

# The devils in the details

## Key problems with the Basle proposals

### Reactions to Basle II are mixed, but there is more agreement on what the key issues it raises are. **Alan McNee** reports

**T**he reaction from the industry to the Basle proposals has been mixed, as our round-up feature, "Basle Poker Game Hots Up", makes clear. But virtually everyone – from regulators to rating agencies to banks – agrees that there are a number of specific flaws in the consultative document that was released in January.

Enumerating the problems at this stage may prove to be a little misleading, since it is widely expected that the Committee will issue a revised Basle II discussion document this summer, based on feedback received during the current consultation period (which ends on 31 May). In particular, new papers on retail credit risk and operational risk are likely to be issued before the final draft.

But conversations with risk managers and other bank officials in the US, Europe and Australia suggest there are several flashpoints:

- the great degree to which the final figure for regulatory capital will diverge from that implied by economic capital calculations;
- the definition and mechanics of the proposed charge for operational risk;
- the treatment of retail portfolios;
- the treatment of credit derivatives;

- the proposed maturity factors for loan portfolios; and
- lack of incentives to progress from basic to sophisticated risk estimation.

#### Excess capital?

The big question for most bankers contemplating the new proposals is simply: "Will we have to hold more capital?" A key element in answering this is the relative risk weights between the existing and proposed systems. While Basle has indicated that it expects aggregate levels of regulatory capital to remain broadly steady, individual banks may well find themselves holding more or less regulatory capital than under the 1988 Accord. And so far there is little consensus in the industry on how accurate or reasonable the proposed risk weights are.

Michael Reinhart, Munich-based

**“The big question for most bankers contemplating the new proposals is simply: “Will we have to hold more capital?””**

head of credit risk control at HypoVereinsbank, says: "The risk weights in all three approaches seem pretty high. Basle has said they want to keep overall capital levels constant, so they assume that regulatory capital for credit risk might shrink, but this shrinkage will be offset by the imposition of extra charges for operational risk. But as things look now, the risk weights seem high and we are concerned that overall regulatory capital might go up."

At rating agency Standard & Poor's in New York, managing director of US large and complex banks Tanya Azarchs says S&P is concerned about consistency of risk weightings across the three proposed methods.

"We are sceptical about whether the overall effect on total capital in banking systems will be neutral, partly because of what we hear from the industry and partly because of the different risk weightings that we've seen. For example, under the standardised approach, a maximum 150 per cent risk weighting would be assigned to BB minus corporate credits. If you go to the foundation approach, a BB minus credit would have a risk weighting of 190 per cent, and lower rated credits would receive even higher weight-

ings. So the two scales don't seem to match very well."

S&P takes almost the opposite view to those bankers who worry about having their regulatory capital burden go up. Instead, the agency has suggested that it might downgrade banks whose regulatory capital levels fall without some concomitant drop in their levels of risk.

"We're concerned that some banks might use the changes as an excuse to reduce their capital requirements," says Azarchs. "The math behind the IRB approach is very similar to the banks' own internal approaches, and most banks believe they are over-capitalised, based on the results of their internal models.

"So the implication is that banks would like the permission it would give them to go ahead and reduce capital. We at S&P don't believe that the big institutions are generally over-capitalised; hence our recent warning that we might downgrade institutions that are putting aside less capital under the new rules."

## Operational risk

Operational risk will be dealt with in a separate feature (available from next week on ERisk) but the main concerns about Basle's proposals are that they are neither forward-looking nor risk-sensitive enough to make sense. The three methodologies for calculating operational risk can be summarised as follows: the first two consist of exposure indicators, which are essentially the size of an institution or a business unit, with a multiplier attached to them. The third option, known as the internal measurement approach (IMA),

attempts to calculate expected losses for each business line, and then to go on to cover unexpected losses by a standardised factor, or gamma.

The problem with the first and second methods is that they assume operational risk is linear, rising directly in relation to the size of the institution or business line. The concern about the third is that it posits a fixed relationship between expected and unexpected losses

you expect a fairly high level of default in retail portfolios, the margins built into retail products are higher."

In other words, since most retail defaults fall into the category of "expected losses", credit risk is already priced into retail products, so retail bankers resent the suggestion that they should take an extra regulatory capital charge for this credit risk.

This leads to the wider question

“Many in the industry welcome the idea of a Pillar One capital charge for operational risk, even if they take issue with the precise methodology proposed. As one US industry veteran puts it: “People haven’t been aggressive enough in setting standards for operational risk – this may be the kick in the butt that the industry needs” ’

that most experts in the field simply do not believe exists.

On the other hand, many in the industry welcome the idea of a Pillar One capital charge for operational risk, even if they take issue with the precise methodology proposed. As one US industry veteran puts it: “People haven't been aggressive enough in setting standards for operational risk – this may be the kick in the butt that the industry needs.”

## Retail credit

The treatment of retail portfolios is a concern to many banks with consumer businesses. One UK banker sums it up as follows: “The level of capital applied under the existing proposals doesn't take into account the fact that, because

of the difference between expected and unexpected losses. “The Basle Committee say they want a cushion for unexpected and expected losses,” says one banker. “But this seems odd, because normally banks incorporate expected losses into the margins they charge. In the first discussions, they were only talking about unexpected losses having capital set aside against them, and now, although they don't mention it in the consultative paper, they do raise this in the technical documents.”

It's a tangle that can only be sorted out if the Committee is clearer about the role of risk capital, and how this relates to different approaches to provisioning across banking lines.

Meanwhile, though bankers say it's important that the proposals better capture retail risk, they are having difficulty pointing to any standard methodology used by the industry. The problem is partly that retail credit risk is dealt with in terms of transactions, products and multiple risk factors rather than by the probability of default of key underlying obligors. This means banks need flexibility to segment and analyse retail risk in ways that make most sense for their individual portfolio (in terms of products, risk factors, numbers of transactions

and so on).

Even within an individual portfolio, the factors that best define the risk tend to change over time. A regulatory rule that rides roughshod over this need for flexibility might make risk measurement worse rather than better, or lead to unintended penalties or arbitrage opportunities for some segments over others.

### Loan maturities

Another common complaint about Basle II is that the maturity adjustment for loans is too steep and uni-

form. The proposals mean that the longer the period that a loan is made for, the greater the risk of default it is assumed to pose – with a standard assumption of a three-year maturity in many instances – and therefore the higher the level of capital that should be set aside for it.

Bankers argue that this is too simplistic, and ignores the various innovative ways in which they can mitigate the risk of default on their loan portfolios. “We question whether the maturity multiplier for loans makes sense within the regu-

## Credit derivatives: worries about “w”

THE TREATMENT OF credit risk mitigation techniques, and in particular credit derivatives, is another contentious, and highly technical, area of the proposals. Banks involved in trading these instruments have expressed concern that, unless they are amended, Basle's plans could stunt the growth of the young credit derivatives market.

If banks get preferential treatment for credit guarantees as opposed to credit derivatives, they may well be tempted to re-characterise derivatives as guarantees. This, too, could lead to market fragmentation and a rise in the cost of credit to the market.

Andrea Fabbri, deputy head of credit derivatives at Banca Commerciale Italiana (BCI), says there are three issues that particularly concern his institution: the introduction of the floor factor, referred to in the proposals as the “w” factor; the double-default factor; and the treatment of credit derivatives on the bank's trading book.

The floor factor, or “w”, establishes a floor below which the risk weight of a mitigated credit risk cannot fall. This is based on the idea that there is a degree of risk implicit in mitigating credit risk using credit derivatives, since the counterparty that is supplying the protection could

itself default or refuse to pay out on the contract because of legal technicalities. The floor factor for credit derivatives is set at 15 per cent.

What this means in practice is that credit derivatives are recognised by regulators as being only 85 per cent effective when it comes to offsetting credit risk – so the bank that has bought protection against a particular exposure still has to set aside regulatory capital on the remaining 15 per cent of that exposure.

Fabbri believes the fixed floor factor for credit derivatives is a mistake, in respect of their credit risk: “If there is to be an incentive to monitor credit, why have a fixed floor factor for every bank?” Instead, he argues, there should be a factor based on the creditworthiness of the counterparty offering the derivative, similar to those available for credit guarantees (these range from zero to 15 per cent depending on whether the guarantor is a bank, a sovereign name or some other entity). “Credit derivatives are actually more efficient than guarantees, so why are they treated as being less efficient?” he asks.

Another justification from Basle for the treatment of credit derivatives is the legal risk of these instruments. But, argue bankers involved in the

trade, the market has adopted the 1999 ISDA credit derivatives standard documentation. This has not proven foolproof – as illustrated by a dispute earlier this year between Deutsche Bank and UBS over a credit default swap – but nonetheless it represents a standardised agreement, as opposed to the generally bilateral nature of traditional bank guarantees. And, points out Fabbri: “The operational risk charge should also cover legal risk, so why is legal risk being double-counted in the operational risk charge and in the ‘w’ floor factor?”

Another factor that might be worrying the regulators with regard to credit derivatives is the “double-default factor”. This refers to the fact that when negotiating a credit derivative, every bank considers the correlation between the seller of protection and the name they are selling protection against (the reference entity).

“If, for example, it's Enron selling protection against default by another energy company, then the correlation is quite high – and the price you pay for the protection should be lower than in a case where the protection seller is a bank,” says Fabbri. “This hasn't been explicitly considered in the new Basle treatment. They justify this omission by saying that

there is no correlation model that can explain it – in other words, they don't have a reliable way of explaining and measuring the correlation. But I'd say that if reliable data is going to be available in the future, then they should leave open the option of using it. This would mean that it could be like the advanced or the standardised approach. We're probably talking about two to three years before such a model is available, but by that time we would have a decent set of historical default correlation data.”

Meanwhile, some bankers suggest that a good halfway house would be to divide the double-default issue into transactions where there is a very high risk and those where the risk is low, and set appropriate regulatory rules.

The treatment of credit derivatives on the trading book is another important issue. If a bank sells protection on an entity on its trading book, and at the same time it buys protection against the same entity for itself, it would only obtain an 80 per cent offset on regulatory capital.

Some credit derivatives traders fear that this could lead to distortions in pricing to absorb this extra capital charge, which in turn might distort credit risk models that are based on market spreads. ■

latory framework," says Reinhart of HypoVereinsbank. "Of course, the longer the period of the loan, the greater the risk. But the planning period for regulatory capital in banks is generally one year. If you impose a maturity multiplier, you are implicitly saying that the banks all have a buy-and-hold strategy. This ignores all the developments in securitisation and credit derivatives in recent years, which allow banks not to hold credit risk." It also neglects the ways that a bank can react to a borrower running into problems, by either blocking off lines of credit or selling on the loan.

### What next?

Some bankers are worried by the methodological hoops that have to be jumped through in order to progress from one of the three new internal ratings based (IRB) options for calculating credit risk to the next. For example, the amount of data required to implement the advanced IRB approach – the most sophisticated of the three options – is seen as posing a serious hurdle.

Reinhart says: "You need seven years' worth of historical data to show that your loss given default has been calculated correctly. And all parameters need to be back-tested each year. All this gives you a maximum 10 per cent capital improvement over the foundation IRB, which you will have to calculate in parallel during a transition period of two years. This is not really enough of an incentive to go to all this trouble and expense."

Others say the real concern is not even the move from foundation IRB to advanced IRB, but

rather from the basic standardised approach to the more sophisticated foundation IRB.

S&P's Azarchs says some banks believe the foundation IRB approach would force them to set aside more capital than the standardised approach.

"The three approaches are supposed to have built-in incentives for banks to move from the least to the most sophisticated," she says. "That works OK in terms of a progression from the foundation to the advanced approach, but it's harder to see the incentive for progressing from the standardised approach to the foundation IRB approach."

If this turns out to be true in prac-

not be able to let them use the standardised approach while the parent company was using the foundation IRB approach.

Reinhart says: "We are still expanding, so when we buy a new bank in an emerging market, for example, there would be a danger that we would have to pull HypoVereinsbank AG back down to its level of sophistication in order to comply with this rule."

So will these various objections be heeded? The period for comments on the consultative document is not over yet, but comments in early April by Basle Committee chairman William McDonough suggest that it is already taking feedback from the industry seriously,

**“A bank that has purchased small and less sophisticated rivals might not be able to let them use the standardised approach while the parent company was using the foundation IRB approach”**

tice, it could be a real problem, since one of the key goals of Basle II is to give banks an incentive to move from the least to the most sophisticated system.

Partial use restrictions are a concern for some institutions, particularly those still growing through merger or acquisition. The Basle committee will only allow a parent company to use one system and a subsidiary another for a limited time – it has not specified how long. This means that, for example, a bank that has purchased smaller and less sophisticated rivals might

and is prepared to compromise on some of the more contentious proposals.

McDonough told ISDA's annual general meeting in Washington that there was a good chance the Committee would change its views on credit derivatives, and amend the 15 per cent floor factor. "I share the view that we may be confusing legal risk and some other kind of risks," he conceded. Whether this spirit of compromise will be extended to the other areas of concern, however, is not yet clear. ■