The future for Basel II

With Basel II delayed yet again, will revisions to the capital Accord occur at all? David Rowe says Basel I is the best argument for persevering, but any revisions must address regulatory arbitrage problems and take greater account of the full range of credit risk mitigation techniques

The Basel Committee on Banking Supervision's attempts at making the regulatory capital rules more credit risk sensitive have been widely supported. Much of that support stems from the fact that the current rules fall woefully short in this regard. They were imposed in the late 1980s, primarily to reverse the steady erosion of bank capital ratios. On that basis, the initiative has been successful. But, as always, there have been unintended consequences.

The crude classification of obligors into sovereigns, banks and others (further divided between OECD and non-OECD) bears only the most tenuous connection to comparative credit risk. As a basis for determining aggregate capital requirements, it has performed reasonably well. In most cases, however, this reflects offsetting of over- and under-assessed assets across the bank's portfolio.

Unfortunately, the rules also have implications for asset allocation decisions. Over time, the concentration of assets that are under-assessed by the Basel rules tend to exceed what would be economically optimal at the expense of holdings of assets that are over-assessed. This misallocation of available financing has negative long-term growth implications. It can also aggravate the trend towards disintermediation of financing away from banks and to institutions not subject to the Basel Accord. Closer alignment of the regulatory capital calculations with economic reality would significantly moderate both these adverse effects.

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Analytical complexity and regulatory arbitrage

A significant challenge faced by the Basel Committee is the wide disparity of sophistication and expertise across banks subject to the capital rules. Despite its weaknesses, the current regime is simple enough to be applied quite consistently across all institutions. The crude and risk-insensitive character of the current rules has provided many widely discussed opportunities for regulatory arbitrage. But consistency of the rules has limited opportunities for cross-institutional arbitrage. Such opportunities would increase dramatically under the new rules.

By providing three alternative capital calculation methods, Basel II creates anomalies that do not exist in Basel I. The most obvious of these relates to the treatment of non-investment-grade credits under the standardised approach versus the foundation or advanced internal ratings-based (IRB) approach. In the standardised approach, the risk weight is either 150% for assets below B– or 100% for unrated assets. Under the IRB approach, this weight can run as high as 625%. In this case, there is an incentive to shift such low-quality assets from institutions using the IRB approach to those using the standardised approach, since the latter will incur a lower regulatory capital charge than the former. This occurs despite the likelihood that the bank using the standardised approach will be less sophisticated and less able to manage the risk or absorb the loss of the low-quality asset. Some provision to limit the most serious opportunities for regulatory arbitrage between institutions appears to be necessary.

Risk mitigation and SMEs

Some of the sternest criticism of the Basel II proposal has been levelled by German chancellor Gerhard Schröder, with broad and vocal support from the Bundestag. The key issue relates to the impact of the proposed rules on the availability and cost of finance to Germany's small and medium-sized enterprises (or SMEs). The main problem is the limited recognition given to risk mitigation techniques in all but the advanced IRB approach.

In the standardised approach, recognised collateral is restricted to cash, bonds rated above a minimum threshold, certain equities and gold. Banks that qualify for the advanced IRB approach are allowed to calculate their loss-given default based on a wider set of transaction characteristics, including a wider range of types of collateral. In many cases, especially in Germany, the SMEs are funded mainly by local and regional banks that will find it hard to justify going beyond the standardised approach. Nevertheless, credit mitigation techniques clearly lower the loss-given default of most middle-market loans relative to their unsecured counterparts.

One excellent example of this is analysis submitted to the Basel Committee by ABN Amro Lease Holding (AALH), a holding company affiliate of Dutch banking firm ABN Amro. AALH provides vehicle leasing and fleet management services to corporate clients. As such, it holds a large volume of financial assets secured by autos and trucks. In their comment, they make a strong case that a very conservative loss-given default assumption for such assets would be 30%. This compares with the 50% assumption they would have to use under the Basel II standardised approach. This is almost certainly just one example among many where non-liquid assets, pledged as security, effectively mitigate credit risk by a demonstrable reduction in the loss-given default.

It seems clear that the Basel Committee will have to allow wider recognition of credit mitigants in the standardised approach if the revised capital Accord is to be successful. Such recognition would not only make the rules more appropriately risk sensitive, it would also address at least some of the political concerns driving vocal German opposition to the proposed changes. ■