to certain categories of borrower.

The fact that the Committee has decided to postpone implementation of the new Accord is to be welcomed. Given the number of submissions in response to the second consultative package, this is surely sensible. The Committee is also to be commended for taking the criticisms seriously. It is to be hoped that the concerns of developing countries are given sufficient weight in this process, which should be as transparent and open as possible. Given the importance of ensuring a stable and suitable level of financing to facilitate much-needed economic development in the poorer parts of the world, it is vital that these issues are seriously addressed.

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Though little attention has yet been paid to Pillar 2 of the proposed Accord, it is likely to have the greatest long-term impact. Entitled “Supervisory Review Process”, a better title would be “Supervisory Discretion”. Pillar 2 prescribes a set of practices that requires supervisors to make judgement calls that are bound to have a substantial subjective component. This form of financial supervision is in place in a few G10 countries, but not all of them. And, perhaps equally importantly, it is virtually unknown in the emerging and transitional economies. Nevertheless, Pillar 2 embodies the future for financial supervision.

Banking is vastly different today than it was 15-30 years ago. Back then, the primary source of vulnerability to a bank’s capital was housed within its loan portfolio. But today, a bank’s capital is exposed not only to credit risk, but also to interest rate and market risk. Problems in loan portfolios tend to take a long time to develop – and an equally long time to repair. Loans seldom go bad overnight. Interest rate and market risk, on the other hand, strike quickly and can destroy an institution’s capital unless fixed immediately.

In sum, loan or credit problems are like cancers – they take a long time to develop and they take a long time to cure. In contrast, interest rate and market risk are more like a high fever. They strike quickly and must be cured immediately.

Historically, bank examination or inspection was an annual affair. For the most part, this was sufficiently frequent to judge the quality of a bank’s loan portfolio. If the situation was found wanting, actions could be taken to improve the quality of that portfolio. There was enough time to solve the problem. Not so for interest rate and market risk; annual examination is not enough. Just look at how quickly the Barings and Long-Term Capital Management crises developed.

Banking supervision, however, cannot be an ongoing activity. Supervisory resources are sorely limited in many countries. Moreover, banks do not want supervisors hanging around their premises 365 days a year. This is not only costly, but disruptive and time-consuming.

For a highly complex financial institution operating 24 hours a day, whose activities encompass many forms of risk-taking, the supervisor in pursuit of his responsibilities is faced with a constraint problem. In particular, the supervisory agency has only a limited supply of trained and experienced examiners or inspectors who are available to cover the entire system. Therefore, the only way that supervisors can oversee a complex international organization is by assuring themselves that bank management itself has the organization under control, that the management knows what’s going on, and that limits (and other restrictions) are being implemented.

Supervisors cannot and should not be permanently on a bank’s premises, peering over management’s shoulder. They need to create a system to evaluate the capacity of a firm’s board of directors and its management to operate a safe, sound and profitable financial institution. Of course, supervisors who can afford it may have a few persons inside a giant bank, simply to keep in contact with any change in risk profile. Nevertheless, for most supervisors and most banks, the best form of supervision will be the supervisors’ analysis and evaluation of the
capacity of management. These judgements will certainly be based on a broad variety of statistical measures and comparisons with other similar institutions. But, in the final analysis, it will be a judgement call by the supervisor whether the board and management are up to the challenge. That judgement is subjective!

Many will undoubtedly oppose this trend – notably banks from countries where the supervisory agency lacks the necessary human and other resources to make those judgement calls, and banks from countries where the supervisory organization is highly politicized (thereby making its judgements based on political pressures, not on good practice). (Of course, this works the other way round too. In a highly politicized system, if banks have sufficient political clout – and they usually do – that can frustrate proper supervisory action.) In addition, bankers will say that they are fearful of supervisors’ subjective judgements since they may not hew to statistical measures that are applied equally across the system. This is a long-standing complaint. Indeed, in the US, whenever banks have disagreed with a supervisor’s action and sued the agency, the charge has tended to be that the agency had acted in a “capricious and arbitrary” way. This represents the standard view that a supervisor should stick to a set of formulæ, ratios and the like, which will be the final arbiter of supervisory actions.

It’s not just bankers who don’t like supervisory subjectivity. In many countries, the supervisors themselves don’t like the idea either, since it opens them to a new level of criticism and dispute. Particularly in domestic financial systems that are populated by just a few banks, the requirement for a bank to have a higher level of capital adequacy than its competitors is inevitably controversial since it affects competitive positioning and pricing. Subjective supervision opens up the supervisor to a lot of heat that most would rather avoid.

This attitude, however, fails to recognize that even in the most mechanistic system of supervision, subjectivity has always played an important role. For example, in the examination and evaluation of a bank’s loan portfolio, both the bank and the examining supervisor make subjective assumptions. If the bank assumes that GDP will grow by 2% in real terms over the coming year, a loan will have a value based upon that assumption. However, if the supervisor believes that GDP will decline by 1% in the next year, the loans will have substantially lower value than that calculated by the bank. If that results in a meaningful deterioration in capital, this judgement may then require the provision of additional capital. The same holds true for real estate loans when the value of a building is based on local vacancy rates and prospects for the coming period. There has always been a subjective element in financial supervision.

No one can forecast the future with unerring accuracy, and the supervisory crystal ball is as clouded as that of the bankers. However, supervisors have one source of information unavailable to the banker – the knowledge of what other bankers in the same market are doing (or not doing). What loans are competitors making? What credits are they shunning? Over time, the supervisory agency will appreciate (and value) the specialized knowledge that a bank may have concerning a particular credit or group of credits. This supervisory conclusion will be based on results. Over time, it will have been noted that a particular bank has been consistently right about a particular credit. So if a bank with an excellent record with respect to a certain credit is refusing to make further loans, while other banks are lending, the supervisor will be alerted to a potential problem. It is then the supervisor’s responsibility to better understand the reasons for the differences in behaviour and to make a judgement concerning the valuation of the loan(s) under scrutiny.
Of course, statistical analysis and loan evaluation will remain an important component of financial supervision. Plus, there is no substitute for on-site supervision – which, when combined with a rigorous system of off-site analysis, provides the supervisor with a multitude of measures. But if the conclusion that supervision will become increasingly subjective is correct, this will require:

- a substantial upgrade in supervisory sophistication and resources in most countries; and
- continued pressure for true supervisory independence, lest the subjective judgements become the playthings of politicians.

In the long run, **Pillar 2 will likely be seen as the most far-reaching of the three pillars proposed in the new Basel Accord.** Pillar 2 requires a meaningful upgrade of the capacity of supervisors in most countries to make judgements that will not always be clear on their face. It will require them to develop assumptions upon which they are willing to act. After all, when an institution is bankrupt, it doesn’t take a rocket scientist to say so. But, in order to prevent bankruptcy and when supervisors determine that management is the problem (more often than not, this is the problem), then pre-bankruptcy removal of all or part of that management team requires a new level of supervisory intervention in many countries. Along with supervisory discretion, supervisors will need to explain their responsibilities to the public far better than many do today. Increased discretion is bound to raise questions, and supervisors should begin to prepare the ground of public understanding now.

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Angela Knight:

Collateral damage to European non-banks: the need to unscramble Basel

About 18 months ago, I said that the Basel Committee’s deliberations would not just affect banks, but that they would adversely impact the securities industry as well. At that time, most people told me I was wrong. But I was not – and, at last, that is now widely recognised. Basel’s proposals, while aimed at stability in the international banking arena, apply to a much wider section of the financial world than just credit institutions. In Europe, the reason for this is that the new Basel proposals (as with the last Accord) are to be incorporated into a revised EU-wide Capital Adequacy Directive - and will then be applied to any financial firm which falls within the Investment Services Directive (ISD) regime. This means that all securities firms - including stockbrokers and all investment management firms (and a significant number of IFAs as well) - that are within the remit of the ISD will be subject to Europe-wide capital requirements, irrespective of their size.

Currently, calculating capital requirements for UK securities firms is simple (at least in theory): three months’ expenses. What is in, and what is out, of the calculation, particularly in volatile times, makes the current formula more complex than this statement implies; but it has worked well enough (particularly since various waivers have also been used to smooth the charge).

However, the current round of Basel will ditch this formula - with a potentially enormous impact on non-credit institutions. As with the banks, the main problem is the proposed mandatory charge for operational risk.

Stockbroking and investment management firms, as we know them in the UK, are essentially mono or duo-line businesses, and the way in which op risk is to be calculated under Basel’s new rules is wholly inappropriate for them. Early in 2001, the Financial Services Authority (FSA) carried out an exercise, using the basic indicator approach outlined in the Basel/EU documents, for 950 firms covered by the ISD regime. The average implied increase in regulatory capital was in excess of 50% - with the least risky firms (the investment managers) seeing the largest increase in regulatory capital, at more than 250%. Capital increases in the stockbroking sector were of the order of 150% - a very substantial increase indeed.

When the standardised approach (the next step up in the level of sophistication) was applied to a number of these firms, not only were there again substantial and unexpected increases, but in some instances the standardised approach actually resulted in a greater increase in regulatory capital than using the basic indicator approach. This is the complete reverse of what was supposed to happen, and we know of no loss experience that justifies it.

One reason for this perverse outcome is that the lines of business which have been assessed as relevant for the purposes of op risk calculations are manifestly too few. Initially, there were only seven - corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, asset management, and retail brokerage. They have now been expanded further. But a bank that is active in all the proposed lines will have a maximum 20% (or, in the latest
proposals, 12%) of its regulatory capital allocated to op risk. To that bank, it is the aggregate amount that matters - and not how op risk is split between various lines. Its op risk requirement will therefore be the same whether retail brokerage gets 5% or 8% of the total (or more, or less). Yet, to the retail brokers this split matters a very great deal as this is their only line of business. In order to apply realistic exposure indicators, it is therefore vital to define explicitly the various permutations of agency broking, principal broking, market-making, and what is happening to settlement and safe custody.

This is complex. For example, there are three separate types of brokerage service - execution only, discretionary, and advisory, though it is not unusual for one firm to do all three (plus associated investment management). Each of these services may involve taking client money, undertaking client clearing and settlement, and looking after client assets. Equally, however, a firm may use the so-called “Model A” approach (where clearing and settlement is subcontracted to a fully-regulated third party, with the firm keeping the market risk and offloading the administrative risk). Or it could use a full “Model B” approach (whereby both market risk and administrative risk are taken on by the third party). All these different regimes carry different risks. For an op risk regime to be appropriate, it would have to recognise these differentials; yet currently it does not. Outsourcing risk implies risk mitigation. Where such outsourcing arrangements are in place, firms must benefit from a reduction in their regulatory capital corresponding to the transfer of that risk.

Equally, there must be a distinction between agency brokers (who act for a client, buying and selling on his behalf) and a broker acting as a principal (i.e. trading on the firm’s own account) – where the risks are much greater. Unfortunately, however, this distinction exists neither in the Basel proposals nor in the EU framework which flows from them.

The point is that, in the brokerage industry, the way firms are structured can be a clear risk mitigator.

Equally, another common practice is the use of insurance. Both the EU and Basel have recognised that insurance has a role – but, again, they are focused only on those credit institutions that use the sophisticated AMA risk analysis technique. This is extraordinary, since it suggests that insurance has a role where risks are high, but not where risks are lower.

Let me put the same point another way. Investment management firms (of whatever sort) fall into one of three categories:

- those that take client money and hold client assets;
- those that take client money, but in which client assets are held by a third party; and
- those that neither take client money nor hold client assets.

Any fair capital regime must recognise these different categories, which materially alter the risk to which firms are exposed.

As it stands, the Basel proposals - which are already enormously controversial in the banking industry (where they were intended to apply) - are a nightmare for the non-banks who operate in Europe under the ISD regime. What should be done? Here is a way forward.
A way forward...

The best solution would be that - since investment and stockbroking firms are not exposed to the same op risk as credit institutions - they should not have a mandatory op risk charge applied to them in the first place.

If, for whatever reason, this is not acceptable, then the Basel regime must be subject to a number of specific modifications:

- There are many small firms in the UK (and elsewhere) who technically come within the ISD and CAD, but whose client base, area of operation and size mean they are never going to use the European “passport”. Thus, a pan-European regime should not apply to them. The realistic way of addressing their regulatory requirements is to devolve responsibility to their home state regulator, and so exclude them from Basel and Commission directives altogether.
- For the rest, industry-specific risk analysis techniques need to be developed for firms that are not credit institutions; they must not be shoehorned into a banking risk regime.
- Risk mitigation, as a result of the way in which a firm operates, must be allowed to reduce its capital requirement.
- The use of insurance to reduce risk also needs to be recognised, and accepted as a risk mitigator.
- In general, any capital charge assessed on non-credit institutions should remain linked to expenditure, the current basis for regulatory capital calculations. It is more stable than income, and so more in keeping with the desire to promote market stability that underpins Basel’s work.
- Quantum and diversification must be recognised. One bargain of £100 carries a much greater risk than 100 bargains of £1. In the first case, if the bargain fails, all has failed; in the second, if a bargain fails then only 1% has caused a problem.

Concern has been expressed that it might be damaging if, in future, non-credit institutions had one capital regime and credit institutions another. The underlying idea should be that no one has an advantage when the same service is being offered by different types of firm. This is fair, but it could be addressed by allowing credit institutions who undertake the same lines of business as non-credit institutions to use the same assessment as the non-banks (should they wish to do so) for that part of their operation.

In conclusion, let me emphasise how important it is that the European securities industry should not find itself at a competitive disadvantage because proposals that were designed for internationally-active banks have been applied too widely within the EU. We need vibrant and competitive markets to serve consumers better in whichever European country they inhabit. Unscrambling Basel is essential if this is to take place.

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Karel Lannoo:

The European policy perspective

In June 1999, when the Basel Committee first released its proposals to amend the 1988 Capital Accord, the discussion paper was cautiously welcomed. The proposals significantly altered the measurement of capital, and were much more market-based. The Committee’s second consultative paper further strengthened this market dimension, by opening the internal ratings-based approach to a larger set of banks than indicated initially. But, at the same time, the level of prescription and detail had grown considerably. The Committee was falling into a paradox of letting the markets play a bigger role in capital adequacy, while at the same time becoming more intrusive about the conditions. A stronger market orientation seemed to give supervisors an excuse to enter deeper into a bank’s internal risk measurement standards. As a result, Basel 2 was undermining its own objectives.

Throughout the 1990s, a consensus built up that the 1988 Accord, while generally positive, had to be reviewed. It was argued that the capital requirement of Basel 1 was not sufficiently market-based, and that it was open to abuse and distortions. The first and second Basel review papers clearly brought this market-oriented element into the calculation of bank capital.

However, the concerns which have been raised suggest that it may now be too market-based, i.e. that it would be procyclical and might aggravate business cycles. Also, the market-based approach is now seen as an excuse for regulators to delve into the banks and control their internal rating models. Moreover, under proposals for supervisory review, regulators will be free to adapt the capital requirement imposed on a bank, depending on its risk profile. Rather than becoming more market-based, the revised Accord may, therefore, become more intrusive and interventionist than its predecessors.

As a result of this controversy, the Committee’s final consultation paper, expected sometime this year, is anxiously awaited. Will Basel add a further degree of complexity, to take all the different comments it has received into account? Will it produce some compromise to alleviate the pro-cyclical elements of the original package? Will the conditions for acceptance of internal rating methods become less intrusive? Will Basel restore the equivalence of the different approaches to measure the level of capital? The answer is almost certain to be even more complexity. But in whose interest will this be?

Increased complexity will reduce transparency; it will obscure the evaluation of capital adequacy, and it will increase the compliance cost of banks. Within a European context, this bodes little good.

The Basel proposals also need to transposed into EU directives, to be applicable in the EU. However, as compared to the first proposals, which were fairly simple and straightforward, Basel 2 will be a nightmare for the Commission, Parliament and Council:

- Following the strategy outlined in the Lamfalussy Report, the European Commission will go for a “framework-type” directive to implement Basel. But that is not so easy. The Commission will first need to decide what is “framework” and what is the detail...
which can be decided by a committee of experts. As experience with the first Lamfalussy directives indicates, the degree of detail in ostensibly framework directives may need to be considerable. Beyond that, the Commission will also need to give enhanced comitology powers to the Banking Advisory Committee, or create a new committee to decide on the technical detail. This is bound to be controversial.

- The Council of Ministers can be expected to take a long time before coming to a common position on any draft directive. Germany’s mittelstand, for example, will lobby hard to ensure that smaller firms are not cut off from bank lending as a result of the new rules. Equally, the City of London will try to minimise the damage to its investment banking community.

- The European Parliament will then be faced with the problem of delivering an opinion on an already complex implementing directive, and on more “comitology” powers. As the Lamfalussy report demonstrated, the latter issue remains a sensitive issue for the EP, and is still not resolved. Furthermore, the Parliament may have a different view on what is “framework” and what is “detail” in a directive.

The end result may be that Basel 2 will become even more complex after Brussels has finished with it than it was already, which will make it even less attractive. Add to this existing problems about a level playing field between the US and EU on the scope of Basel capital rules, and the need for more comparability of supervisory practices across Europe. (That is a contentious area: Pillar 2 could be read as justifying differences in supervisory practices within the EU, while European banks and the Commission actually want more comparability.)

The conclusion from a European policy perspective is simple. Basel should give up the level of complexity that has been developed in the last two years, and should opt instead for a more simple capital standard, which should be as close as possible to the amount of capital that banks would hold in the absence of a government-sponsored safety net. In doing so, regulators would give proof of both their modesty and their insight. And they would considerably ease their job in the years to come.

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Robert Laslett:

SMEs and the Basel Accord

When Gerhard Schröder warns that Germany may block the EU’s adoption of the new Basel Accord because of the implications for mittelstand companies, regulatory detail becomes a major political issue. Why are the German authorities doing this? And are they right?

The obvious arguments would suggest that the German authorities are wrong: either Basel 2 would not cut lending to the mittelstand and their fears are misplaced, or there are unrecognised risks in German banks portfolios of mittelstand loans and arguments for privileged treatment are special pleading which the rest of us should treat with suspicion.

But if we look a bit deeper, the proposed treatment of mittelstand and other SME loans within the new Accord does raise legitimate concerns. For one thing, SME loan performance is possibly the most pro-cyclical of all bank exposures; so it is essential that there is an appropriate treatment of SME capital requirements over the business cycle. And secondly, the new Accord may reduce critical flows of finance to start-up companies, especially in bank-dominated financial systems such as that of Germany, and thus hinder long-term growth.

SMEs always pose special problems for bank regulators. Just as in a competition context, where one has to find out whether they constitute an “economic market” of their own, so in a capital adequacy context, one has to ask whether they can be subsumed into other classes, or whether they are an asset class of their own. And if so, what are their risk characteristics?

Problems arise because SMEs are so diverse, ranging from sole proprietors and “micro-enterprises” to medium-sized firms on the verge of accessing the capital markets.

The smallest SMEs could almost be treated as households, but are individually riskier and more strongly cyclical. Meanwhile, the largest SMEs (on EU definitions) can have a turnover of £25 million, employ hundreds of people, and have professional management with an established track record. They thus appear to pose similar risks to larger corporates. But even they vary a great deal in the extent to which they depend on banks for their external financing. In the UK they have a wide range of alternatives - including asset finance, venture capital, factoring and invoice discounting. But this is not as true in bank-dominated systems such as Germany and Japan. And, even in the UK, it remains the case that bank lending to SMEs is illiquid – it is hard to find buyers for an SME loan portfolio – and even medium-sized enterprises have few places other than banks to turn to for general financing, posing special risks in a business downturn.

The Basel rules do not distinguish SMEs as an asset class: they are all treated either as corporates or as retail lending. Under Basel 1, all corporate and retail exposure had a 100% weighting, and banks were able to cross-subsidise the riskiest of them if they wished. Discouraging this through differential weightings is one of the main aims of the new Accord.

The standardised Basel 2 approach proposes weightings of 20-150%, while the internal

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1 Though the Basel Committee stresses that these numbers are still just hypothetical.
ratings based (IRB) approach could result in weightings anywhere from 14-625%\(^1\). There is, thus, scope for some SMEs to benefit from cutting the weighting on the best (AA and AAA) corporates to the 14-20% range in the way that Basel 2 would allow. But it seems likely that many more SMEs would suffer from raising the weighting on the worst risks (B- and below) to the 150-625% range that Basel 2 would also permit.

Nevertheless, on balance, the standardised approach would impose only relatively minor costs on SMEs. Even if a bank’s entire SME loan portfolio was rated B- and below, and if regulatory capital had an opportunity cost of 5%, the incremental cost of moving from Basel 1 to the standardised approach would only be about 0.2% of the total loan portfolio. The maximum cost would be perhaps 10-20% of the margin on SME lending in the UK, and a somewhat larger proportion in countries like Germany where bank margins are lower. In practice, the cost increase would surely be lower still and, being common across all banks lending to SMEs, would not greatly affect their relative competitive positions.

The IRB approach would, however, increase the costs of lending to SMEs more substantially. Using the same stylised example, the maximum cost of moving from Basel 1 to the IRB approach could be as much as 2% of the portfolio. Again, though, the actual figure would be lower, especially in light of the Committee’s suggestions on November 5 to allow physical collateral and other assets to be used to reduce credit risks. Although there could still be a substantial cost increment for SME borrowers, banks will not be obliged to adopt the IRB approach, and smaller and less sophisticated institutions may be better advised to stick with the standardised approach. As a result, where national regulatory systems allow this degree of flexibility, SMEs should have little to fear from Basel 2.

Another approach is to argue, with the European Banking Federation and some of the major British clearers, that the risk weightings emerging from IRB calculations for corporates are simply too steep for SME loans. One suggestion is that SMEs should be treated along with exposures to households – a relatively uncorrelated asset class - as part of standardised retail exposures.

These arguments apply most forcefully to the smallest of SMEs, and it may well make sense to allow banks to classify such enterprises as a retail exposure, even when loans are not extended on standardised small business terms. This conforms with banking practice. Major British banks for example tend to confine their SME category to borrowers with a turnover of £1 million or less – a far cry from the EU’s £25 million cutoff. Allowing banks to classify these very small borrowers as retail, and consequently to apply a lower risk-weighting, would recognise their different risk characteristics.

But it would scarcely be wise to treat all SME exposures as retail. The slope used by Basel to compute IRB risk weights for corporates assumes an asset correlation of 20%, and in normal times SME loan portfolios do have a lower correlation than this. But, whatever else they do, the Basel rules must be designed to protect the banking system in times of crisis. At times of macroeconomic downturn, correlations tend to rise rapidly towards 100%, and SME loans are no exception. Arbitrarily reducing the correlation to cut costs to SMEs would increase the risks to the banks in times of macroeconomic downturn.

Nor would we favour reducing the IRB requirements on the basis of correlations established only during the relatively tranquil 1990s. Systemic stress often coincides with times of
An alternative approach ...

macroeconomic instability, when SMEs are in distress. The larger SMEs, who account for most of the systemic risk, must continue to be classified as corporate exposures.

Regulators would then have to take an interest in how banks allocated SMEs to their retail portfolio, to prevent their treating medium-sized corporates in this way. UK banks charge more to SMEs for money transmission services than they do to personal customers, and are therefore keen to “graduate” micro-enterprises into businesses. Basel 2 threatens to make them pay a penalty for doing this. If banks sought to classify micro-enterprises as retail for capital adequacy purposes, but as corporates for charging purposes, the competition authorities might suspect they were trying to have it both ways.

While perfectly sensible, these sorts of response to the problems that Basel 2 would pose for SME lending are trying to preserve the old world rather than embracing the new. They help to insulate SME “relationship banking” from the pressure towards formal risk assessments that Basel 2 brings with it. But it is the illiquid character of SME loans that gives them special risk characteristics for both banks and borrowers, and the longer-term goal of public policy should be to make them more liquid, rather than preserve the information monopolies inherent in relationship banking that make them illiquid.

Part of the underlying problem is that banks all have different risk-rating systems for SMEs, so information cannot readily be shared or transferred. Pressure from regulators for more uniform systems would tend to make SME loans more transferable. This would bring benefits both for banks, which would find these assets more liquid in the event of a crisis, and for borrowers, who would not face as intense a “credit crunch” when banks came under pressure. In addition, borrowers would then find it easier to shop around among banks for a better deal, thus improving competition.

In the US, the Small Business Administration has introduced a programme through which banks can effectively sell on the portion of their loans that is certified and guaranteed by the SBA in the secondary market. In the longer term, this sort of approach might also pay dividends in Europe and Japan.

These remedies may allay, but are unlikely to fully assuage, German fears that politically-powerful mittelstand companies would face a much higher cost of borrowing under Basel 2. Had it been introduced in the 1960s or 1970s when the mittelstand was economically strong, one suspects that the Germans would have had few fears about differentiating capital requirements by risk. But they oppose it now, because Germany faces major structural change and the prospect of another macroeconomic downturn.

The structural arguments for protecting SMEs in a downturn are well-known, and would not be fully addressed by treating the smallest enterprises as retail. For example, Joseph Stiglitz and others have argued that - if banks have to cut their risky assets in a crisis to meet their capital requirements - they will inevitably have to reduce their lending to those SMEs that depend on them. This worsens the real effects of financial crises, as happened in Asia in the 1990s. It is obviously important that these structural effects be taken into account in the overall cost-benefit analysis of the Basel proposal.

A compromise formula, one that adequately reflects current risk-management practice with regard to SME lending and that does not overly discourage the supply of bank finance to the
smallest enterprises, can probably be found for Pillar 1 of the Accord. But there are deeper challenges. First, the system has to ensure that the process of supervisory review under Pillar 2 provides appropriate incentives for banks to move forward and embrace accepted standardised approaches to assessing and managing the risks inherent in SME lending. And second, national authorities (like the FSA) must examine the full range of costs and benefits of Basel against a challenging counterfactual to ensure that it is worth its weight.

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The objective of the January 2001 proposals for reform of the 1988 Accord is “to align capital adequacy assessment more closely with the key elements of banking risks and to provide incentives to banks to enhance their risk measurement and management capabilities”.

This sounds fine, but is this objective appropriate? In this note, I explain why the Committee’s goal of increasing the risk-sensitivity of capital requirements is misplaced. With our present state of knowledge, the balance of judgement must be that the best policy is to limit the risk-sensitivity of capital requirements to the standardised approach set out in the January 2001 documents. Internal modelling of risks (the IRB approaches) is best handled within Pillar 2 and Pillar 3 of the new Accord.

To accentuate the positive... The January 2001 documents are an impressive piece of work. The Committee’s proposals are welcome, not least because they will produce a fundamental rethinking of risk-management across the industry. They propose extending the framework of regulatory capital and supervisory review to cover the entire field of bank risk management. They also detail an attractive ‘evolutionary’ approach to the modelling of bank risks intended, eventually, to allow banks to use their own internal methodologies for the computation of capital requirements.

But we cannot ignore the negative... Basel proposes sweeping changes to bank regulation and capital, yet offers no analysis whatsoever of the costs and benefits of capital regulation and banking supervision. In consequence, the Committee fails to address key questions:

- What are the benefits of having capital requirements?
- How large are these benefits?
- To what extent (if at all) do the benefits of capital requirements increase when they are more closely aligned with bank risk?
- What compliance costs are associated with capital requirements (and how rapidly do these costs rise with the risk-sensitivity of capital requirements)?
- What degree of risk-sensitivity of capital requirements achieves an appropriate balance of these costs and benefits?

The absence of any cost/benefit analysis underlies the criticisms directed at the new proposals.

How did the Basel Committee manage to take its eye off the ball to such an extent? This is partly due to a myth. If regulators control capital, it is argued, and if capital is the bulwark against the full range of bank risks, then adequate regulatory capital must reflect bank portfolio

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1 A fuller statement of the arguments of this paper is provided in “Minimum capital requirements and the design of the new Basel Accord: a constructive critique”, Journal of Financial Regulation and Compliance, Volume 9, number 4, 2001, Henry Stewart Publications.
risk. Better alignment of regulatory capital with bank risk must, therefore, be a good thing.

This is plausible, seductive, widely accepted - and wrong. Regulators do not directly control bank capital; banks always seek to hold capital above the regulatory minimum (for a number of reasons, including avoiding regulatory sanction, maintaining a ‘war chest’ for acquisitions and maintaining their standing with credit rating agencies). Thus, what matters when it comes to maintaining the safety and soundness of a bank is the total level of prudential capital, not the regulatory minimum requirement. Fine-tuning regulatory capital to bank risks is, therefore, not of huge importance in reducing the risk of bank failure. What matters is the overall level of capital (regulatory minimum plus the buffer), and this can be appropriately “risk-sensitive” even when regulatory capital requirements are computed on a comparatively crude basis.

A related concern is with “regulatory capital arbitrage” – the adjustment of bank portfolios so as to reduce regulatory capital requirements without a corresponding reduction in bank risk. This is said to have been an important (though probably not decisive) motive for securitisation of US bank assets.

From a conventional perspective, regulatory capital arbitrage is a thoroughly bad thing. If the world’s banks are bent on self-destruction, and minimum capital requirements are the only thing Preventing an implosion of the global financial system, then indeed it is imperative that bank regulators never rest in their efforts to prevent such “distortions” of regulation.

The job of policing the world’s banks is hard enough without inventing such imaginary dangers. The fact is that the great majority of banks (certainly the few score institutions that account for 95% of OECD banking assets) are fundamentally profitable, risk-averse institutions with strong incentives to control their own risk, and little to gain from gross regulatory capital arbitrage. It is the bank’s own risk management and corporate governance that provides the principal bulwark of bank safety and soundness. Capital regulation is only an adjunct to the bank’s own risk-management function. Yes, a few rogue banks do sometimes behave fraudulently. But fine tuning of regulatory capital requirements is no substitute for close supervision of such ‘bad’ banks. Risk alignment does little to deal with the problems of fraud or moral hazard.

The Basel Committee is therefore on the right track when it seeks to promote improvements in risk measurement and management. But its proposals in this area confute regulatory minimum capital and desired capital. There is no reason at all for regulatory capital and desired capital to be computed using the same models. It is perfectly possible for regulatory minimum capital requirements to be risk-insensitive, while overall desired capital can be computed using the most sophisticated modelling tools.

It is true that it proved useful, in the 1990s, to encourage banks to compute regulatory capital requirements for traded assets using their own internal models. There was good reason for this. Standard capital requirements imposed far too high levels of capital against holdings of liquid marketable assets and were a serious hindrance to trading operations. One approach might have been to withdraw capital requirements against these assets altogether, and let banks decide for themselves how much capital to hold. However, regulators took the view that such an approach would leave banks with substantial trading risks over-exposed to a possible systemic crisis. The outcome, in the 1996 (amended) Basel Accord and the EU’s Capital Adequacy Directive, was to require banks to hold a minimum of three times the amount of capital indicated by their own internal models. In practice of course they hold somewhat more than this, again to
avoid breach of the regulations. But this time the issues are different. The overall level of regulatory capital enshrined in the 1988 Accord for general commercial banking is not too high (indeed, the main concern is that regulatory capital is insufficient for typical bank risks). There is no parallel with the mid-1990s.

This raises another issue, yet to be settled amongst risk-management professionals: What is the relationship between ‘economic’ and ‘regulatory’ capital?

Many think of regulatory capital and economic capital (an assessment of capital needs based on internal asset ratings or an internal model of bank portfolio risks) as substitutes. A bank, they would say, must have enough capital to satisfy both its economic and regulatory capital requirements. Therefore the minimum level of capital needed to run a bank is simply the larger of aggregate economic capital and regulatory capital.

This comparison of economic capital and regulatory capital as substitutes is misplaced because it is not a “like-for-like” comparison. Economic capital is a bottom-up measure of relative risk, while regulatory capital is an imposed aggregate constraint.

The principal use of economic capital is for comparison of the relative performance of different banking activities. Which line of business delivers the better return for shareholders, adjusting for the associated risks? The actual practice for calculating economic capital varies between institutions. Ideally, it should be a ‘marginal’ or portfolio-based calculation, but cruder approaches, most commonly internal ratings, are often used. The historical (or expected) return on economic capital can then be applied as an easily understood performance measure. Many major banks now use return on economic capital as a standard performance measure, and incorporate it into their incentive and remuneration schemes.

As already emphasised, a bank needs to operate with some buffer above its minimum regulatory requirement, in order to reduce the risk of a regulatory breach. This is a bottom-up computation, which takes account both of the strategic needs of the bank and the views of rating agencies.

Economic and regulatory capital are, thus, not substitutes. A bank needs to hold the regulatory minimum level of capital plus some buffer. An economic capital model can be a convenient tool for assessing how large a buffer of free capital to hold above the regulatory minimum, but it is not a substitute for that regulatory capital.

How then should the Basel Committee encourage the greater use of formal tools for measuring and managing bank risk? The obvious step would be to invite banks to publish regular assessments of their total capital requirements, using the most appropriate risk management tools for their own institution. Banks which demonstrated a satisfactory track record in assessing their risks (demonstrated by keeping close to their desired level of capital) and which passed a supervisory review of their risk management systems, could then be given a very substantial discount on their regulatory capital requirements, of the order of 20-30%. This would provide an appropriate incentive for the development of effective risk-management tools, without interfering with the practice of risk management or imposing undue compliance costs.

In this approach, the regulatory capital requirements themselves could remain relatively risk-insensitive. This would deal, at a stroke, with some of the principal criticisms levelled against
the January 2001 proposals. Pro-cyclicality would no longer be such an issue; Basel would be considerably less burdensome to implement than the current proposals - and, at the same time, would interfere far less with best practice in bank risk management.

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Robin Monro-Davies:

**Complexity is the price of increased sophistication**

Like many commentators, Fitch has already publicly declared its support for the proposed amendments to the Basel 1988 Capital Accord, commonly referred to as Basel 2. Specifically, the basic thrust of the proposed Accord is to strengthen the relationship between economic and regulatory capital, which should, in turn, improve risk management standards - and, therefore, promote greater financial stability.

However, in order to meet this deceptively simple objective, the proposed Accord is necessarily complex in all but its most simple forms. As a result, it will be expensive to implement and will raise the cost of regulation. The twin factors of complexity and cost will limit, at least in the short-term, the application of all but the most basic aspects of the proposed Accord to large, sophisticated financial institutions with well-developed risk management systems.

In addition, the proposed Accord undermines one of the key attractions of the original, i.e. its simplicity. By developing a basic system for measuring regulatory capital, the original Accord put in place a consistent and relatively robust system that was less open to subjective interpretation by individual regulators for measuring and comparing the capitalisation of banks on a global basis. By contrast, the scope, discretion and flexibility of the proposed Accord mean that transparency could actually be reduced, with capital ratios varying between financial institutions. This would not be due to differences in exposure to risk, but to the different methodologies employed. For example, at the most basic level, the new Accord allows 18 different combinations of methodologies for calculating an institution’s Tier 1 ratio.

The IRB (internal ratings-based) approach is inevitably the most complex part of the proposed Accord since, by definition, it centres on the use of sophisticated credit models for calculating risk-weighted assets (although still more complex portfolio models are not yet recognised). Ironically, the IRB approach was developed in response to pressure from the banks who were anxious to avoid using the standardised approach - and, therefore, becoming reliant on external ratings.

The banks are now faced with the challenge of developing complex credit models based on comprehensive and reliable default and loss data - a task which is probably beyond the majority of financial institutions at this time.

In addition, at face value, use of the IRB approach reflects a move from public to private sector regulation as the authorities effectively delegate their responsibilities for the calculation of credit risk to the banks. However, in reality, the opposite is true. Conscious of the need to maintain a high level of supervision, especially during the transition period from the current regime to the new Accord, the authorities are proposing a rigorous model approval and ongoing supervisory process combined with aggressive disclosure requirements. The regulatory burden on institutions opting for the IRB over the standardised approach, therefore, is actually likely to increase.
In addition, the direct role of regulators in Basel 2 remains crucial. From the model approval process to the control over critical data inputs to the calculation of operational risk haircuts, regulators will continue to have a major effect on regulatory capital requirements. Consequently, given that many of these factors are open to interpretation by individual regulators, there is a significant danger of inconsistencies between different banking systems, even different banks - something which could undermine the Accord’s long held objective of creating a level playing field in global financial services.

Deceptively, the Accord’s proposals on operational risk are currently relatively short. However, this reflects their preliminary nature and the further work and research that needs to be conducted. Also, as a new area of risk, from a regulatory capital perspective, the op-risk issue is proving to be one of the Accord’s most contentious topics. Although the proposals contain a fairly straightforward basic indicator approach (based on gross income), the majority of banks are expected to use the more complex standardised approach, based on business units and appropriate risk indicators, or move to an IRB-type approach. Again, as with credit, the more banks take responsibility for calculating their exposure to operational risk, the more complex the methodologies become.

Given the potential complexities of the new regime, the cost of developing and implementing new risk management systems will clearly be significant.

In order to justify these costs, banks must be incentivised to invest via lower regulatory capital requirements - although, clearly, they should seek to improve their risk management systems regardless of regulatory issues. However, under the initial proposals published in January 2001, it was by no means certain that sufficient capital incentives existed to encourage banks to move to increasingly complex (and, therefore, expensive) regulatory regimes. Indeed, in Fitch’s estimation, most banks utilising the IRB approach would probably end up with a higher capital charge than those using the standardised approach.

Not surprisingly, the Basel Committee, in a June press release, recognised this issue and stated its intention to recalibrate risk weight functions under the IRB approach to ensure adequate incentives. Nevertheless, for the majority of banks, the cost of developing ever more sophisticated and complex credit and risk management models will remain prohibitive, as the compensation resulting from a lower capital charge is unlikely to be sufficient to justify the expenditure. Consequently, while large, complex financial institutions with existing comprehensive risk management systems are likely to utilise the more sophisticated aspects of the Accord, most banks are understandably likely to continue to opt for cost-effective simplicity.

Robin Monro-Davies is ceo of Fitch IBCA, Duff and Phelps, the international rating agency.
The Basel Committee’s proposals, in their latest form, continue to cause problems for the asset finance and consumer credit sector. There is a great risk that the new Accord will cause serious distortions in the market, between different kinds of finance more generally and different providers of asset finance in particular.

Asset finance – leasing and related products which finance business investment - takes security, as the name indicates, in the asset itself. It does not rely on any kind of charge upon the customer’s business. From this simple fact, a huge industry has developed in recent decades. In the UK, for example, members of the Finance and Leasing Association (the major trade body for asset finance) financed 25.1 per cent of fixed capital investment in 2000, excluding property.

This attribute of asset finance has so far not registered in the proposals from Basel, though there are signs that the message is finally beginning to get through. In contrast, real property is already recognised as collateral in the current proposals. This reduces the amount of regulatory capital that is required – and, in consequence, debt backed by property is at a competitive advantage over asset finance since banks’ loan pricing is significantly influenced by the capital required.

There was no sign of any recognition of the significance of asset security in the Committee’s 1999 proposals. In the 600 or so pages that made up the consultation papers released in January 2001, silence still reigned. Only in the paper on ‘specialised financing’, released in October 2001, did the Basel Committee recognise - too briefly, but nevertheless for the first time - that asset security did matter. However, it did so only in the very limited case of operating leases (where the customer takes finance for only part of the economic life of the asset) that rely solely on the value of the asset, as opposed to the customer’s credit. Finance leases – where the customer takes finance for the whole economic life of the asset - continue effectively to be treated as a form of debt (with the notable exception mentioned above, that they are at a disadvantage compared with debt backed by real property).

The failure to recognise the taking of security by asset finance providers potentially affects a very wide range of customers, because of the pervasive presence of asset finance. Of the £23.4 billion of asset finance provided in the UK in 2000, vehicles were the biggest market. Twenty-eight percent of that total financed cars, and 12% commercial vehicles. A further 18% went on plant and machinery, so vital to manufacturing, including inward investment in that sector. Eighteen percent went on equipment of various kinds, for the office, the operating theatre and so on. Since transport is such a hot issue in the UK, it is worth pointing out that asset finance accounted for 68% of transport investment in the UK in 2000. One could go on.

The finance itself is provided by bank subsidiaries, specialist finance houses which are not banks, and finance arms of manufacturers (known in the industry as ‘captives’, though they are not always by any means tied to providing finance just for their owner’s product range). Only bank subsidiaries will be affected directly by the new Capital Accord. To the extent that it
compels tougher provisioning than commercial circumstances dictate, bank subsidiaries will, therefore, be put at a competitive disadvantage compared with non-bank finance houses and captives.

As part of its dialogue with the FSA on the Basel proposals, the FLA has collected data on losses within the asset finance business, going back to 1991 (to iron out cyclical effects as far as possible). Fifteen members responded, including two businesses not regulated as banks in the UK (though one has bank status in the US). Five were able to give a run of data for the whole period. Nine banks gave data for 1996, and all 12 banks gave data for 1997-2000. The 2000 data amounted to 45 per cent of the total turnover recorded by FLA members which provided asset finance in that year.

One key message emerged very strongly: Losses were very low and remained very low throughout the period. Several big ticket finance providers reported that they had never suffered a loss. In only two years did losses exceed 1% of turnover, and in most years they were well below 1%. There was no obvious cyclical effect.

The European trade association for the industry, Leaseurope, has commissioned its own research from an Italian university, covering a number of national markets in Continental Europe. This has produced very similar results.

Against this background, the significance of asset security ought to be recognised in some way in the new Accord. There are a number of ways of doing this. But first the Committee has to demonstrate that it has taken on board the significance of security.

In addition to its treatment of asset finance, the Accord, as currently proposed, has a number of other holes. One of particular relevance is the treatment of business done with small and medium-sized enterprises (SMEs).

There was a real danger in the earlier Basel proposals that provisioning for such business would make it much more difficult for bank-owned asset finance businesses to compete. This is always damaging; but, as the global economy enters a more difficult period, it is particularly inappropriate. It now looks as though the Committee will not provide any detailed thoughts on SMEs until its final proposals, due later this year. This uncertainty is damaging, particularly as the fear remains that SME business will suffer discrimination. Fifty three percent of the new business done in 2000 by FLA providers of asset finance went to businesses with a turnover less than £5 million; 30% went to customers with a turnover below £1 million. So this is a very important point, for asset finance and UK SMEs. Other European countries share this concern.

The way that Basel proposes to treat consumer credit is also a bit of a black hole. This industry’s security lies ultimately in the very large number of customers that are dealt with, and the relatively small exposure of a lender to each individual. The overall risk of default is priced into the finance that is provided. In the Basel 2 proposals, these exposures will be dealt with in the retail category. Discussion papers have been promised, but they have not yet materialised. The FLA hopes that the regulators will publish some sort of consultation paper soon, to allow a genuine discussion before the definitive proposals are published.

A final concern is the European Union. In many countries, banks are supervised under the Basel regime, and that will continue under the new Accord. In the EU, however, a directive
provides for banking supervision. There must be a risk that this directive will differ significantly from the Accord. Both the Committee and the European Commission are making reassuring statements about the need for any new directive to stay in step with the Accord; but the Commission cannot deliver the two arms of legislative authority in the EU, the Council and the Parliament. With the Accord and any implementing directive due to be implemented in 2005, the asset finance and consumer credit sector, like others, faces years of uncertainty. This could be very damaging. The US asset finance industry is dominated by non-banks, which on present prospects could get a considerable competitive advantage from Basel. EU uncertainties (or, worse, distortions in any implementing directive) could exacerbate that.

All in all, there still seems a long way to go in recognising the special attributes of asset finance and consumer credit, despite the late stage of the work on Basel 2. We now believe that regulators are finally listening to the sector. But the jury is still out on whether they will deliver a regime that allows the sector to perform efficiently in the interests of its customers and the wider economy.

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Ray Soifer:

What investors really want to know: thoughts on Pillar 3

Perhaps the most interesting page of the Basel Committee’s latest Working Paper on Pillar 3 – Market Discipline (September 2001) is the one which lists the members of the “Transparency Group” that produced it: twenty-three distinguished ladies and gentlemen, every one a regulator or central banker.

In their own words, “the Committee aims to encourage market discipline by developing a set of disclosure recommendations (and requirements) which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment and management processes, and hence the capital adequacy of the institution.” (Consultative Document, January 2001) Although some of the data came from interviews, how many of the authors were “market participants” themselves, in a position to know at first hand what private-sector analysts and fund managers – the people who really determine a bank’s share price and cost of capital – want and need to know? None.

I hope you will indulge me for a moment as I recite the first article of the Analysts’ Creed: Transparency is good. For many years, I thundered from my then pulpit as a brokerage-house equity analyst that the banking institutions which demand transparency from the countries to which they lend must set a proper example themselves. That said, however, Transparency is good leaves a more important question unanswered: transparency about what?

The Basel Transparency Group assumes that “market participants” – stock analysts and fund managers – will be sufficiently interested in assessing capital adequacy that they will happily sift through the reams of validation data on risk models which the Working Paper’s reporting templates intend that banks provide. While the September document represents some improvement over the even more detailed requirements which the Group proposed in January, this underlying assumption is unchanged. Moreover, the Working Paper goes on to say that in view of further work being undertaken by the Basel Committee, “alternative or additional disclosure requirements may need to be introduced”.

I submit that for analysts and fund managers, assessing a bank’s capital adequacy and the accuracy of its risk models are of only marginal relevance, at best, to their investment decisions. What matters to them about capital and models is not whether they think these are adequate (whatever that means, since capital adequacy is very context-specific: you tell me the economic, market and credit environment the bank will face over the next few years, then I’ll give you my opinion), but rather whether the bank satisfies the requirements of regulators and rating agencies. Failure to do that can have serious consequences for the bank’s shareholders.

Regulators and rating agencies have access to internal data which market participants do not. Hence, from the standpoint of capital adequacy, public disclosure of validation data is largely irrelevant. The people who need to know already have access to the information with which they will formulate the findings upon which analysts and investors have no choice but to rely, since it is those findings, and not the underlying data, which really matter in the end.

Moreover, as Standard & Poor’s explained in its own comments on Basel 2, banks need...
capital to protect against *unexpected* risks, not the statistically expected losses which are normally covered by bad debt provisions and the like. If applied today, the backtesting periods contemplated by Basel 2 would not even cover a garden-variety recession in the US or UK economies.

If market participants have little reason to spend much time on their own assessments of capital adequacy or the historical accuracy of a bank’s models, *what do they care about?* And how should a bank go about meeting those concerns?

Basel 2 is primarily about risk *measurement*. Shareholder value, however, depends upon risk *management*: maximising risk-adjusted return. A sound approach to risk measurement, which the Basel Committee considers in Pillars 1 and 2, is of course necessary for effective risk management; but by itself is not enough. Once you have the information, it’s what you do with it that counts.

Banks are in the business of taking risk. For a given institution, the most appropriate levels and distribution of risks are not zero, but those for which it is best positioned and most capable of managing for optimal returns. Every bank has its own risk management process. For some, this involves highly sophisticated economic capital models; for some, a strong credit culture run by experienced managers; for some, strict limits and diversification policies. The ideal bank would have all of these.

For the bank wanting to maximise shareholder value, even earning a high risk-adjusted return is not enough. Investors must be persuaded to give those earnings a consistently high valuation. That, in turn, requires building understanding and confidence. The right disclosure policy, combined with an effective communication programme, can go a long way towards doing that.

During and after the transition to Basel 2, we are likely to see a major shift in the way in which analysts, and their fund manager clients, evaluate banks’ risk management, comparable to the change which Basel 1 produced in the evaluation of capital ratios. This will provide forward-looking institutions with a unique opportunity to lead the educational process through which this shift in thinking will come about, and thus to help shape the way in which their portfolios and risk management processes will be viewed by investors in the years to come. How should banks prepare for this?

Last year, the US banking and securities regulators commissioned a Working Group on Financial Disclosure, chaired by Walter Shipley (the recently-retired chairman of Chase) and consisting of 11 major banks and investment banking firms: eight leading American institutions plus HSBC, UBS and Deutsche Bank. Unlike the Basel Transparency Group, this was a private-sector body including many of the largest market participants in the world.

The Shipley group recommended that disclosures on credit and market risk should reflect information that is consistent with an organization’s approach to risk management. Disclosures should explain how risk within a firm changes over time, and should evolve with innovations in a firm’s risk management practices. Shipley also recommended that disclosures should balance quantitative and qualitative information and include clear discussions about a firm’s risk management practices.

The Shipley report recommended that there should be as strong a link as possible between
the framework relied upon by senior management to evaluate the risks and returns of the business and the information that is disclosed. Such a linkage provides insight into management practice, financial performance and risk discipline, while also helping to ensure that the information disclosed will be meaningful. At the same time, disclosures need to be easily understood, non-proprietary and based on a mature risk framework.

Shipley went on to note that because well-run firms may have very different, but equally valid, approaches to risk management and monitoring, meaningful comparisons across firms will be difficult to achieve and, indeed, are not as important as presenting the best currently available view of each firm’s risk profile - and, I would add, its risk management process and risk-adjusted returns.

Whatever the Basel Committee eventually decides, such an approach will benefit those banks which do risk management well, with effective programmes to communicate their processes and results to the investment community, at the expense of the rest. Isn’t that what market discipline is supposed to accomplish?

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Lawrence J. White:

Don’t like the “power” of the bond rating firms? Basel 2 will only make it worse

Complaints about the three major bond rating firms - Moody’s, Standard and Poor’s, and Fitch - abound: “They’re too slow to respond to financial deterioration...” “They’re too quick to respond to temporary blips...” “They’re too powerful.”

Maybe they are; maybe they aren’t. But what is never mentioned in this stream of complaints is the web of regulatory protection that heightens whatever “power” the Big Three might otherwise have. And the adoption of Basel 2 will only exacerbate these protectionist tendencies.

Finance and financial markets are riddled with problems of “asymmetric information”: Would-be borrowers know more about themselves and their likely repayment prospects than do prospective lenders. Traditionally, specialist lenders - such as banks and other depositories, insurance companies, and finance companies - have largely relied on their own expertise in assessing potential borrowers and monitoring those who receive loans, although they have sometimes also relied on information collected by credit reporting firms, such as Dun & Bradstreet.

But the less specialized and less knowledgeable lenders in the bond markets (i.e., bond buyers) need all the help that they can get in gathering and assessing the creditworthiness of potential borrowers and then in monitoring borrowers after the loan has been made.

John Moody recognized this need when he first published bond ratings in 1909. Poor’s Publishing Company followed in 1916; then the Standard Statistics Company in 1922 (the S&P merger occurred in 1941); then Fitch in 1924.

In today’s world of ever-more complicated financial structurings, complex derivatives, and rocket scientist-created financial arrangements, the broad expertise and extensive histories of the Big Three bond rating firms would seem to make them a natural choice for that extra help that financial market participants often want.

There is, however, something additional - and less meritorious - that helps support the Big Three’s predominant position as raters in today’s financial markets worldwide: protective governmental regulation. Though this protective regulatory web is little known, it is crucial in protecting the Big Three against significant incursions by entrants into the ratings field. And Basel 2 will only make the problem worse.

I will describe the regulatory morass in the United States, where Moody’s and S&P have their headquarters and the majority of their business (over 70% of Moody’s income arises from its US activities), and where Fitch also has an important share of its business. This US base is an important platform for their worldwide reputations. However, similar protectionism (for them and others) exists elsewhere, and Basel 2 will institutionalize it.

Since the early 1930s, US bank regulators have required banks to pay attention to the rating
firms’ ratings of the corporate bonds held in their portfolios. Insurance regulators followed suit in the early 1940s; pension fund regulators followed after them; and the regulatory requirements for the use of bond ratings across a broad range of financial industries have been expanding ever since. In essence, the regulators have been delegating to the rating firms their safety judgments about securities.

But *whose ratings* should be heeded for regulatory purposes? What would prevent a bogus ratings firm from “awarding” AAA ratings to any firm that paid it a sufficiently high fee?

Surprisingly, that question was not raised until 1975. In that year, the US Securities and Exchange Commission, wanting to apply ratings to broker-dealers’ capital requirements but realizing that the “whose ratings” question had never been addressed, established a new regulatory category: a “nationally recognized statistical rating organization” (NRSRO). NRSROs’ ratings would be the ones that must be heeded in regulatory requirements. The other financial regulators soon adopted the SEC’s NRSRO designations.

The SEC immediately “grandfathered” Moody’s, S&P, and Fitch. It then certified only four new NRSROs over the next 17 years, and has permitted no new entrants since 1992. The four entrants subsequently merged among themselves and with Fitch, so just the original three remain today.

The SEC’s unwillingness to certify new entrants has been bad enough. But in 1997 the SEC threatened to make it worse by proposing five necessary criteria that would near-guarantee an absence of new entrants to challenge the incumbents:1

- national recognition, which means that the rating organization is recognized as an issuer of credible and reliable ratings by the predominant users of securities ratings in the US;
- adequate staffing, financial resources, and organizational structure to ensure that a rater can issue credible and reliable ratings of the debt of issuers, including the ability to operate independently of economic pressures or control by companies it rates and a sufficient number of staff members qualified in terms of education and expertise to thoroughly and competently evaluate an issuer’s credit;
- use of systematic rating procedures that are designed to ensure credible and accurate ratings;
- extensive contacts with the management of issuers, including access to senior level management of the issuers; and
- internal procedures to prevent misuse of non-public information and compliance with these procedures.

Consider the first criterion. It would surely be recognized by Yossarian, the protagonist of Joseph Heller’s *Catch 22*; so would the fourth, since a potential entrant would be unlikely to gain access to management if it is not already an NRSRO.

In addition, criteria two through five represent assessments of inputs rather than an assessment of the output (e.g., efficacy in predicting bond defaults) of an NRSRO. For example,

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1 So as to avoid any sins of paraphrasing, I have used the original language of the SEC.
a potential entrant with a different methodology for rating bonds - say, by using the Black-Scholes option-pricing methodology for estimating default probabilities (as does a small non-NRSRO in San Francisco, KMV) - might be an accurate predictor of defaults, but would surely flunk the fourth criterion (and probably a few others as well).

Mercifully, the SEC has not finalized these proposed criteria. But it is still likely to keep the NRSRO gates closed, and the position of the Big Three will remain entrenched, as the only entities whose ratings can get a company’s bonds into (or out of) the portfolios of banks, insurance companies, pension funds, money market mutual funds, and a host of other regulated financial institutions.

The “standardised” approach of Basel 2 gears minimum bank capital requirements to the bond ratings of its borrowers (if the latter are publicly traded). Thus, Basel 2 will expand the regulatory-driven demand for bond ratings. But whose ratings? Basel 2 recognizes that the reliability of the credit rating firms - it uses the phrase “external credit assessment institutions” (ECAIs) - is crucial for the “standardised” approach to be effective and that bank regulators must certify the ECAIs. Basel 2 specifies six criteria that an ECAI must satisfy:

- **objectivity**: rigorous methodology and historical validity of its credit assessments;
- **independence**: not subject to economic or political pressures;
- **international access/transparency**: assessments available to both domestic and foreign institutions; (the general methodology should be publicly available);
- **disclosure**: both qualitative (e.g., definition of default, time horizon) and quantitative (actual default rates in each assessment category; transition rates from one assessment category to another over time);
- **resources**: sufficient resources to carry out high quality credit assessments, including on-going contacts with the managements of the assessed entities; (assessments to be based on methodologies combining qualitative and quantitative approaches); and
- **credibility**: independent parties’ use of assessments (existence of internal procedures to prevent the misuse of confidential information).

Though Basel 2 is somewhat more sensitive to “output” considerations (e.g., historical validity of an ECAI’s methods) than are the SEC’s proposed regulations, the proposal is nevertheless heavily oriented toward specifying inputs - and thus will tend to favor large incumbents over smaller innovative entrants. Adoption of Basel 2 will raise worldwide barriers to entry into the credit rating industry.

The expanded regulatory use of ratings internationally raises other dangers as well. First, if countries are going to be using ratings for financial (safety and soundness) regulatory purposes, will they be more likely to regulate directly the ECAIs that generate the ratings, so as to yield the rating “quality” that the financial regulators desire? Of course, by setting the criteria for approval, financial regulators are already - indirectly or implicitly - regulating the rating firms; but regulation could well be more direct, explicit, and intrusive.

Further, with respect to ratings of sovereign debt, what happens if a government is unhappy with the rating (or a rating change) of its debt by an ECAI? Will the ECAI’s approval status (which would be important for its ability to rate corporate and other non-sovereign debt) in a
country be contingent on its delivering “acceptable” ratings?

In sum, Basel 2 will surely mean stifled entry and innovation in the ratings field, with heightened protection and entrenchment for incumbent raters - and maybe even some governmental pressures on ratings firms to produce “desired” ratings.

Financial market participants ought to be able to make their own choices as to which rating firms - if any - will help them pierce the “fog” of asymmetric information. Equivalently, the rating firms ought to meet a market test, like any other firm in a market economy. But so long as financial regulators delegate their safety judgments to ratings firms - which Basel 2 will exacerbate - regulators will also have to certify rating firms. And the history of such certification, plus the criteria for certification specified in Basel 2, suggests that entry barriers will be raised, innovative entrants will be discouraged, and incumbents further entrenched and protected.

How can this knot be untangled? The best place to start is at its center: the regulators’ delegation of safety judgments to the rating firms. Though regulators’ use of market information is often to be encouraged, this use has the larger cost of distorting the structure of the ratings industry and the financial markets’ use of ratings.

So, let us propose a radical shift of regime: Regulators ought not to be delegating safety judgments to the ratings industry. The “standardised” approach of Basel 2 should be scrapped. In its place, bank regulators could make their own judgments as to how the characteristics of a borrower’s traded securities - say, spreads and volatility - should affect a bank’s capital requirements. Or bank regulators could adopt a “supervisory” approach that has some of the flavor of the “foundation” or “advanced” approaches: Regulators would ask banks to provide systematic judgments for the risk assessments that they are using for individual assets or classes of assets. Banks’ justifications could include internal systems or reliance on third parties’ judgments, but the latter would also involve the reasons for that reliance (“Rating firm X’s ratings have predicted past defaults with a high degree of accuracy and timeliness...”).

With this withdrawal of delegation, Basel 2 could also scrap its section on ECAIs. Financial market participants could form their own judgments about ratings and raters. Ratings firms would have to meet a market test.

If such a plan is too radical and the “standardised” approach is unavoidable, then certification of ECAIs also is unavoidable. But Basel 2 must then revise its certification criteria so as to stress output (efficacy, accuracy) criteria rather than inputs, and thus leave the door much farther open for meritorious entrants, so that financial market participants will have more choices and incumbents will not enjoy their current protected positions.

I strongly favor the radical shift of regime. John Moody surely would have favored it too. After all, he was also the muckraking author of "The Truth about the Trusts".

Larry White is the Arthur E. Imperatore professor of economics at the Stern School of Business, New York University. He is on the CSFI’s advisory board, and is a former US bank regulator.
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2. “Derivatives for the retail client”: A proposal to permit retail investors access to the risk management aspects of financial derivatives, currently available only at the wholesale level. By Andrew Dobson. Nov 1993 (Only photostat available) £10/$15

3. “Rating environmental risk”: A proposal for a new rating scheme that would assess a company’s environmental exposure against its financial ability to manage that exposure. By David Lascelles. December 1993 £25/$40

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