

My comments on the Basel Committees' consultative document "Revisions to the Standardised Approach for credit risk".

March 27, 2015

Sir, I object the whole document "Revisions to the Standardised Approach for credit risk", on account that it does not yet acknowledge, much less correct, the most fundamental mistakes with the whole approach of setting bank equity requirements based on credit-risk weights.

The mistakes I refer to and that I would briefly like to point out are:

1. When referring to the "probability-of-default estimates" of borrowers and assets... it ignores that bank already manage and clear for these perceived credit risks, and so that these probabilities have little or nothing to do with the probabilities of a bank having problems.

Again, the regulator has no business looking at the basically the same credit risks bankers are seeing and clearing for through interest rates, size of exposure and other terms. The regulator should look at the risk of banks not perceiving the credit risks correctly or not managing these correctly. If you do so you can empirically establish that all major bank crises are derived from excessive exposures to what has been erroneously perceived as safe, and not from what has been correctly perceived as risky. And, in this respect, the realities would point 180 degrees in the opposite direction... higher equity for what is perceived as safe.

2. The regulator has not considered that allowing banks to leverage their equity, and the support they receive from taxpayers, differently depending on the perceived risk of the borrower/asset, introduces a violent distortion of the allocation of bank credit to the real economy. This because it allows banks to obtain different risk-adjusted returns on equity that what would have been the case without this regulatory distortion.

In the medium and long term, in an environment where bank credit is misallocated, there will be no safe banks. In a game of roulette, every bet has exactly the same expected value, and that is why the game works and survives. Changing the payout rates in roulette, by using something like your risk-weights, would crash a casino in seconds... and with "casino", I refer to our economies.

3. The regulator has de facto exceeded whatever authority it could have been given, by for instance setting the risk weight for central governments at zero while imposing a risk weight of 100 percent on the loans to an unrated SME or entrepreneur. That can only be explained in the context of a statist ideology. That has transformed the “risk-free rate” into a subsidized risk-free rate.

In fact, it is morally reprehensible for regulators to discriminate the access to bank credit in favor of “the safe” and against “the risky”... that creates a regulatory-subsidy to the safe and a regulatory-tax on the risky. By limiting the opportunities of “the risky” to have fair access to bank credit, the regulator is de facto increasing the inequalities in the world.

4. To top it up, the risk-weighted equity requirements are portfolio invariant, something that is absolute lunacy, since it ignores both the benefits of diversification and the dangers of excessive concentration.

5. As I warned in a letter in the Financial Times in January 2003, the excessive importance given to some few human fallible credit rating agencies introduced a serious source of systemic risk. What we read in this proposal only increases the complexity, and therefore increases the possibility of gaming the regulations, and increases the distortions, all without really diminishing any systemic risks.

6. Borrowers are always interested in presenting themselves to the banks as being a low credit risk, in order to obtain lower risk premiums. And bankers used always to be interested in questioning the creditworthiness of the borrowers, in order to obtain higher risk premiums. That struggle helped to allocate bank credit efficiently to the real economy.

But, credit-risk-weighted equity requirements for banks and changed the relations. Now more important for the risk adjusted return on bank equity than the negotiation of risk premiums with borrowers, is dressing up the credit operation in such a way so as to allow the highest possible leverage of bank equity. And so, instead of using the tensions between borrowers and lenders, regulators managed to align both of these parties against them. Not too bright!

7. The distortions are causing serious economic risks. Just an example of it, is that the liquidity provided by current QEs cannot reach “the risky”, those

we perhaps most need bank credit to reach. It is saddening to now see your proposal, in the case of senior corporate exposures, to set the risk-weights in function of size... as if the larger you are the safer you are... ignoring that the larger and the safer they seem the more you will be hurt if something goes wrong. Why on earth should The Large have even better access to bank credit relative to The Small than what they would usually anyhow have?

8. It is stated: “The credit risk standardised approach treatment for sovereigns, central banks and public sector entities are not within the scope of these proposals. The Committee will consider these exposures as part of a broader and holistic review of sovereign-related risks.” “Holistic” Ha! Don’t you understand that what is someone’s light risk-weight, becomes immediately someone else’s very heavy risk weight?

9. The document does not indicate any concerns with how to go from here to there. Basel III introduced the not risk weighted leverage ratio, which will act as an equity floor, and you are also currently consulting on “Capital floors: the design of a framework based on standardised approaches”. But, raising the equity/capital floor, while maintaining the roof of the credit-risk-weighted equity requirements, will only increase the distortions, and could cause irreparable damages to the economies. For a more figurative explanation I refer you to the movie “The drowning pool”.

I have some other objections, but, for the time being, these will do.

Regulators, please, before you keep on regulating, go back and define the purpose of banks. It has to be more than to just be safe mattresses. It has to at least include not distorting the allocation of bank credit.

With these credit risk adverse regulations, banks are financing less and less the risky future; and only refinancing more and more the safer past. That has to stop, for the good of our children and grandchildren. “A ship in harbor is safe, but that is not what ships are for.” John Augustus Shedd, 1850-1926

In 1999, in a Op-Ed in I wrote: “The possible Big Bang that scares me the most is the one that could happen the day those genius bank regulators in Basel, playing Gods, manage to introduce a systemic error in the financial system, which will cause the collapse of our banks”.

We have already seen too many low-risk-weights AAA bombs detonate with disastrous consequences. So when are you bank regulators going to stop trying being the self appointed risk managers for the world? You're doing a lousy job at it, and not being held accountable for it.

Per Kurowski

PS. What do I like in the document? Though subject to all my other concerns, like not agreeing with the risk weighing, I do like the CET1 ratio used when setting risk-weights for banks. That ratio indicates that the better capitalized a bank is, the less will other banks be required to hold equity when lending to it, so the better borrowing conditions it can obtain, thereby leveraging the usual market response. That looks like a relative unobtrusive way to nudge banks into being better capitalized.

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