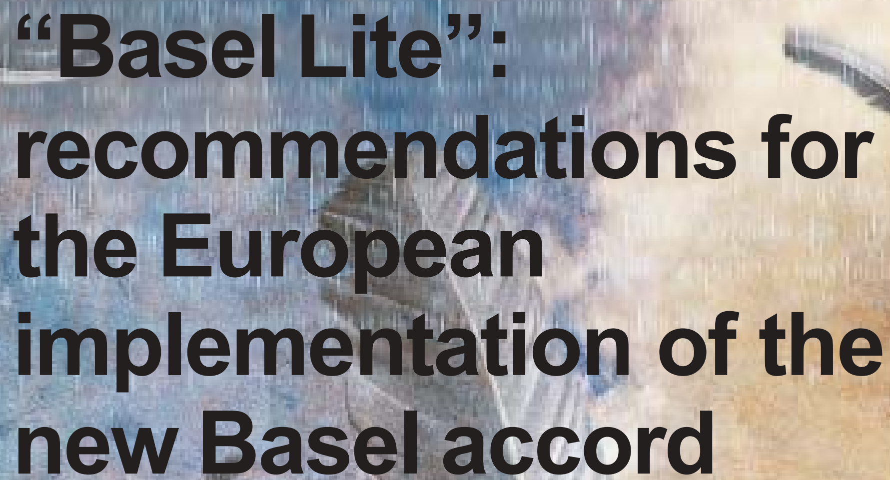

"Basel Lite": recommendations for the European implementation of the new Basel accord

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C S F I

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"Basel Lite": recommendations for the European implementation of the new Basel accord [1]

Alistair Milne, Cass Business School [2]

Foreword

With publication of CP3 imminent, one might reasonably think that it is now too late to consider any fundamental change in what is colloquially known as "Basel 2" – the massively detailed, highly prescriptive and (in the view of many) essentially counter-productive rules on bank capital that have been worked out over the last few years by the Basel Committee on Banking Supervision. And, indeed, that is exactly what the Committee itself says: it is too late for a rethink, so, if you don't want to be left behind come 2006, book your systems engineers now. (After all, retooling for Basel 2 is the kind of event that dwarfs Y2K, perhaps running at over $100 million for even a medium-sized European or US bank.)

But that is not necessarily the case.

It is not just that the Committee chairman, Bill McDonough, is stepping down in the Summer – though that might provide an opportunity to pause for thought. It is – says Alistair Milne in this important paper – also that recent comments by senior regulators in the US make it clear that Europe and the US now have very different conceptions of how to apply Basel 2. For the US, it appears that the intention is to apply it only to the top dozen or so banks; in Europe, it currently appears that the aim is to make virtually all banks (and indeed many non-bank financial institutions) fall under its remit through a new directive (known as CAD3). Unfortunately, says Milne, CAD3 as it stands is even more narrowly prescriptive than the Basel 2 rules that it is intended to implement – which means (he says) that European financial institutions will find themselves at a double disadvantage unless they can wriggle out of the Basel/Brussels corset.

What he proposes is a compromise: "Basel lite", in which CAD3 is restructured such that most of the detail of Basel is relegated to technical appendices that can be amended easily (through the so-called Lamfalussy process). Only the general principles of better risk management would find their way into the main body of the Directive – where they would only be changeable through the cumbersome "level 1" process, which can take years.

This is a neat wrinkle. It takes the best bits of Basel (and there are many) and enshrines them in EU legislation, while leaving those bits which are likely to require frequent amendment (or that could put European financial institutions at a competitive disadvantage *vis-à-vis* the US) in a form which can be changed as circumstances dictate. Given that the drafting of CAD3 is inevitably lagging behind Basel, Milne feels that we have time to promote this kind of compromise – and, for the good of the European financial sector, we probably should.

Andrew Hilton
CSFI

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[1] The author of this paper owes more than the usual debts of gratitude. First to Andrew Hilton, of the Centre for the Study of Financial Innovation, for the original proposal to produce yet another piece on the new Basel accord. Then to the participants in two CSFI meetings held in London during the summer of 2002 to discuss the possibilities of a "lite" version of the accord. These meetings drew in a wide range of practitioners, academics, and policy makers, who voiced their views frankly and off the record about the January 2001 proposals from the Basel Committee and the issues that need to be faced in order for them to be implemented effectively. The drafting has also benefited from subsequent comments offered by Brandon Davies of the Global Association of Risk Managers, Peter Follak, and Geoffrey Wood – but none of these should be assumed to agree with the views expressed in this paper.
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Abstract

The new Basel accord on bank capital adequacy is flawed. Problems include lack of verification, excessive prescription, and inappropriate interference in bank governance. This is why the US is implementing the accord for only a dozen or so banks. A new Capital Adequacy Directive will incorporate the accord into EU law. This paper argues that to preserve the competitiveness of European banks and the safety and soundness of the EU financial system, the articles of the Directive must cover only underlying principles of capital measurement, supervision, and disclosure; leaving all details of capital calculations to easily amended technical appendices.

1. Introduction

Work has been continuing for more than five years on the new Basel accord on bank capital adequacy ("Basel 2"). There is much to commend about the new accord. Much effort has gone into devising risk-sensitive measures of regulatory capital that are aligned more closely with banks' own systems of capital allocation and that reduce incentives to move exposures off-balance sheet. The detailed attention to the modelling of capital requirements, especially the 'internal ratings-based' (or IRB) approach to measuring risk-weighted capital requirements, is having a major impact on bank data collection and risk management. Whether and how the accord is eventually implemented, the new concepts and measures of risk it promotes will have a major practical influence.

Already, Basel 2 isn't working out

Despite these successes the new agreement is not working out as its architects intended. The 1988 accord ("Basel 1"), despite containing only the crudest allowance for risk, has been applied by supervisors, analysts and managers to assess the safety of virtually every bank in every corner of the world. The expectation had been that the improved risk measures of the new accord would find similarly wide application and set new global standards for the assessment of solvency risk. But the US authorities have recently decided that they will apply the accord to only a dozen or so of their largest and most internationally active banks.[3] Most US banks will continue to be supervised and regulated under the provisions of the 1988 accord. The new accord will, therefore, not be the standard for capital and risk management in US banking – and presumably will not be the standard for the rest of the world either.

Even before the recent US decision, it was doubtful whether the new accord provides an appropriate long-term basis for regulating Europe's banks. As documented in Section 3 below, implemented as it stands the accord will absorb substantial supervisory resources, impose high compliance costs on the industry, inhibit banking competition, continue to conflict with many banks' own risk-sensitive measures of economic capital, and introduce inappropriate interference with banks' own governance (substituting a compliance culture for the pursuit of shareholder value). The complexity of the accord also makes it difficult to police and restricts the ability of financial authorities to respond to financial crises, suggesting that it will damage rather than promote bank safety and soundness. The balance of costs over benefits appears clearly negative.

Despite such serious and widespread doubts about the accord, the European Commission has planned that it be fully incorporated into European law through a third European Capital Adequacy Directive (CAD3), with only very limited possibilities of subsequent amendment. In contrast to US plans, this directive will be applicable to all credit institutions in the EU (institutions of all sizes, not just banks but also investment and investment services firms).

European implementation is a particular problem

Even more worryingly, the new accord is to be implemented in Europe with very limited use of the Lamfalussy procedure of enhanced "comitology" – under which technical rules can be legislated at a lower "level 2", subject to subsequent amendment through a committee system. It is abundantly clear that such an experimental regime as the new Basel accord needs to be introduced in a very flexible manner that allows it to be adapted to experience. The maximum use of comitology is required.

Instead, it appears that virtually every detail of the new accord is being considered as political rather than technical, and thus virtually the entire accord will be included as "level 1" legislation.

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[3] See Hawke (2003) and Ferguson (2003).

No matter how badly this serves the interests of the European financial sector, any significant changes to the application of the new Basel accord in Europe will, therefore, require a full process of "co-legislation". This will require at least four years, even after there is political agreement on the need for change. It is difficult to conceive of a worse approach to implementing a complex and untested regulatory regime.

The US decision to implement Basel 2 for only the largest US banks forces European authorities to reconsider. Do they:

1. plough ahead and fully implement the new Basel accord at "level 1" of European law for all banks and investment institutions, cognisant that doing so is likely to disadvantage European banks compared to their US competitors, hinder the development of Europe-wide banking competition, damage the safety and soundness of the European financial system and be extremely difficult to amend even when these flaws become apparent to all?
2. abandon the new accord altogether? or
3. seek some different route to implementation that will allow European banks (and banking markets) to benefit from the new accord, while introducing an appropriate degree of flexibility in its application within Europe?

The second of these options, while involving a clear loss of face to the authorities, is clearly preferable to the first. The issue for discussion is whether there is some third way – a "lite" version of Basel – that is preferable to completely abandoning the new accord.

A "third way" is possible

This paper argues that such a "third way" is possible. The European Union needs to distance itself from the prescriptive recommendations of the Basel Committee. What is needed is to restrict the core articles of the new Capital Adequacy Directive – those which can only be amended through the process of "co-legislation", which takes several years – to statements of the general principles of bank capital regulation, supervisory review, disclosure, and bank governance that can be applied consistently throughout the EU. This is the appropriate area for political debate and discussion. All the technical details, including pretty much everything in the new Basel accord, can then be placed in technical annexes subject to amendment by specialist committees. This will be difficult – politicians will be reluctant to delegate potentially controversial decisions to technical sub-committees. But it is the only sensible alternative to abandoning the accord and reverting to the use of the 1988 accord for all Europe's banks.

How have we ended up in this situation? Such a simple risk-sensitive regulatory capital framework, based on broad principles, was pretty much where the Basel Committee started five years ago, when it sought to develop a replacement for the 1988 accord. But the Committee decided that in order to achieve the desired degree of risk-sensitivity, it needed to develop a complex set of rules and standards for the calculation of minimum regulatory capital (Pillar 1 of the new accord) supplemented by procedures for supervisory review (Pillar 2) and disclosure (Pillar 3).

Why did the Basel Committee avoid the alternative approach of basing calculations of capital adequacy on a small number of core principles, applied across different asset classes and regulatory jurisdictions?[4] This would have avoided the complexity of the new accord and would

[4] See Ward (2002) section 8, for a detailed discussion of the distinction between rules, standards, and principles as applied in banking regulation. Note that the 'other' Basel Committee, on payments systems (the CPC), avoids a rule-based approach and instead recommends general principles for the operation of large value payment systems.

have been relatively easy to adjust in the face of changes in risk management practice. It could also easily have been adopted by supervisors in the US or the UK, who are used to applying supervisory judgement to assess the risk exposure of individual banks.

There is a European performance for "rules-based" regulation

It seems that the objection that persuaded the Committee to propose instead a prescriptive rule-based approach is that, in many European countries, notably Germany, supervisors are accustomed only to applying rule-based supervision and have not in the past applied the same degree of discretionary judgement as their US or UK counterparts. A major reason for this difference in practice is that in Germany citizens and firms have formal constitutional rights that limit the ability of supervisors to exercise such judgement. But this does not mean that supervisory discretion is impossible. In these constitutional regimes it simply requires that regulation be applied with a certain degree of certainty and predictability. In practice, this means that discretionary decisions are possible, but that they must follow internal guidelines set by supervisory authorities. Ironically, it seems that an unwillingness to challenge entrenched European supervisory habits and practice led the Basel Committee to produce an accord that is a highly inappropriate basis for European legislation.

Even a few months ago, the conception of producing a "lite" alternative to the new accord seemed misplaced on pragmatic grounds. It appeared simply too late to direct the Basel train to a new destination. The principles underlying the new accord had come under heavy criticism from many commentators (see for example Danielson *et al*. (2001) and many of the contributions to *Bumps on the road to Basel, CSFI* (2001)), and a number of proposals had been offered as alternatives to the new accord (including Milne (2001), Ward (2002), and Taylor (2002)). But it was also clear that the Basel Committee had no intention of going back to the drawing board and starting its work all over again after five years of considerable effort.

But the recent *de facto* partial US withdrawal from Basel, and the fact that attention is moving from Basel itself to the European Capital Adequacy Directive, now makes it appropriate to return to fundamental issues. Europe will be ill-served if there is not a fundamental rethink about the implementation of Basel in European law. What is needed is to distinguish the principles behind the new accord (principles that deserve to become a permanent part of European banking legislation) from the practical measures developed to apply these principles (measures such as the IRB procedures that will need to be amended in the light of supervisory experience – and so must be restricted to relatively easily amended technical appendices).

2. Recent developments in the Basel process

Costs and benefits of Basel

Is the new accord a cost-effective way of promoting bank safety and soundness? On the positive side, it will create (indeed, has already created) incentives for institutions to improve their systems of data-collection and analysis. For most banks, IRB qualification will require huge changes in the way they collect and organise data. It will also push regulatory capital requirements closer to economic capital and, to the extent that supervisors are able to exercise discretion, should allow different approaches to regulation of different banks (instead of "one size fits all").

On the negative side, it contains a mass of detail some of which may be inappropriate or already outdated. There may also be unintended consequences, including the exacerbation of cyclical movements in bank lending. Beyond that, the accord will place substantial strain on limited

supervisory resources and impose considerable compliance costs on the industry. Many of the more sophisticated institutions are well advanced in introducing their own statistically-based systems of risk management, and following the differing requirements of the new accord may hinder rather than help these efforts. The additional burden of costs and procedures placed on the industry may well also materially reduce competition in banking services – and (so it is feared) reduce the supply of credit to particular sectors, such as smaller business or low income countries.

Efforts to improve the accord and deal with some of these criticisms have continued ever since the release of the second set of consultation papers in January 2001. The Basel Committee is now due to release a third and final consultation paper in May 2003, taking on board the responses to the January 2001 consultation and the outcome of a series of "quantitative impact studies" (QIS2, QIS2.5, QIS3) conducted in 2001 and 2002. Full implementation of the new accord is, thus, anticipated by the end of 2006.

The framework of the accord will be unchanged in the new consultation document.[5] There will continue to be three "pillars". Pillar 1 will specify the calculation of required regulatory capital, offering three alternative approaches. Pillar 2 will set standards for supervisory review. Pillar 3 will establish disclosure requirements, to facilitate market discipline of bank safety and soundness.

Under Pillar 1, there will be a standardised approach, applying the same fixed risk weightings approach as the 1988 accord, but with a somewhat more sophisticated gradation of "buckets" than before. For bank, corporate, and sovereign exposures, the risk weights will now be dependent upon external ratings, where these are available. There will be no distinction between OECD and non-OECD sovereign exposures.

In the industrial countries, most banks of medium or large size will be seeking to qualify instead for the alternative internal ratings approach to computing regulatory capital for credit risk. Under this option the calculation of regulatory capital will vary according to the type of exposure, for instance, corporate, mortgage or retail. Pillar 1 will also include calculations to allow for other categories, such as operational and market risks.

The most significant changes since January 2001 will be in the treatment of operational risk, especially with the introduction of the so called "advanced management approach" (or AMA), whereby banks are given considerable flexibility in their approach to computing capital reserves.

Criticisms of CP2...

The January 2001 consultation document stimulated considerable debate, and some sharp criticism. One of the commonest criticisms was a concern that capital computations under Pillar 1 would be excessively "pro-cyclical". The new consultation paper will, therefore, include two major corrections to mitigate such procylicality:

- The "risk-curve" – i.e. the relationship between the capital charge and the probability of default (PD) – has been substantially flattened for both corporate and other retail exposures.
- Banks are being required to take a "long-run" view when setting internal ratings. This means that, rather like the rating agencies, they will be required to set the internal rating of an obligor at an average level corresponding to their assessment of market conditions over several years ahead, not just a one-year horizon. But, as the experience of rating agencies shows, even such "through the cycle" ratings can be reduced sharply during a recession as views alter about medium to long-run prospects.

[5] An accessible summary of the changes being agreed ahead of the new consultation is given in Jackson (2002).

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- The treatment of defaulted assets has been amended to take fuller account of protection given by specific provisions.

A further common criticism was about the complexity of the new procedures. These have been simplified in important ways, most notably by transferring allowances for credit risk mitigation and calculations for interest rate risk into Pillar 2.

Some of the most politically sensitive proposals in the new accord have turned out to be over the treatment of exposures to small and medium-sized enterprises. In Germany, Chancellor Schröder publicly criticised the new accord for its treatment of SMEs.[6] Responding to this political pressure was a further important reason for flattening the risk curve for corporate exposures, and an additional risk-curve for SMEs is now to be introduced – reducing somewhat the capital charges on small companies that are too big to be treated as retail.

Arguably, this flattening of the risk-curve was appropriate to compensate for the insufficient allowance for diversification of exposures to smaller and medium sized companies in the January 2001 capital weightings. But such a flattening of the risk curve is at best only a crude approximation to diversification. The effects of portfolio diversification can only be accurately captured in the risk-curve in the unlikely situation that all bank portfolios, across the world, are equally diversified for any given comparable level of internal ratings.

In the most recent development, revealed in testimony to Congress by the US Comptroller of the Currency, Jerry Hawke (Hawke (2003)), and the Vice-President of the Federal Reserve, Roger Ferguson (Ferguson (2003)), the US authorities have revealed that the new Basel accord will be applied only to a dozen or so of the largest US banks, together with a small number of other institutions that choose (and are approved for) this relatively sophisticated treatment. Altogether, only some 20 or so US banks are likely to be subject to the new accord. All remaining US banks will apparently continue to be supervised and regulated under the provisions of the old 1988 accord.

This is a major blow against the global acceptance of the new accord. It would have been possible for the US authorities to apply the standardised approach to capital adequacy calculations of the new accord to all US banks (other than the very largest). Hence it was perfectly feasible for the US to adopt the new accord for all banks. By reverting to the 1988 accord, however, the US authorities have clearly signalled that they do not want the thinking or procedures of the new Basel accord applied to the bulk of US banks. At least as far as the US is concerned, this accord is for the big boys only. Therefore, the general expectation that the new Basel accord would have a similar impact to the original 1988 accord, establishing basic standards of bank risk management that could be applied across the globe, will now not be met.

This poses a serious challenge for Europe – does Europe follow the US example and introduce Basel only for the largest banks? Does it plough on implementing Basel regardless? Does it give up altogether? As this paper argues, there is another alternative – Europe can still opt for a “lite” version of Basel. This does not mean throwing away all the hard work of the Committee. But it does mean allowing much greater flexibility than the Basel Committee has ever contemplated and tackling a number of issues that the Committee has entirely neglected. The remaining sections of this paper suggest how this might be done.

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[6] See Laslett (2002).

3. Unaddressed problems with the Basel 2 proposals

The previous section has documented the substantial revisions that are being made to the new accord, in particular to reduce the "pro-cyclicality" of capital requirements and to avoid any reduction in the supply of bank lending to small and medium sized enterprise. Despite these revisions, there remain many problems with the Basel 2 proposals. The European third Capital Adequacy Directive needs to take these into account, not least because the directive will have force of law and, once enacted, will be difficult to amend.

Three such problems are identified here. These are:

There are still problems to resolve

- the lack of procedures for *verification*, both of the measurement of bank capital adequacy under IRB and of qualification for IRB treatment;
- the *excessive prescription* of the accord, creating barriers to competition and increasingly falling behind best practice in risk management; and
- the need to address the consequences of the accord for *bank governance*.

These problems have the potential both to undermine the safety and soundness of European banks and to hamper European banks in global competition with banks from the United States or elsewhere. Requiring European banks to manage risks according to the formulaic approach of Basel 2 potentially leaves them far behind best practice in risk quantification and management. Failures of verification or governance could allow the continued operation of unsound institutions for long periods of time, generating large-scale losses.

Verification

For banks adopting the IRB approach, the computation of the PD (probability of default) and LGD (loss given default) inputs to minimum capital requirements will require both sophisticated calculations and considered professional judgement. These will be the preserve of risk management professionals within the banks. It will no longer be possible for banking analysts or supervisors independently to check the inputs used to compute minimum regulatory capital.

New responsibility, therefore, arises for the review of the key inputs into these calculations. The allocation of this responsibility is not discussed in the new accord. For supervisors to do this alone will place very heavy demands on their resources. It also creates considerable risks for the process of supervision and regulation since supervisors are then taking responsibility for overseeing the quality of a bank's IRB processes. Bank failure always creates considerable political pressure for government compensation of uninsured depositors; but these pressures will be all the greater in the case of the failure of an IRB-qualified bank whose processes have passed supervisory review. Bank management will always be able to justify poor risk assessment on the grounds that this is what the supervisors have required of them.

The difficulty of verifying the inputs to the IRB approach could result in the re-emergence of major differences in capital charges between countries. Recall the motivation for the original 1988 accord. The fear then was that certain regulatory jurisdictions – notably Japan, but also others – were allowing their banks to operate internationally with inadequate capital reserves.[7] US and

[7] The political economy of the 1988 accord is well documented in Kapstein (1994).

UK banks in particular objected to the encroachment on to their markets, while regulators around the world were concerned about the implications of the expansion of undercapitalised institutions for the safety and soundness of the international financial system. A crude but externally verifiable process – the 1988 accord – was thus agreed to prevent further developments of this kind, establishing a “level” international playing field in banking competition and controlling the international expansion of weakly capitalised banks.

If individual national supervisors have sole responsibility for reviewing the inputs, then the IRB approach could undo the work of the 1988 accord. Calculations will suffer from country bias. This can be expected to benefit most banks from jurisdictions where supervisors are prepared to respond most to pressures from their own institutions. Time will reveal the size of these country biases.

Similar questions arise about how IRB qualification will itself be verified. This is where pressures on national supervisors are likely to be strongest, with the temptation to grant their own banks premature IRB qualification so as to avoid the embarrassment of a national “champion”.

Another issue concerns the circumstances under which supervisors would revoke IRB qualification. Qualification cannot be a “once and for all” decision, since bank portfolios change considerably over time. There should therefore be circumstances in which a bank would lose its IRB qualification. But the procedures under which this might happen are not discussed in the new accord. Again, national supervisors may find it difficult to overcome the political pressures associated with revoking the IRB qualification of a major national bank.

Even in the absence of concern about the maintenance of standards for reviewing IRB inputs and IRB qualification, there will still be pressure from banks themselves for clarification of the process. Individual banks will seek clarity – and possibly also a right of appeal against supervisory decision.

<u>There are thus strong reasons for supplementing the role of national supervisors in the verification of IRB capital adequacy</u>. Four possibilities seem to merit mention:

1. “Self verification” by banks of the quality of their own PD and LGD calculations. Here, a possible procedure would be a requirement that all data and procedures for determining PD and LGD be logged. If, in the event of major credit losses, a failure to calculate PD and LGD to professional standards is established, management and/or shareholders would be subject to penalty. This would amount to something like the “pre-commitment” approach that has been widely recommended for computation of capital requirements for market risk. There are problems with such self-verification procedures, but they still represent an attractive alternative to making this a purely supervisory responsibility.
2. An extension of the disclosure regime for IRB calculations: Subject to limitations of commercial confidentiality (which would really only apply to large corporate loans), banks could be required (possibly after some lapse of time) publicly to release all data used for computation of PD and LGD. Were bank analysts or other external commentators able to spot major lapses in these calculations, then the bank would suffer reputational damage. This would place an additional discipline on these calculations.
3. Making verification of Pillar 1 risk measurement a requirement for the external audit of a bank’s accounting statements: Involvement of auditors in the verification of capital adequacy calculations may be a sensible long-term goal. But there are also substantial costs. Risk measurement and the calculation of bank capital adequacy generally use self-standing

databases and systems. Only market risks are integrated with bank accounting ledgers. In the short run, it would be extremely costly to force banks to reconcile their risk data with accounting data, especially since there are currently significant changes required to the way in which financial accounts are structured as a result of the move to International Accounting Standards by the beginning of 2005. Risk measurement under Pillar 1 could not in the short term be subject to external accounting audit; even in the long run this would involve considerable additional compliance costs.

4. "Supervising the supervisors", with international arrangements for reviewing and comparing supervisory decisions in different countries: While it is difficult to envisage such arrangements operating at a global level, such arrangements would be possible within the European Union.

Excessive prescription

The advanced IRB approach, offered in the new accord, is in fact not particularly advanced, lagging behind the procedures already adopted by many major banks. It uses a relatively crude breakdown of exposures (corporate, mortgage, retail unsecured, etc) and fails to allow for diversification of risks among these exposures. It also imposes fixed levels of correlation within each category of exposure that are likely to be inappropriate for many institutions.

The Basel Committee recognises the danger of the accord falling behind best practice in risk management. It states that the accord will be an evolutionary process, moving gradually towards higher standards of risk management. But the capital calculations of the new accord appear to be inconsistent with this aspiration, requiring capital requirements to be calculated according to very specific procedures.

The detailed prescriptions of the IRB approach also threaten to act as a brake on competition. It will be very difficult for IRB banks to take on new categories of exposure, or to expand internationally, because in these cases they will have insufficient data to compute PDs and LGDs. For the same reason, rigorous adherence to IRB treatment will also stifle innovation in new products. It is not possible to have back data on the performance of new products – and these, therefore, will be unable to qualify for IRB treatment.

IRB qualification also threatens to distort the market for mergers and acquisitions. Here, there are two problems. First, it creates a regulatory incentive for large qualified institutions, with the capability to operate the IRB procedures, to acquire smaller unqualified institutions. There is an especially strong incentive to acquire small mortgage banks, since regulatory capital for mortgage books will be very much lower when calculated using the IRB approach than using the standardised approach.

At the same time, IRB qualification will place a regulatory disincentive on mergers between two relatively large diversified institutions, should only one of them be IRB-qualified. In this case, the migration on to a single risk management system will typically take some years and in the meantime the merged institution will have to lose IRB qualification. This disincentive should only apply to mergers between large banks; transitional arrangements could be put in place for acquisition of small unqualified institutions, since in this case migration on to a single risk management system could be achieved relatively quickly.

All these reasons make a strong case for allowing a much greater degree of flexibility in the computation of capital requirements than envisaged in the new accord.

One possibility would be for capital calculations to be conducted for components of bank portfolios, rather than for an entire institution. Thus a bank could choose, as appropriate, to apply standardised, foundation IRB or advanced IRB to different exposures. Such capital calculations would not limit banking competition. They would also result in much less distortion of merger and acquisitions, especially if even small mortgage banks were allowed to apply IRB approaches to their mortgage books.

An objection to such an approach, allowing banks to choose whichever approach they deem appropriate to a particular exposure, is that the bank will always prefer the calculation that yields the lowest level of regulatory capital. But since all acceptable calculations will yield reasonable capital charges, this does not greatly matter. Falling back on the "standardised" computations will typically result in relatively high levels of required capital. And if there were ever a belief that a bank was achieving an inappropriate reduction of capital requirements, then the process of supervisory review could be used to require a more conservative calculation. Allowing banks to choose the calculation that suits them, within broad regulatory bounds, would introduce a highly desirable flexibility to the calculation of regulatory capital.

Aside from potential damage to competition, there are further practical reasons for arguing that it is exposures rather than institutions that should qualify for IRB treatment. There are some substantial segments of bank portfolios where data on past credit performance is very limited indeed. The question then arises as to what proportion of bank assets must have acceptable PDs and LGD estimates, in order to obtain IRB qualification. This issue does not arise if qualification is on an exposure basis. And exposure-based qualification gives supervisors an ability to "fine tune" regulatory capital requirements, offering and withdrawing IRB treatment for particular bank assets depending upon their judgement as to the appropriateness of the resulting capital allocations.

An institution-based approach to IRB qualification also damages bank governance. IRB qualification will then be sought as a demonstration to the outside world that a bank has sufficiently sophisticated risk management to be able to qualify. Failure to qualify will reduce share valuations – and possibly put downward pressure on a bank's credit rating. There will, thus, be substantial commercial pressures on banks to qualify for IRB if they possibly can – and pressures on supervisors to grant that qualification, even if this is not really justified. These biases are removed if IRB calculations are applied on an exposure basis.

Let's look at general principles

A further flexibility, that must surely be seriously considered for the third Capital Adequacy Directive if it really is to be "evolutionary", is the possibility of using alternative methods for computing capital requirements other than those specified by the Basel Committee. This is the only way of making the accord "future proof" – adapting to future developments in best-practice modelling of credit and other risks. But accepting such alternatives would require a shift from a rule-based approach to the application of general principles for the calculation of capital requirements.

<u>What might such general principles look like</u>? They would need to be expressed in terms of reducing the probability of bank default to some required level over a specified time horizon. At the same time, they would have to acknowledge the difficulties of quantifying credit and other non-market risks and allow procedures for assessing default risks even when there is insufficient data to undertake this task with any degree of statistical precision. Professional judgement would play a major role.

Such general principles would, in effect, allow internal credit risk modelling for the computation of capital requirements, much as the accord on market risk allowed internal market risk modelling. Credit risk modelling is still in its infancy; but the decision of the Basel Committee not to countenance credit risk modelling, as an alternative to the IRB calculations, seems short-sighted.

Bank governance

In banks, as in other companies, governance is central. Management is in control, but acts on behalf of the banks' owners, whether these are institutional shareholders (as is now usual across the developed world), private shareholders, customers, or government. Governance – and hence the behaviour of banks – depends upon how powerfully shareholders and other outsiders are able to exert influence on managerial decisions. Audited accounts and other disclosures are key to the ability of outsiders to exert this influence. Finally, internal culture and controls are also a major determinants of corporate behaviour.

Bank governance differs in significant respects from that of other companies. Historically banks have been subject to a much greater degree of state control or regulation than other industries. In the United States, for more than half a century, banks were limited in their ability to create branch networks and prevented from combining commercial and investment banking activities. In continental Europe, and in many emerging markets, a large proportion of bank assets have been under state ownership or backed by state guarantees.

Even private sector banks may follow non-commercial objectives. In some countries – most notably in the *Keiretsu* system of Japan and the *Hausbank* system of Germany – privately-owned banks have maintained close relationships with corporate customers, offering flexibility and terms of lending that might be difficult to justify on purely commercial grounds. In many countries, and especially in particular sectors of business such as agriculture or housing finance, a significant proportion of banks are mutuals owned by their customers. The trend over recent years has been for these non-commercial forms of bank organisation to decline in importance, through privatisation, demutualisation, the breakdown of relationship banking, and diminishing political influence on the banking sector. But non-commercial organisation and goals still remain important.

Bank governance also operates rather differently from that of non-financial companies, whenever capital adequacy or solvency is under threat. Wholesale interbank and debt markets then play a disciplinary role, although this is again very dependent upon the quality of publicly available information and expectations about the response of the authorities. Supervisory intervention is also critical, although this is dependent upon supervisors having the information that alerts them to difficulties. In many episodes of bank failure, the presence of explicit deposit insurance or of an implicit safety net has weakened bank discipline, encouraging high levels of risk-taking – and sometimes the transfer of funds to close shareholders or related parties. The opportunity for this is much greater if there is supervisory forbearance, with supervisors delaying closure or restructuring of the bank and allowing such moral hazard to continue over a period of time.

Finally, internal controls and management culture play a particularly prominent role in banking. Most banks take on a wide variety of risks, and senior management cannot be aware of every exposure. Thus in banks, more than in most companies, there is need for appropriate risk measurement and risk controls, and for these to be applied to all decisions. As a result, much effort has taken place in the banking industry, over recent decades, to substitute appropriate "risk sensitive" measures of performance and control, for simple targets and controls based on the book value of assets.

The new accord has implications for all these aspects of bank governance. This is welcome – and, in the light of recent problems of corporate governance in the US and Europe, timely. Most obviously, Pillar 3 of the new accord seeks to develop a regime of disclosure that will allow debt holders and shareholders to exert greater discipline over bank management. But insufficient attention seems to have been paid to the implications of the other pillars of the accord for bank governance.

Pillar 2 of the new accord lays down principles for discretionary supervisory review, encouraging early intervention in failing banks. But it says nothing about the kinds of penalties that should be imposed on banks in response to a breach of capital adequacy, thus leaving considerable room for discretion. Moreover, since supervisors will retain considerable latitude in interpretation of the term "early", this principle will not be obviously effective at preventing forbearance (delay in supervisory intervention). In the European context, there is a need for clarification of the roles of the authorities when a bank is in difficulties. It is also necessary to ensure that this is broadly consistent across the EU, and that banks in particular countries do not enjoy an excessively generous safety net.

A further European concern arises over the supervisory response to a systemic banking crisis (as opposed to the failure of a single institution). Ultimately, capital is needed to absorb losses. In the event of widespread and large scale losses that threaten the functioning of the financial system, one appropriate response is to allow capitalisation to fall *below* minimum required levels. This allows time for permanent restructuring – including the management of non-performing assets, the provision of fiscal support, and the raising of new external capital. The Basel accord is not legally binding and therefore does not constrain the public policy response to such a systemic crisis. But the new Capital Adequacy Directive will be legally binding. It is therefore of critical importance that it is drafted in a way that does not undesirably constrain the response to a systemic crisis. In particular, it must give authorities the power to authorise – in prescribed circumstances and for a temporary period – bank operation with capital below regulatory requirements.

Even when there are no doubts over solvency, the new accord offers a basis for wide-ranging intervention by supervisors in bank activities. Principle 3 of Pillar 2 states that supervisors should expect banks to operate above the minimum regulatory capital ratios. This gives national supervisors considerable discretion, but no general guidance is given as to how this discretion is to be applied. Principle 1 is more specific – listing a number of risks, other than those captured by Pillar 1 of the accord, that should be taken into account when determining capital levels and outlining procedures for external monitoring and internal review. Finally principle 2 recommends supervisors to keep a general watching brief on the quality of bank capital regimes, taking action when these are unsatisfactory. These, together with the powers that supervisors will have for awarding (and removing) IRB qualification, will enable supervisors – should they so wish – to engage on an active basis in influencing the commercial decisions of banks.

This is not to say that Pillar 2 of the new accord is unwelcome. Pillar 2 is essential for introducing necessary flexibility of the new capital regime. But there is an evident danger that the accord will substitute supervisory review for other disciplines upon bank management and employees. In particular, the principles of the new Capital Adequacy Directive need to address the following issues:

- The new accord risks undermining a culture of risk management based on risk/return trade-offs, substituting compliance with regulatory IRB calculations for the more important risk

management responsibility of providing best possible calculations of exposure to the risk of loss. This is another strong reason for allowing alternative procedures for calculating Pillar 1 regulatory capital requirements. Allowing risk managers to substitute their own calculations for those prescribed by legislation will give back to management the responsibility for introducing the most appropriate system of risk management.
- Principles 1 and 2, in Pillar 2 of the new accord, could be interpreted as suggesting that supervisors should be responsible for assessing the quality of systems of capital management in the banking industry. This is inappropriate. Supervisors do not have the resources to undertake this task – and, in any case, such review is the responsibility of the banks themselves since the principal beneficiaries of such systems are bank shareholders. Again, there is a risk of supervisory intervention substituting for shareholder discipline.

Following principle 2 of Pillar 2, it should be assumed that any bank that is qualified for IRB calculations (or any other acceptable internal calculations) must have an effective system of capital management with appropriate internal control and oversight by shareholders. As in New Zealand, bank management might also be required to attest to the quality of these systems and suffer penalties if they are found to be of inadequate quality. The role of supervisors would then be limited to ensuring that such a system existed, and less supervisory resources would need to be directed to assessing the functioning of such systems.

4.The weaknesses of the proposed third Capital Adequacy Directive

The Commission published a working document in November 2002 (European Commission (2002)), revealing the key features of the Capital Adequacy Directive that will transpose the new Basel accord into European law:

- The new CAD will reflect the principle that ‘the EU capital framework should be revised in a manner that is consistent with the new Basel accord, but appropriately differentiated where necessary to take account of the specificities of the EU context’.
- In common with other EU banking directives, CAD3 will apply to all ‘credit institutions’, including investment firms and investment services firms as well as to deposit banks.
- The Directive will consist of a set of articles and supporting annexes. Both the articles and annexes will be approved by the lengthy ‘co-legislative’ procedure, requiring approval by the European Parliament.
- After the co-legislative procedure, the annexes of the new accord will be subject to the new “comitology” procedure established by the Lamfalussy Committee. These annexes will be at “level 2”, so it will be possible to amend them without the lengthy co-legislation procedure. (Details of how comitology will apply to banking legislation such as the CAD, and the necessary advisory committees to support the process, are currently under consultation.) On the other hand, the articles setting out the mechanisms for calculation of capital adequacy and operation of supervisory review and disclosure will be at “level 1”. Changes to these will not be possible through comitology and will require further co-legislation.
- The Directive will follow closely the new Basel accord. In the working document, basic operation of the standardised, foundation, and advanced IRB approaches are all included in the level 1 articles of the Directive. The level 2 annexes, while lengthy, are restricted to technical definitions and rules (e.g. the precise “risk curves” applied to different categories of exposure).

- The cover letter for the working documents states that “there must be a structure and process to ensure appropriate supervisory consistency and convergence to avoid intra-jurisdictional competitive distortion and regulatory arbitrage”. Title 3 of the working document details how this is intended to work, requiring EU members to introduce legislative changes so as to allow all EU supervisors to apply Pillar 2 of the new accord (supervisory review) in a broadly consistent manner.
- Consultation on the working document was invited until end-January 2003. A final Commission consultative document is planned for the late Spring/early Summer (after publication of the final Basel committee consultation paper). It is intended that the draft Directive should be adopted by the Commission in early 2004, and that the necessary EU level and national legislation should be complete by end-2006 – in time for the world-wide implementation of the new Basel accord.

Basel 2 could be “profoundly negative” for European banks...

The steps taken to promote harmonisation of supervisory review procedures are very appropriate. But this is about all that can be said in favour of the working document. If the final Directive follows the working document in other respects, it will have a profoundly negative impact – both on the competitive position of Europe’s banks and on the safety and soundness of the European financial system.

The Directive, at least as outlined in the working document, fails to address many problems with the new accord, including the problems of verification, of excessive prescription, and of bank governance discussed in the previous section of this paper. Many substantial changes are required to deal with these problems. Problems of verification and bank governance threaten to undermine bank safety and soundness. Hobbling European banks with the excessively prescriptive calculations of Basel, threatens their ability to compete with US and other non-EU competitors.

...thanks to CAD 3

For the accord itself, which has no independent legal force, there was no need to deal with problems such as verification of governance. Indeed, the accord was never intended to be a complete statement about supervisory procedure and practice. But for the new Capital Adequacy Directive, which has force of law and which will be immensely difficult to revise, it is essential that all such problems be addressed. Not to do so will lead to create difficulties for the European financial sector.

This problem is exacerbated because the potential flexibility of Lamfalussy-type comitology procedures is being thrown away by placing far too much in “level 1” articles. They incorporate a large amount of detail about the different methods for computing regulatory capital – details that will become outdated even before implementation in 2006. At the same time, “level 1” contains almost nothing on the general principles of regulation and supervision to be applied across the European Union, principles that might be expected to be applicable for a long period of time.

Little of any importance has been placed in the (relatively) easily-amended technical annexes. If the CAD is passed in this form, it means that Europe will not only end up with largely inflexible bank capital regulation, but it will also be forced to operate under this regulation for the best part of a decade – with no ability to amend the regime to cope with emerging problems. With the US adopting Basel in a far more flexible manner, US banks will be able to gain considerable competitive advantages over their European competitors.

The structure of the proposed Directive is thus entirely unwelcome, both for the European banking industry and for Europe’s citizens.

Rewrite CAD 3

How can this be corrected? The solution is for the new Directive to be rewritten, so that the articles concentrate on a statement of general principle for the setting of regulatory capital, supervisory review, disclosure, and good bank governance. These principles should indicate the role of supervisors and others, and the kinds of penalties or restrictions that might be imposed where an institution becomes undercapitalised or bank governance is seriously malfunctioning. Both the framework and the details of the computation of capital adequacy –whether for market risk, credit risk or operational risk – should be confined to the annexes to the Directive. Only in this way will the necessary flexibility of capital regulation be possible.

Europe now needs to start a process that should have been begun some years ago, alongside the work of the Basel Committee. It is now necessary to discuss and debate the general principles that will support European banking regulation for decades to come. The present paper makes many suggestions, but the main point is the need to develop such general principles in the first place and to ensure that only these are included in the (permanent) "level 1" articles of the new Directive.

As pointed out by Ridley (2003), a general failure of European financial regulatory initiatives, tends to be the absence of any "pre-consultation" on the objectives and general principles of proposed legislation. The result is incoherent law. The most pressing example is the new Capital Adequacy Directive. This is of such importance to the operation of Europe's banks that, even at this late stage, such pre-consultation must be undertaken. If this is not possible without a delay in the introduction of the new Directive, then delay there must be.

5. Conclusions and recommendations

This paper carries a strong message: stop the implementation of the new European Capital Adequacy Directive in its present form, lest it inflict long term damage on Europe's banks and financial system. Introduce instead far more flexible legislation, focussing on general principles of regulation and supervision.

The reasoning is as follows:

1. While there is much of merit in the new Basel accord, it proposes a hugely complex approach to bank capital regulation that will inevitably prove to have many weaknesses and unintended consequences. Amongst the likely consequences are:
   - failure to police capital adequacy, resulting in widespread variations in bank safety and soundness;
   - national favouritism in qualification for the relatively favourable internal ratings-based approach to capital adequacy;
   - the continuation of sharply different regulatory practices across the European Union;
   - inhibition of banking competition – especially the expansion of cross-border banking services;
   - the handicapping of European banks in wholesale markets, especially in relation to US competitors;
   - the creation of a compliance culture focussing on obeying regulatory rules rather than accurate assessment of bank risks;
   - increased regulatory "forbearance" – i.e. slow response to failing institutions; and

- the worsening of systemic crises because supervisors have no ability to allow banks temporarily to operate with below-minimum capital requirements.

2. There is presently considerable variation of supervisory practice across Europe, with some jurisdictions emphasising rule-based regulation with relatively little supervisory discretion and others practising considerable flexibility in bank supervision. Europe needs to follow one approach, presumably that of discretion and flexibility since this will be the only way to achieve broadly consistent practice across widely varying institutional settings. The objective of the new Capital Adequacy Directive, and the subject matter of its permanent articles, must be the establishment of broad principles for bank capital regulation and supervision that can be applied across Europe. All political concerns about the operation of bank capital regulation need to be resolved at the general level of principle.

3. All details of capital calculations (i.e. the entire Pillar 1 of Basel) need to be confined to the relatively easily amended annexes of the Directive. Alternative calculations should also be allowed, subject to supervisory approval.

Some will argue that these are politically unrealistic goals. This may be so; in which case Europe needs to abandon the new Basel accord altogether. No action will be better than implementing the new Capital Adequacy Directive in its presently proposed form.

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The Basel Accords represent agreement of member countries of the Basel Committee on the need and method to strengthen regulation in order to achieve and sustain a sound international banking system. The Accords are designed to satisfy a yearning of industrialized countries for a common framework for the supervision of internationally active banks.Â â€œThe Basel Accord is not a static framework but is being developed and improved continuously. The Basel Committee neither ignores market participantsâ€™ comments on the Accord nor denies that there may be potential for improvement.Â This chapter discusses the new Basel Capital Accord with respect to rating based modeling, probabilities of default, and the required economic capital of financial institutions. On 29 April 2003 the Basel Committee on Banking Supervision (BCBS) issued its third consultative proposals (CP3) on the New Basel Capital Accord asking for comments from all interested parties by 31 July 2003. This note, which benefited from comments provided by the Banking Supervision Committee, contains the contribution of the European Central Bank (ECB) on the matter.Â First, the ECB considers it to be of the utmost importance that the current schedule for finalisation and implementation of the New Accord be strictly followed. A timely finalisation by the end of this year would maintain confidence in the New Accord and the credibility of the process.