Comments on Basel Committee's discussion paper "The regulatory framework: balancing risk sensitivity, simplicity and comparability"

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The Basel Committee's interesting paper referred to in the title above discusses key issues related to the safety and soundness of banks, providing insightful views about every one of them. While mostly agreeing with the paper's main premises and conclusions, I wish to suggest that there might be room for some added precision in the discussion of some concepts, as I argue below.

The paper appropriately refers to the multidimensional character of risk, but some statements seem more consistent with a one dimensional characterization of risk. For instance, when discussing "comparability", the paper states that a "capital framework achieves *perfect comparability*" [if] "two banks with portfolios having identical risk profiles apply the framework rules and arrive at the same amount of risk weighted assets, and two banks with different risk profiles should produce risk numbers that are different proportionally to the differences in risk." (Page 3)[2]

It is evident that two banks with identical risk profiles should arrive at the same value of risk weighted assets, and consequently at the same amount of required capital. But two different risk profiles may produce the same risk weighted asset value and hence the same capital requirement, if for instance one profile is riskier in one dimension, and less risky in another. Also, since risk is multidimensional it is not clear how "proportionally" should be interpreted in this context.

Still on the question of risk, the paper discusses the idea of "ex post risk sensitivity" stating that "a standard is risk sensitive if, other things being equal, it can distinguish with reasonable accuracy between sound banks and those that are likely to fail. Risk is of course unobservable, hence, this type of risk sensitivity can only be accurately assessed ex post" (Page 4)

It is not clear what is meant with ex-post risk sensitivity. Risk may in principle be calculated in some situations, let's say as a probability distribution of events and associated losses. When events materialize or fail to materialize, there is no uncertainty anymore and hence no risk, only the occurrences. Ex post facto one cannot assess whether a risk had been properly assessed just because event B occurred and not any of the other possibilities. A good bet may very well result in a loss, and a better capitalized bank can still fail while a less well capitalized may not.

One of the interesting ideas discussed in the paper is the relation between precision and complexity in risk calculation, where the search for the first has too often led to an excess in the second, with more harm done than good. Clearly in general there is no simple way to calculate risk precisely; hence this is a trade-off that banks and regulators have to live with. But the implications of this observation on comparability and governance are worth considering.

[1] The views expressed in this note are the author's, and do not represent those of the World Bank, or FIRST donors.
[2] All quotes below are from the Basel paper.

“To the extent that a degree of complexity achieves much more accurate risk measurement, it is an investment worth making. In practice, however, not all the aforesaid benefits may be fully achievable. In the Committee’s view, therefore, there may be scope for reducing the complexity of the capital framework without altering its overall rigour so as to improve the balance between simplicity and risk sensitivity, and to enhance comparability. In particular, the Committee’s focus is on undue complexity”. (Page 10)

The fact that often complexity hasn’t paid is not a reason not to pursue it when a “more accurate measurement” will be achieved. A different argument for avoiding complexity is to try to strike a better “balance between simplicity and risk sensitivity”, a goal that may be worth pursuing but one which will probably have a cost in precision. Even risks associated with apparently simple operations may be complex to truly calculate, and hence complexity cannot be ruled out a priori.

“Comparability of capital across banks and over time is an important attribute of a sound capital adequacy regime” (Page 12). One may question, though, if comparability across jurisdictions is relevant or even possible. Does it really make sense to compare let’s say a bank operating 20 American states with another operating in 20 African countries? The differences in the nature of risks, quality of data available to estimate those risks and the resulting imprecisions are such that a meaningful comparability seems rather difficult to achieve.

Back to risk, the paper states that “A bank’s board and senior management may, at times, find it challenging to fully understand the risk profile of a bank’s underlying risk profile and, as a result, the key drivers of the capital framework, even though the public has a legitimate expectation that they have that ability, and they are under a legal obligation to do so. This can impair bank’s risk management and impact the ability of the board and senior management of a bank to ensure that the bank has adequate capital to support its risks.” (Page 11)

No doubt, an undesirable consequence of complex risk calculations is the challenge posed by these calculations to senior management to “fully understand” the underlying risks of the bank. One may ask, though, what it means for a person to fully understand a risk profile? Should we not distinguish between understanding the calculation on one hand, and understanding the implications of the results of that calculation in terms of exposures to events, etc. on the other? Should board members be expected to fully understand the technical intricacies of the risk calculation of a portfolio of complex instruments? Probably not.

About transparency, the paper says that “One of the fundamental problems to have emerged in recent years is the difficulty that investors face in comparing risk-weighted assets across banks and over time. The most direct way of tackling this problem would be to improve transparency: that is, to give investors the information they need to make such comparisons, including the drivers of changes in risk-weighted assets, and especially those affecting risk-weighted assets derived from internal models.” (Page 14)

The difficulty pointed out is real enough, and full disclosure should by all means be promoted. However, full disclosure doesn’t guarantee equal and general investor understanding. The idea

that investors will always be able to see -or see the same thing- through a mass of complex information is a sort of illusion. There are challenges posed by complexity that full disclosure will not solve. Chess is an extreme case. It is perfectly transparent to all, but better players will see threats and winning moves where others will only see chessmen. Simplicity, desirable as it may be, should not be demanded. The clock cannot be turned back on financial development.

The financial world has still not overcome the trauma of the recent crisis, and since so many of its causes have been attributed to the complexity of instruments, there is a tendency to overvalue simplicity. All other things being equal, simplicity might be better than complexity (except perhaps for those seeking intellectual challenges as a sport) but simplicity is not a variable that can be arbitrarily set by markets or regulators.