Forgotten pillars

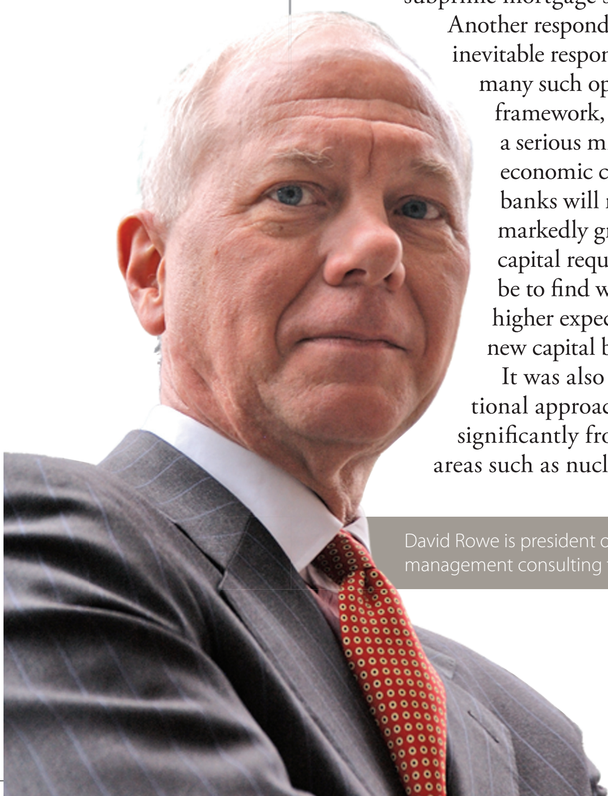
As well as doubling down on complexity, Basel III represents the triumph of Pillar I capital rules and the total neglect of Pillars II and III, ***David Rowe*** *argues*

My column in the December issue of *Risk*, entitled *Basel Faulty*, elicited more numerous and more extensive comments than anything I have written in many years (*Risk* December 2012, page 68, www.risk.net/2228045). Every response I received was supportive of my critical stance but they offered a variety of specific viewpoints.[1]

One recurring theme was that a more complex Pillar I capital calculation is having two effects:

- Resources are being siphoned away from bank-specific risk systems and into prescriptive compliance tasks, preventing institutions working on projects that could improve the quality and timeliness of their risk management.
- It is creating an ever-higher barrier to entry, enhancing the competitive advantage of large, systemically important financial institutions (Sifis).

One correspondent referred to an essay by the economist Thomas Sowell, in which he argues that losses are more important than profits in maintaining a robust competitive system. It is the fear of losses, especially personal losses, that promotes prudence. While such fear offers no assurance against reckless behavior, undermining this motivation through implicit guarantees to Sifis is bound to have deleterious consequences. Trying to replace diminished fear of failure with intrusive and detailed shared rules only promotes the homogeneity that drives correlations higher and makes the industry more prone to systemic crises. Indeed, some Basel capital rules actively encouraged excessive concentrations in questionable assets – for example, Greek government bonds and AAA tranches of subprime mortgage securities.



Another respondent pointed out that arbitrage is the inevitable response to rigid rules. He argued there are many such opportunities in the emerging Basel III framework, encouraging decisions that will result in a serious misallocation of resources and significant economic cost. A third commenter asked how banks will react to regulatory capital levels that are markedly greater than carefully derived economic capital requirements. One possible response would be to find ways to take greater risk – and associated higher expected returns – as a way of justifying the new capital burden.

It was also noted that the traditional distributional approach to assessing risk in finance differs significantly from the approach in other industries. In areas such as nuclear power, chemical engineering, air transport and the military, deep scenario analysis is at the heart of the risk assessment process, consuming a huge amount of time and effort. Such analysis is almost unheard of in finance. It was certainly lacking in the months leading up to the subprime crisis of late 2007 and 2008.

Michael Mainelli argues that Basel I was, in part, intended to open up global competition by minimising "pettifogging rules" that favoured local banks over potential foreign competitors. In contrast, he describes Basel III as a regime that enshrines the status quo, cutting off the opportunity for local and regional banks to grow into viable competitors to the current crop of too-big-to-fail institutions.[2]

One phenomenon that seems to link all these comments is the triumph of complex quantitative procedures over respect for, and reliance on, seasoned professional judgement – or, to put it another way, the triumph of Pillar I over Pillars II and III.

For those who do not recall, the three-pillar approach was introduced with Basel II. The first of those pillars is a minimum capital requirement, calculated in different ways for institutions of differing sophistication. Pillar II is a supervisory review process through which additional capital requirements can be imposed. Sadly, supervisors too often find themselves overmatched when challenging well-paid bank staff about the integrity of their regulatory capital calculations. Only in extreme circumstances do supervisors feel empowered to impose supplemental capital requirements.

Pillar III relates to market discipline and assumes expanded risk disclosures will help keep banks in line by enabling investors to reward or punish institutions on the basis of their risk profile. The utter failure of this effort was revealed vividly by the seizing up of the interbank loan market after the collapse of Lehman Brothers in September 2008. Even the banks themselves were unable to assess the risk of their peers with any real confidence.

Now we are piling ever more onerous and complex regulatory requirements on banks in a vain attempt to reduce the likelihood of failure to zero. The realisation that such a regime could prevent banks from fulfilling their inherently risky role in the economy – intermediating savings to investment and providing maturity transformation services – seems to have been lost.

I will let Michael Mainelli have the last word. He concludes the essay cited above with the following: "Basel IV is overdue, but there must be some surplus Soviet regulation we can use to start composing it." ■

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[1] *Special thanks to Michael Mainelli, Raphael Douady, Bob Mark, Eduardo Canabarro, Joseph Pimbley, John Newman, Fred Vacelet and Oscar McCarthy for extended comments*
[2] *Mainelli M,* Money in a time of choleric: Basel blows the bubbles, *Journal of Risk Finance, 12(4), pages 348–350. Available at:* www.zyen.com/component/content/article.html?id=742