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Statement of the Shadow Financial Regulatory Committee on

Would Basel II Have Helped Prevent the Subprime Turmoil?

December 10, 2007

On November 5, 2007 the four U.S. bank regulatory agencies approved the final implementation of the rule to implement the Basel II Accord on Capital Adequacy. Proponents argue that the new approach addresses many of the weaknesses in Basel I that may have contributed to the turmoil in national and international credit markets since July 2007. They claim that Basel I provided a regulatory incentive for banks to securitize mortgages. Mortgages held on the balance sheet were subject to a 50 percent capital charge, while securities backed by mortgages were subject to a 20 percent capital charge. There is no capital charge when mortgages are sold to a special purpose vehicle, such as a mortgage conduit or a Structured Investment Vehicle (SIV) sponsored by the bank, and the bank's contingent support with a short-term line of credit was not subject to a capital charge. Basel II reduces this incentive in two ways: first, it reduces the capital charge for mortgages held on the balance sheet to 35 percent; second, it imposes a capital charge on short-term lines of credit.

Nevertheless, the Shadow Committee believes that the recent turmoil reinforces serious concerns about the very foundations of the Basel II approach that the Committee has raised many times in recent years. Basel II is enormously complex—the implementing rule is 629 pages. It attempts to

make regulatory capital charges more sensitive to risk in one of two ways: reliance on external credit ratings issued by the ratings agencies, or reliance on internal ratings based on the bank's own risk models. The Committee has criticized these procedures for their prescriptiveness and conceptual shortcomings (Statements No. 160, 169, 179, 223, and 238). Both approaches have additionally been called into question as a result of the recent financial turmoil.

The ratings agency methodology appears to have been fundamentally flawed with regard to securitized subprime mortgages. The credibility of these ratings has been undermined by frequent and large downgrades, affecting even the highest-rated tranches of claims on some securitization vehicles.

At the same time, internal models employed by some of the largest and most-sophisticated market participants have failed to track risk accurately. These models appear to have systematically underestimated the risks inherent in complex securitizations and have led to large losses and substantial downward revisions of earnings.

In addition, the turmoil has highlighted two risks that are not adequately addressed in Basel II: liquidity risk and reputation risk. Several special purpose vehicles experienced losses due to liquidity risk when they were forced to sell some of their assets at fire-sale prices when doubts arose about the reliability of ratings and holders of their maturing short-term liabilities would not renew their funding. Reputation risk surfaced when some leading institutions rescued their off-balance sheet entities, even though they were not contractually obliged to do so.

Finally, the turmoil has accentuated the importance of maintaining a minimum leverage ratio limit as part of prudential capital regulation. Although the debate about value of the leverage capital ratio continues among regulators, the markets appear to focus on the leverage ratio as the primary indicator of financial strength rather than risk-weighted regulatory capital ratios.