European Shadow Financial Regulatory Committee

Statement No. 16

Basel and Zurich, 12 May 2003

Bank Supervisors' Business: Risk Management or Systemic Stability?

In this statement, the European Shadow Financial Regulatory Committee (ESFRC) presents objections to the highly complex approach of the draft New Basel Capital Accord (Basel II). We consider it to be excessively focused on the regulation of risk management by individual banks. In addition, we strongly object to the treatment of operational risk, the politically influenced issues around lending to the small and medium sized enterprises (SMEs), the insufficient consideration of the issue of pro-cyclicality, and the reduced emphasis on the third pillar, i.e. market discipline.

We offer recommendations to deal with these issues and we propose that European authorities apply the substance of the Basel II advanced approach only to very large internationally active banks. Remaining banks would have the option of a simplified standardised approach.

Background

On April 29, 2003 the Basel Committee on Banking Supervision issued its third and final consultative paper (CP3) for a New Basel Capital Accord. The New Accord should be implemented in the G10 countries by the end of 2006 for internationally active banks. In the EU, current plans for the Accord apply to all banks and investment firms in an update of the Capital Adequacy Directive (CAD III).

The 1988 Basel Accord was applied consistently in a large group of countries and contributed to an overall increase in regulatory capital. The Accord had some important weaknesses, such as the crudeness of the risk weightings and the consequent risk arbitrage within broad categories of loans. First and second proposals for review were presented in 1999 and 2001. Basel II would comprise three pillars, 1) minimum capital requirements, 2) supervisory review of capital adequacy, and 3) market discipline by public disclosure. Within the first pillar, three approaches were proposed to deal with credit risk: (i) the standardised approach with risk weights based on *external* credit assessments, and two *internal* ratings-based (IRB) approaches, (ii) the foundation IRB and (iii) the advanced IRB. The latter two approaches would be open to "sophisticated" banks, if authorised by supervisors. The proposals also included a requirement for capital to be held against operational risk.

During the consultative processes, concessions have been made to political pressures, such as for example in lending to SMEs, retail exposures, credit derivatives and mortgages. The involvement of supervisors in the internal risk management process of banks has also been strengthened in CP3.

In previous statements, the Shadow Financial Regulatory Committees of Europe, Japan, Latin America, and the US have already criticised the proposed New Accord for its complexity and arbitrariness. The New Accord was seen to attach only limited importance to market discipline and to lack an adequate enforcement mechanism.

Regulatory capture, competition, and systemic risk

It is a common phenomenon in all areas of regulation that regulators become "captured" by the industry they regulate, meaning that they take on the objectives of management in the firms they regulate. They may thereby lose sight of the ultimate objectives of regulation. Regulatory capture is particularly serious in industries such as banking where there is a conflict of interest between the firms' objectives (to maximise profits) and the objectives of the regulation (to provide consumer protection and maintain systemic stability).

The complexity of Basel II and the role assigned to national supervisors make an arm's length relation between regulators and the regulated nearly impossible. While the traditional role of supervisors is to oversee banks' implementation of rules designed to enhance consumer protection and financial stability, the CP3 assigns supervisors roles that make them deeply involved in the micro decisions of risk management. Since banks have an a priori advantage in both technical competence and the knowledge of their specific techniques, supervisors will have to acquire the corresponding knowledge or remain unable to supervise properly. The banks and the supervisors have already had to work together in Basel II and further collaborative work is needed to resolve the many issues left to be determined on the national level.

The deep involvement of supervisors as regulators and risk managers implies that any bank failure may be viewed as the failure of the supervisor, and indirectly of the government. The reluctance to allow banks to fail may increase further, with the consequence that risk-taking incentives of banks are not reduced as intended in Basel II. The risk of systemic crisis may actually increase rather than decrease as intended. The vicious circle of incentives for risk taking, an increased need for supervisory involvement, and increased capture by regulators would undermine the whole aim of the internal ratings-based approach.

Information disclosure and market discipline

The risks of regulatory capture can be reduced by increased market discipline. CP3 weakens information disclosure requirements, notably on internal ratings. Moreover, it leaves the detailed decisions on information disclosure to national supervisors, who may compete in laxity. We continue to recommend mandatory issue of subordinated debt to improve market discipline.

Capital requirements for operational risk

Operational risk is different from credit and market risk. It refers to the causes and not the consequences of losses. Reduction of operational risk is fundamentally related to good management. The right medicine for operational losses is not equity capital but effective corporate governance, early planning and insurance.

The CP3 specifies three approaches to calculation of capital requirement for operational risk. Two of them (the "Basic Indicator Approach" and the "Standardised Approach") are based on gross income in the bank as a whole or in specific areas. The rubric for the third "Advanced Measurement Approach" shows that the Committee is highly aware of the weak conceptual foundation of an operational risk charge when the Committee suggests that banks will be given an "unprecedented amount of flexibility" to develop approaches to measure the risk.

The proper context for dealing with operational risk is pillar 2 (supervisory review) but the ESFRC accepts as a pragmatic adjustment a flat charge (corresponding to the Basic Indicator Approach) to compensate for the reduction of capital in the banking system due to the new credit risk regime.

Quantitative Impact Study 3

On May 5, 2003 the Basel Committee published an overview of global results with respect to the third Quantitative Impact Study (QIS3). The objective of the study is to gauge the impact of the latest Basel II proposals on minimum capital requirements. For the standardised approach the QIS3 reports a moderate overall (i.e., credit risk and operational risk) increase in regulatory capital requirements. Larger banks face an 11% and 6% average increase in the G10 and EU respectively, while smaller banks are confronted with a 3% and 1% increase respectively. The results are quite different for the IRB approaches. In the foundation IRB approach the average capital requirement for smaller banks decreases by 19% and 20% in the G10 and EU respectively, while it remains about the same for larger banks (3% increase in the G10 and 4% decrease in the EU).

The ESFRC thinks these estimates are too conservative, and there will be a substantial overall reduction of the regulatory capital requirement. We base this assessment on the fact that the Basel Committee itself says that it believes the results, particularly from non-retail activities, tend to overstate the minimum capital requirements *on implementation*. This is particularly the case in the area of credit risk mitigation, where it has proved difficult for banks in many countries to recognise all the types of collateral which are allowed to reduce the capital requirements.

QIS3 implies that, most likely, the regulatory capital requirement on implementation will be substantially lower than the current projections. This significant reduction in the amount of capital held by banks in the EU and G10 is contrary to the stated objective of the Basel Committee, and it may have potentially adverse consequences for the stability of the banking system.

How should the EU react to the US approach?

On its adoption, the US authorities have proposed that Basel II should only be applied on a compulsory basis to around 10 large internationally active banks. The authorities expect that another 10 banks will adopt it voluntarily. The remaining banks would be subject to a national version of the 1988 Basel Accord. The rationale for this decision relates inter alia to the complexity of the framework for all parties, including regulators and senior bank managers. We acknowledge the basis of the US approach and share the worry about complexity, but we are also concerned about the implication of the US approach for a level playing field, and the repercussions for banking systems outside the G10.

At the EU level, the ESFRC recommends the adoption of a CADIII which would make Basel II mandatory only for the large internationally active banks and investment firms. Smaller institutions should have the option of adopting either a simplified version of the "standardised approach" or the new rules if they consider it in their interests to do so.

SMEs

We regret that the issue of capital requirements for SMEs has become a political issue rather than an economic one. If there are distortions in the credit markets for SMEs, they should be remedied through fundamental reform accompanied by transitional measures and not by ad-hoc approaches favouring SMEs, such as differentiated capital requirements based on the size of the borrower or reclassification of smaller loans as retail.

Pro-cyclicality

Implementation of Basel II may increase the pro-cyclical effects of capital requirements, because banks will have to increase their capital bases in recessions when borrowers appear more risky. Even though some pro-cyclicality is inevitable, regulatory measures should not aggravate it. The issue deserves careful attention and requires further analysis. One way of mitigating pro-cyclicality is through dynamic provisioning, wherein provisions are built up in good times in order to enhance the resources to cater for defaults in bad times. This inter-temporal perspective could be a useful complementary approach to Basel II, and it will help to preserve both macroeconomic and financial stability.

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