Basel **faulty**

Having been broadly supportive of global bank capital standards over the past 25 years, ***David Rowe*** *explains why the latest iteration of the framework has changed his stance*

Since the mid-1980s, when I left economic forecasting in favour of financial risk management, I have voiced specific criticisms about the details of the Basel Capital Accord, which was first agreed in 1988 and has now reached its third iteration, Basel III. I felt the Basel Committee on Banking Supervision was remarkably late to the party in using dynamic simulation methods to evaluate counterparty credit exposure – a policy change that appeared in Basel II in 2005.[1] I also agreed with the view that, without policy discretion over the 8% capital ratio, Basel II was dangerously pro-cyclical.[2] Nevertheless, I have been broadly supportive of the effort to develop internationally co-ordinated risk management standards and minimum capital requirements for banks. Sadly, I believe Basel III has gone badly astray.

The original accord was developed with one overwhelming goal in mind, namely to force higher minimum capital requirements for banks worldwide. I believe this was significantly motivated by the failure of banks to rebuild their capital ratios in the years following the recession of 1973–74. Without regulatory requirements, competitive pressures appeared to be pushing banks to maintain leverage in the pursuit of higher returns on capital, and the resulting sense of urgency among regulators saw a necessarily simple accord implemented quickly.

While some rough sense of risk sensitivity was considered desirable, this was distinctly secondary to the prime directive of forcing higher capital ratios with minimum delay. For all its faults, Basel I was successful in meeting its central goal. Bank capital ratios rose in the years following its implementation.

By the late 1990s, the limited risk sensitivity of Basel I was seen as a problem. Banks were increasingly motivated to engage in regulatory arbitrage to reduce their required capital ratios even if these actions had little impact, or an adverse impact, on their true level of risk. The basic trade-off in Basel II was to introduce far greater complexity into the capital calculation as the price for making the resulting minimum regulatory capital requirement more sensitive to a bank's actual risk.

It was also believed that more extensive data and analytical requirements would encourage more sophisticated internal risk assessment and better risk control. As the global financial crisis demonstrated, however, such analysis was primarily focused on measuring short-term fluctuations in earnings. Despite occasional rhetoric to the contrary, Basel II tended to divert attention and resources away from less easily quantified structural and systemic issues that could, and did, prove lethal to many firms.

Given the massive societal impact of the global financial crisis, and the role of banks at the heart of that crisis, a serious reconsideration of the Basel framework was inevitable. What then, should we make of the emerging structure of Basel III? Unfortunately, it seems to embody the worst features of both Basel I and Basel II. Where Basel I was conceptually and operationally quite simple, Basel III is massively complex and operationally costly. Whereas the implementation requirements of Basel II could, with careful planning, be leveraged to support improved internal risk measurement, the even more complex requirements of Basel III look increasingly like a dead-weight compliance exercise. Sadly, in a world of limited resources, these costly requirements will divert efforts away from bank-specific activities that would support more effective risk management.

Rather than doubling down on complexity by piling on new and costly calculations, the Basel Committee should recognise the attempt to define a commonly applicable method of risk quantification has been pushed well beyond the point of diminishing returns. Indeed, as some argued before 2008, a broadly applied common method for measuring risk creates a degree of homogeneity that can make a system less resilient in a crisis. It would be far better to preserve only the parts of Basel II that plausibly contribute to more effective internal risk measurement and management. Higher minimum capital requirements can be imposed by simply increasing parameters such as the value-at-risk multiplier.

Beyond this, supervisors should demand that individual bank systems provide a level of risk information consistent with the business they are running. Benchmarks for what is acceptable should be based on systems at banks with a similar strategy and associated risk configuration.

Is this kind of shift in emphasis likely to be forthcoming? Being a realist at heart, I fear not. I strongly suspect that organisational inertia is simply too great. Sadly, focusing almost exclusively on intrusive and complex micro-regulation will not prevent a future crisis as long as institutions that are too-big-to-fail – or that are allowed to fail, more to the point – continue to exist. ■

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[1] *See, for example, Rowe D,* Down with add-ons, *October 2000;* Counterparty risk: let's get serious, *November 2000; and* Frozen in time, *April 2001 in the corresponding issues of Risk*
[2] *See Rowe D,* Basel II and pro-cyclicality, *Risk November 2002 as well as four additional instalments of this column in early 2003*