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Basel 2

The New Basel Accord is an important step in the regulation and supervision of banking markets with significant implications for the development of financial markets and the competitive positions of banks.

Although Basel 2 was designed principally for the largest international banks operating in international, highly developed, financial markets, supervisors and bankers from the Australia-Pacific Economic Cooperation (APEC) economies cannot afford to ignore its key messages and implications.

What are the key messages?

First, Basel 2 has been driven by the ongoing explosive growth in financial market activities of banks and exciting developments in risk management practices. While Basel 2 provides a template for supervision in such a world, it is not an end in itself. Indeed, a major objective and potential benefit is the increased focus on, and incentives to adopt, advanced risk management practices.

Basel 2 should be seen as a means to improve banking sector risk management practices and continue development of robust and safe financial systems. Of, course, implementing Basel 2 is only one of many ways in which national supervisors can achieve those objectives, and for many economies, Basel 2 may, at this stage, involve too large a step to be taken in the near future. Nevertheless, the emphasis of Basel 2 on the principles of improved risk management, effective supervisory practices and the role of market discipline should be acceptable to all banking supervisors. Noticeably, the USA has decided not to implement Basel 2 for most of its banks, largely on the grounds that it believes it is achieving those objectives with its current supervisory and regulatory arrangements.

Important also, and close to the hearts of bankers, is the attempt to make regulation more compatible with efficient banking practices and decision making, in particular, aligning measures of regulatory and economic capital and facilitating more efficient risk-based pricing of credit. The overall economic and social benefits of such developments, through more efficient allocation of credit, should not be downplayed.

Dramatic developments in risk management practices have occurred in recent years driven by theoretical advances in finance and improvements in information technology and systems. Another motivating factor has been the need for improved risk management to cope with challenges resulting from modern financial instruments and markets. This will continue.

It is critical for bankers to recognise that they ignore such developments at their peril. Users of advanced techniques who can identify lower risk borrowers and attract them by appropriate risk-based pricing, will capture those customers. This will leave the risk management Luddites (the non-users) among banks with, unknown to them, poorer average quality customers to whom they are not charging adequate risk-based credit spreads. Longer run poor performance and demise awaits.

The problems for bankers arising from this revolution in the world of risk management are significant, even for those who can see the revolution occurring around them. One problem is that risk management systems can be very expensive. Estimates of the cost of achieving Basel 2 IRB status run as high as US$ 100 million plus. Smaller banks need to find ways of tapping into the improved risk management technology at low cost, even if it does not involve aiming to achieve IRB status.

Unfortunately, Basel 2 has a potential sting in its tail even for those small banks that are striving for best practice without IRB status. The Basel Committee has advocated capital concessions (lower capital charges) for IRB banks as an incentive to encourage banks towards that goal. Laudable as an incentive, the potential dangers it creates for a level playing field are substantial.

What are the risks inherent in Basel 2?

Most importantly, from the banks' perspective, Basel 2 may affect the relative competitive position of banks. I will return to this shortly. Also of concern is the possibility that regulatory compliance costs incurred by bankers will increase. This is clearly the case for banks wishing to achieve IRB status.

The potential for Basel 2 to affect economy-wide flows of funds and cost of capital (borrowing) for different types of bank customers is also relevant. If regulatory risk weight schedules under the standardised approach do not appropriately reflect the true risks, loan pricing and credit availability can be distorted. For example, academic studies have demonstrated that the standardised risk weights in Basel 2 for highly rated corporates are still too high, relative to those for lower rated corporates.

Another important concern is the potential for risk-based capital requirements to have pro-cyclical macroeconomic effects. If ratings decline in a recession, as tends to happen, the capital charges for banks with existing loan exposures to customers with deteriorating ratings will increase. The need to improve capital positions may cause banks to cut back new lending, aggravating the economic downturn.

The risks for competitive equality in banking markets occur at two levels. The first level relates to the competitive position of IRB versus standardised banks in servicing particular customer groups. For some classes of customers, the effective capital charges will differ dramatically between the IRB and standardised approaches, with consequent implications for the loan interest rates different banks must charge to achieve their required returns on capital.

Perhaps paradoxically, this appears to be most apparent in the cases of retail and mortgage lending, where the Quantitative Impact Studies of the Basel

Committee have demonstrated dramatic declines in capital charges for IRB banks.

There are also some interesting possibilities in the business lending area where international competition may see businesses receiving quite different loan pricing from IRB banks, mid to large size US banks operating under Basel 1, and other banks operating under the standardised approach of Basel 2.

Indeed, the US decision to apply Basel 1 to all but the largest banks may have some significant implications for how other countries approach the question of permitted forms of entry of foreign banks. For example, it would appear that a US bank operating as a branch in a foreign country could be subject to US capital regulation and have a 100 per cent risk weight for all corporate lending, while a US bank subsidiary and local banks operating in a country applying Basel 2 standardised approach would have risk weights related to external ratings. The US branch might then have a capital advantage in servicing lower credit quality businesses whose risk weight is 150 per cent. Conversely, its competitive ability in dealing with SMEs where Basel 2 has a 50 per cent risk weight might be weakened.

The second level of risk lies in the Basel Committee proposal that IRB banks have a capital advantage, proposed on the basis of creating incentives for adoption of expensive advanced risk management models to qualify for IRB status. There are some serious questions to be asked about why capital concessions are necessary to induce banks to adopt such value-adding techniques and their effects on the competitive ability of large versus small banks generally.

The potential effects run beyond the banking sector. Capital market (non-intermediated) funding is increasing relative to bank markets worldwide (with the spur to growth often coming from bank securitisation of mortgages). To the extent that risk-based loan pricing based on Basel 2 risk weights does not align well with corporate funding costs achievable from capital markets, the relative roles of banking and capital markets may be influenced. Based on studies of credit spreads and default probabilities in US capital markets, it would appear that highly rated corporates may find capital market funding preferable to bank based funding (from banks operating on the standardised approach) with lower rated corporates finding bank financing more attractive.

As I have noted earlier, changing risk weights may change flows of funds and relative borrowing costs throughout the economy. If the internal risk weights for IRB banks for housing mortgages and retail lending are as low as the Quantitative Impact Studies have indicated, there is the potential for such banks to make significant inroads into those markets at the expense of other banks operating under the standardised approach. It would be quite anomalous if a capital accord developed primarily to suit the sophisticated activities of very large banks in international markets, had the effect of giving them a competitive advantage in the ‘bread and butter’ markets where smaller local banks can, arguably, assess and manage risk equally well.

Finally, Basel 2 pays (quite rightly) particular attention to the risks involved in various types of securitisation and design of appropriate capital charges and supervisory approaches. The effect of such changes on the growth and types of securitisation arrangements is yet to be determined, but the key role of securitisation in developing private debt markets makes this an important consideration for APEC countries looking to develop bond markets.

While there are inherent risks and problems with the New Basel Accord, this does not mean that banks and supervisors in the APEC economies should not welcome it. Rather, that there is much to be done in assessing how the New Basel Accord needs to be implemented in the region to achieve the benefits of a more risk-sensitive capital-based supervisory process. Such implementation may be many years away with the near-term task for supervisors and bankers simply being to establish the preconditions for successful implementation.

These include such things as developing the risk-management skills and capacity within the banking sectors, which is of course one of the objectives of the new Accord. This is not a simple task although skills can be bought and there is much willingness among the international banking community to share risk-management knowledge. However, development of appropriate information and management systems and instilling modern risk-management cultures is a more challenging task.

Indeed, in terms of the longer run goal of banks achieving IRB status, one of the most challenging issues is the development of adequate databases of credit risk and operational risk experience. within the region's financial markets high priority should be given to cooperation between banks to develop economy wide databases capable of testing advanced risk management models.

The other areas that require considerable attention are Pillars Two and Three of the new Accord. Pillar Two places great emphasis on effective supervisory process. It proposes principles such as: supervisory ability to require banks to hold capital buffers above minimum requirements; ability to intervene early; ability to assess bank management capacity; and governance. Whether supervisors in the region have the powers to achieve such outcomes is, however, not addressed in the new Accord. Ensuring that such powers are available is an important part of the preparatory work for Basel 2, and required regardless of Basel 2. Here, differences in the legal systems of countries in the APEC region, with different reliance on civil versus common law, can create special issues for the role of regulatory rules versus regulatory discretion and warrant particular attention.

Similar issues surround Pillar Three (Market Discipline). It will be highly desirable for market discipline to be used as a complement to supervision in inducing improved risk management in banking. The Basel Committee provides a number of recommendations about appropriate disclosures by banks to improve transparency and facilitate market discipline.

Provision of information, however, is not enough of itself to create market discipline. For that to occur there needs to be a significant group of bank stakeholders ‘at risk’, who have incentives to monitor bank behaviour and exert influence on management either through governance arrangements or through the signals sent to management by movements in asset (stock and bond) prices. It is also necessary that bank management respond to those signals.

Again, there is significant scope across the APEC region for institutional changes to be made to facilitate increased reliance on market discipline. It is not clear that in many countries bank stakeholders such as depositors or even bond holders see themselves as being ‘at risk’ given the ‘bail-outs’ and implicit guarantees often given by governments. Often, corporate governance arrangements are weak, so that boards and management are entrenched and thus able to avoid fully responding to stakeholder efforts at imposing discipline. Continued growth of stock and bond markets in the region should be encouraged, particularly through increased issues by banks of capital instruments with risk-sensitive pricing.

One of the areas of significant concern is the ability of bank supervisors in the region to access the resources needed to acquire the skills and expertise to adequately assess risk taking and management by increasingly sophisticated banks. Designing and instituting adequate regulatory funding mechanisms is crucial for effective supervision, and the large costs involved in regulators gaining a proper understanding of IRB systems make this an important agenda item for future capacity building.

In conclusion there is much capacity building to be done in APEC financial markets, which is linked inherently to the gradual implementation of Basel 2. Many important steps have been taken already, and there is a demonstrated willingness to share knowledge and experience. But it is important to remember that these are steps towards the ultimate objective of a safer and more efficient financial system, not just the introduction of a particular template for supervision and regulation. How best to achieve that ultimate objective, and the appropriate way to adapt or adopt the Basel Committee recommendations to achieve that objective, are matters which need ongoing study and discussion by bankers and regulators at both domestic and international levels.

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