Basel II too fragile to cope with modern pressures

The international banking regulation system is under scrutiny, writes **Kevin Davis**.

The global financial crisis has sparked calls for a reassessment of financial regulation — including the need for improved global co-ordination — given the international linkages and spillovers from the US sub-prime crisis in recent months.

Notably, this is occurring while new internationally agreed banking egulations (the Basel II Capital Accord) are being introduced by national regulators.

While the events prompting the ecent financial mayhem occurred nder Basel I, and partly reflect its weaknesses, an obvious question is whether the new accord will inhibit ecurrences.

Probably not, although some of he grosser transgressions of rudent banking practice involving ff-balance sheet activities might be revented.

For example, under Basel I, banks voided capital charges for 364 day ack-up liquidity facilities to onduits and structured investment ehicles (which accessed short-term ommercial paper markets to fund onger-term assets).

Similarly, Basel I capital equirements provided incentives or banks to retain riskier tranches of securitisations on balance sheet, which the new accord seeks to rectify through improved risk assessment.

But it would be unrealistic to place too much hope in the new accord to resolve underlying problems in the financial system identified by recent events.

There are two main reasons: one is weaknesses in the new accord itself; the other is that many problems emanate from outside the banking systems covered by the accord.

On the latter point, the sub-prime crisis and its international ramifications stem as much from the role of non-bank mortgage originators and investment banks who sliced, diced, repackaged and sold credit exposures into world financial markets.

Agency problems resulting from misaligned incentives are most severe when there are major information deficiencies, such as created by complex financial engineering.

Not only have mortgage originators (who are not ultimately exposed to the credit risk created) had no incentive to act prudently, but the sellers and distributors of securities have also been able to, sometimes perhaps unknowingly, pass on excessive risks to underinformed investors.

It is clear that a major challenge facing financial regulators in the modern world of complex financial instruments is ensuring adequate disclosure of risk, and perhaps its fair pricing, which even many creators of such instruments do not apparently understand.

Market discipline, the third pillar of the new accord, based on disclosure and financially literate investors is clearly a fragile pillar. It is also one that government bail-outs of financial markets, regardless of their short-term necessity, tend to undermine.

Also important is improved internal discipline in banks and other financiers. A willingness to provide finance to complex corporate business structures with a lack of clarity regarding risks involved, rather than eschew such possibilities and lose market share, has re-emerged, as memories fade of past experience and the merits of not being a large player in certain markets.

Turning specifically to Basel II, international co-ordination is already a past dream, with the US retaining Basel I, and all of its failings, for all but the largest banks.

But, given the weaknesses exposed in the financial infrastructure that underpins Basel II, that may not be such a major issue after all.

This is because two important actors under the Basel II standardised approach, designed to apply to all but the largest international banks, are the ratings agencies and the credit insurers.

Capital requirements on corporate loans would be linked to ratings given by approved ratings agencies, while credit enhancement of securities by highly rated insurers would reduce capital requirements.

Recent developments (late ratings downgrades and the questionable capital strength of credit insurers) have exposed significant fragility and potential conflicts in these areas warranting review.

But a major concern for prudential regulators emerging from recent experiences is the degree of trust that can be placed in the internal risk management systems and practices of banks.

Under Basel II, capital requirements for credit, market, and operational risk for approved large "sophisticated" banks are based on outputs from these internal models.

Market risk models have long been used with reasonable success, but are most fragile in crises, when liquidity dries up.

Credit risk modelling is a constantly evolving art and sadly lacking in reliable historical data. The failure of models to get within cooee of correct risk assessment of many complex products in which large banks are dealing must give some cause for concern, and it would be interesting to see some "back-testing" results released for public scrutiny.

And as for relying on internal models and practices for capital requirements for operational risk, which includes rogue trading, as they say in France: Nous osons maintenant? (Do we dare to now?).

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