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Statement of the Shadow Financial Regulatory Committee

on

The Basel Committee's Revised Capital Accord Proposal

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In January 2001 the Basel Committee issued a revised proposal for replacing its 1988 Capital Accord. The 2001 proposal reflects comments on the Basel Committee's earlier proposed revision, released in June 1999.

The latest proposal, which would become effective in 2004 if adopted by the member country regulators, is more detailed and far more complex than its earlier version. In response to various comments, the Basel Committee has attempted to afford banks more flexibility in complying with new capital standards and to provide banks with incentives to strengthen their internal systems for measuring, monitoring and controlling risk. In addition, the Basel Committee has extended the regulatory framework to encompass operational risk as well as credit and market risk. The result is a scheme that, while seemingly precise, would not be accurate. Given the current, imperfect state of knowledge about risk measurement, the ever expanding variety of financial instruments and risks, and the innovative nature of financial markets, it is impossible to specify a single formula that would provide a credible and robust measure of capital adequacy.

While the Basel Committee has been responsive to many of its critics by making capital requirements more reflective of the ways in which banks assess their own vulnerability to risk, we continue to believe that the general emphasis of the proposal is misplaced. *Although the task of computing the correct economic* *capital for a bank is very difficult and complex, bank capital regulation need not be.* Indeed, greater complexity in bank regulation reduces transparency, and may increase the scope for regulatory arbitrage and regulatory forbearance. The new proposal – as did its predecessor – rests on the view that banking regulators, rather than the markets, are better positioned to set capital levels for banks. The Shadow Committee believes otherwise and continues to advocate a subordinated debt requirement as the best means for disciplining large banks against excessively risky behavior.

The fact that the proposed standards are becoming more complex with each revision, coupled with the long delay in their ultimate implementation, underscores the basic flaw in the Basel Committee's approach. Increased complexity fails to improve accuracy, while it obscures the evaluation of capital adequacy and almost surely imposes needless compliance costs on banks. Moreover, the lengthy process entailed in revising the capital standards highlights the difficulty regulators face in keeping up with past developments, much less with current innovations. Only the market can do that, which is a major reason why this Committee has continued to advocate the harnessing of market discipline – through a subordinated debt requirement – as the best means for assuring bank safety.

Overview of the January 2001 Draft of the New Basel Bank Capital Accord

The new proposal, which, even though incomplete, is described in well over 400 pages, has three "mutually reinforcing pillars": (I) minimum capital requirements; (II) supervisory review of banks' capital adequacy; and (III) market discipline to strengthen capital adequacy. The Basel proposal is in some respects extremely detailed and in others, remarkably vague. It is difficult to convey the scope and extraordinary complexity of the document in summary fashion. Nevertheless, the overall motivation and direction for the proposed reforms is clear: to attempt to mimic the market in disciplining banks while affording banks and their regulators substantial flexibility in specifying and enforcing minimum capital standards.

Several aspects of the old Accord are maintained under the new proposal. The definitions of Tier 1 and Tier 2 capital and the rules limiting their components are unchanged. As the Shadow Committee has noted in Statement 160, the limitation implied by these rules on the use of subordinated debt to satisfy capital requirements may have perverse consequences for bank capital regulation. The requirements continue to be based on accounting data rather than market values, and are thus subject to the existing discrepancies and inaccuracies across national accounting systems. And the Basel Committee continues to insist on a minimum ratio of total capital to risk-weighted assets of 8% without any rationale for why that level is appropriate.

Although the definition of the numerator in the risk-based capital computation remains the same under the proposed guidelines, the proposed risk-weighted denominator is entirely different. The proposal describes two ways to compute capital charges for credit risk and operational risk (which was ignored altogether in the original Accord).

The new proposal provides two new ways to compute capital charges for credit risk, the Standardized Approach and the Internal-Ratings-Based Approach. The Standardized Approach requires banks to allocate their exposures to risk buckets as defined by the regulators. Risk weights assigned to the buckets depend on the identity of the borrower and differ for claims on sovereigns, banks and securities firms, corporations, and retail customers. Claims for sovereigns no longer hinge on a country's membership in the Organization for Economic Cooperation and Development, but instead on the rating assigned by an "external rating agency." It retains from the original draft a difference in risk weights from bucket to bucket that is strikingly different from the difference in risk premiums observed in the market place. It also retains an odd disincentive for borrowers to seek a credit rating, by treating unrated borrowers more favorably than borrowers who receive a rating below B-. (These shortcomings are present for each of the other categories of borrower as well.)

Claims on banks and securities firms may be assigned risk weights in two alternative ways. One places the borrower one category below the rating of the country in which it is headquartered. The other depends on the risk-weighting of the institution (with a floor of 20%). This latter option retains an incentive favoring short-term lending to banks and securities firms for institutions rated below A- but above B-. Many observers believe that a similar bias in the 1988 Accord may have contributed to the vulnerability of several Asian economies to the debt crisis that erupted in 1997. Oddly, banks and securities firms rated BBB+ to B- are given significantly more favorable treatment than comparably rated corporations, thus maintaining, to a lesser extent, a bias toward interbank lending found in the original Accord. In contrast to the original Accord, which placed all corporate borrowers in the 100% risk category, the Standardized Approach recognizes differences in the credit quality of corporate borrowers, as reflected in external credit ratings.

For corporate and retail as well as other loans, the proposal also tries to take into account a range of credit mitigation techniques, including collateral, guarantees and credit risk derivatives, that were ignored altogether in the original Accord. Like the credit risk buckets, risk mitigators are categorized and categories are assigned "haircuts" with an arbitrary minimum floor of 15%. Similarly, the Basel Committee has attempted to eliminate some opportunities for regulatory arbitrage that emerged with the development of securitization, by relating the riskiness of securitization tranches to external credit assessments.

The Internal-Rating-Based (IRB) Approach makes use of banks' own internal risk systems for specifying minimum capital requirements, and sets forth an extensive and often subjective set of minimum requirements for banks to be eligible to use this alternative approach. It has two variants: Foundation and Advanced. The Foundation IRB Approach is available to banks that meet several eligibility requirements, which differ for six different lines of business. Under this approach, instead of relying on external assessments of creditworthiness, the bank is able to use its own estimates of probabilities of default for each borrower. These borrower-specific factors, supplied by the bank, are then combined with supervisory determined estimates of loss given default, exposure at default and effective maturities to arrive at regulatory risk weights.

The Advanced IRB Approach allows banks to place even greater reliance on internal credit systems by using not only their estimates of the probability of default, but also their own estimates of the loss given default, exposure at default and effective maturities. Presumably this will permit the computation of capital requirements that better reflect the risks assumed, but the eligibility conditions for employing the Advanced Approach are even higher than for the Foundation approach.

The proposal also contemplates adjustments for concentration risk. Banks with excessive concentrations of risk to a single borrower or sector will be subject to an additional capital requirement or "granularity adjustment." Banks with very low concentrations of risk will benefit from a reduction in their capital requirement, at the discretion of the domestic regulator.

The Basel Committee has also outlined a similar three-pronged approach to the evaluation of capital adequacy for operational risk, with incentives for banks to invest in better risk management processes to qualify for each more-advanced approach. The Basic Indicatory Approach would involve an assessment that is a fixed percentage of gross income. The Standardized Approach would disaggregate the bank's business into at least six different lines of business with different, yet-to-be-determined risk weights attached to each. And the Internal Measurement Approach would rely in an as yet unspecified way on the bank's own data and modeling of operational risk. The overall assessment for operational risk is expected to represent 20% of the minimum regulatory capital.

The Second Pillar, the Supervisory Review Process, is intended to strengthen capital adequacy standards by validating risk management systems, reviewing internal controls, and assessing whether capital generated by the new approaches is commensurate with banks' risk profiles. The Basel Committee is pressing for all supervisory authorities to have the power to compel the banks that they oversee to hold capital above the regulatory minimum, when appropriate. The Basel Committee also comes very close to, but stops short of, advocating Prompt Corrective Action. It does urge that supervisors intervene at an early stage to prevent capital from falling below minimal levels and require rapid remedial action if capital is not maintained or restored.

The Third Pillar, Market Discipline, attempts to strengthen the role of capital markets in achieving capital adequacy by introducing disclosure recommendations and requirements. These include not only core disclosures that convey "vital information" that is basic to the operation of market discipline, but also disclosure about risk systems and capital adequacy calculations that are intended to reinforce the monitoring efforts of the supervisory authorities.

The Shadow Committee's Response

The vast increase in the complexity of the new Basel standards is not likely to improve the measurement of risk or the maintenance of adequate capital. In fact, in several key respects, these rules would make effective capital regulation less likely. First, under all the proposed capital adequacy rules (the Standardized Approach, the Foundation IRB

Approach, and the Advanced IRB Approach) banks and regulators would be given substantial new discretionary authority to determine the rules that govern the measurement of bank risk, as well as to judge the levels of particular risks within any of the proposed systems of risk measurement. Banks would choose how their risks are rated. Under the standardized approach, they would choose the type of rating agency that would determine their risk ratings. They would also decide whether to opt for the IRB approach.

Domestic regulators would have more discretion over bank capital than under the current standards. Indeed, one could even argue that the Basel standards would cease to be global standards at all. In the area of interest rate risk measurement, regulation is entirely discretionary. With respect to credit risk, domestic regulators would determine which banks qualify for the IRB approach and would set disclosure standards for banks. They also would be charged with the evaluation of the adequacy of internal models and what, if any, penalties to impose on banks whose internal models repeatedly understate their risks. Domestic regulators also would determine what if any additional capital must be held as the result of a lack of "granularity" of the bank portfolio, or excessive concentration of risk in some sectors.

Increased discretion for banks and regulators would likely result in increased opportunities for risk arbitrage by banks and greater potential for regulatory forbearance, both of which undermine effective capital regulation. Regulatory evaluations of bank risk and capital requirements would differ across banks within the same country and across countries, depending on bank choices and differences in the latitude regulators in particular countries grant banks. The number, complexity, and opaqueness of the new rules established under the Basel proposal would add to regulatory forbearance by making it harder to hold regulators accountable for their judgments about bank risk. It is worth noting that American and British regulators currently do not agree even about the appropriate method to measure the probability of loan default using historical data. Given that absence of agreement, the potential for regulatory inconsistency is great.

Second, several features of the new rules would aggravate the arbitrariness of current risk measurement. That is most apparent in the operational risk weight of 20%, a number that lacks clear basis in logic or evidence. The same can be said of the 15% floor placed on risk mitigation. The quantitative matrix that translates (in the Foundation IRB Approach) probabilities of default and loss given default into specific risk weights is also rather arbitrary, and the low risk weight for commercial real estate assets outside the United States is a particularly egregious case of arbitrary, and politically motivated, risk measurement.

Finally, the proposals to increase reliance on ratings for regulatory purposes likely would degrade the quality of information conveyed by ratings. The use of ratings to set risk weights encourages ratings grade inflation, as ratings agencies face strong incentives to relax ratings requirements. And the specific risk weights used in the standardized approach actually discourage some firms from seeking debt ratings, since unrated firms carry a risk weight of 100%, while low-rated firms carry a risk weight of 150%.

Thus, the Shadow Committee sees few benefits, many costs, and many potential risks from the additional complexity of the latest proposals. The presumed reason for the complexity is that the Basel Committee is attempting, at best it can, to mimic what the market should require banks to maintain in the way of minimum capital, taking account of the risks that individual banks take in their various activities. The Shadow Committee agrees that determining the proper level of capital commensurate with the risks taken by a bank is a complex task; but the rules established to regulate the minimum required amount of capital need not, and should not, be complex. Complexity is counterproductive; detailed micromanagement requires both needless inflexibility of rules and, insofar as rules are flexible, susceptibility to manipulation of those rules by banks and forbearance of enforcement by regulators.

Subordinated Debt: A Better Approach

If the objective is – as it should be – to establish a set of rules that ensure a comprehensive, adaptive, and objective measurement of bank risk, and ensure that bank capital is maintained commensurate with that measure of risk, then the only viable alternative is to rely in large part on the *market itself* to provide measurement of risk and (in concert with regulatory enforcement of simple rules such as a leverage ratio) the incentives for banks to maintain adequate capital.

This is why the Shadow Committee continues to call for a mandatory system of subordinated debt, at least for large banks [Statement Nos. 160 and 168]. As set forth in our statement on the Basel Committee's June 1999 proposal, we supported such a mandate as a supplement to the existing Basel capital framework. We continue to adhere to that view.

In brief, our suggested subordinated debt requirement would require applicable banks to back their assets with a certain minimum percentage of long-term uninsured subordinated debt. Holders of subordinated debt would apply the market discipline that the Basel Committee ostensibly wants to harness. The yields on such debt would signal to banks how much risk the market is willing to tolerate, and to regulators when to intervene and prevent banks from taking additional risks. As such, a subordinated debt requirement would supplement and strengthen the system of "structured early intervention and restructuring" or "prompt corrective action" embodied in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

A subordinated debt (SD) requirement has clear advantages relative to the January 2001 Basel proposal:

- The SD requirement is simple and straightforward to implement, compared to the highly complex system proposed by the Basel Committee.

- The SD requirement avoids the long delays associated with protracted investigation and study that are inherent in the latest Basel proposal.

- A related advantage is the SD requirement does not require three more years for national regulators to implement.

- Because it relies on market discipline, an SD requirement, by its nature, adapts to ongoing market developments. In contrast, the lengthy development process entailed in revising the Basel framework underscores how difficult it is for regulators to keep up with constant changes in the markets.

- Market measures of risk are neither arbitrary, nor susceptible to manipulation by banks or regulators, and holders of bank debt have strong pecuniary incentives not to forbear.

- An SD requirement combined with appropriate disclosure avoids the problem of establishing hard rules for measuring subjective or hard-to-quantify risks that are evaluated in the markets on a case by case basis – notably, measuring the extent to which particular securitizations involve the hidden retention of risk by banks, or the extent to which derivatives may fail to mitigate opposing risks on the bank's balance sheet, or the extent to which operational risk is present – all of which are issues of great concern to the Basel Committee, and which motivate many of their complex discretionary standards. Banks that are subject to market judgments about these risks will face strong incentives to manage risk properly.

In the process of developing its recommendations, the Basel Committee succeeded in highlighting the important elements of information that would be relevant for gauging bank risk. Such information should be of great interest both to private market participants and to regulators. If the Basel Committee believes that it cannot rely on the market to produce adequate incentives for appropriate voluntary disclosure, then transforming its 2001 proposal into a plan for mandatory disclosure would be far preferable to its prescribed capital requirements.