

# Basle poker game heats up

**With the May deadline for reaction to the latest Basle proposals on regulatory capital almost upon us, Rob Jameson tries to read between the lines of an increasingly urgent industry dialogue**

The banking industry has reached a critical point in its deliberations with the regulators over proposed changes to regulatory capital. Following the January 16 publication of the detailed second-round set of proposals by the Basle Committee on Banking Supervision<sup>1</sup>, this Spring has seen a tense dialogue develop as bankers and regulators get in quickly to influence each other on the key issues. But at the same time, according to one regulator, "everyone is trying to keep some of their powder dry until the end of the consultation period on May 31".

That's because both sides know that this round of consultation is the last chance to make truly significant changes not only to the way regulatory capital is calculated – the headline item – but also to how banks are supervised and how they communicate their risks to markets and analysts.

It's a poker game with high stakes, and a lot of hands have been won and lost already. Bankers know that they have won the principle that regulatory capital should be linked more closely to the economic value of the credit risks they run, and that this should be evaluated using a bank's own internal credit assessments.

But while they've won that round, they can't be sure how much

money they'll collect from the pot until the regulators fix the exact weightings that will link the proposed risk calculation methodologies to a final capital charge.

Meanwhile, the regulators have said they'll only trust the banks' internal risk estimates in return for a hefty set of qualitative improvements in bank credit processes – some of which look frighteningly inflexible to industry experts. And they've thrown in a couple of wild cards in the form of obliging banks to make detailed public disclosures about their risks and risk management activities (see box A, page 2), and a specific capital charge for operational risk. Bankers don't like either of these fundamental changes, but the regulators have made it clear they won't be backing down on the principles involved.

Even where the principles of the new proposals have largely been thrashed out, there are some red-hot devils in the details. These include the way that retail credit risk is calculated, the degree to which credit derivatives are assumed to mitigate credit risk, restrictions on the degree to which banks can pick and mix the different methodologies, and the problem of how much historical credit data is required from banks – as the accompanying feature, "The Devils in the Details", describes.

The rights and wrongs of details such as the "w" factor, which limits the risk-offsetting abilities of credit derivatives in the proposed regulatory capital calculation, might seem arcane. But it's a detail some investment bankers say will determine whether the credit derivatives market – one of the banking industry's brightest hopes for the future – is either stunted or put on a course of growth hormones.

## The fearful innovators

With all this talk of regulatory revolution, it's important to remember the things that Basle II is not going to change (see Box B, page 3).

It's not going to change the definition of capital hammered out in the 1988 Capital Accord. It's not going to change the amount of capital banks have to hold against market risk, though it has implications for market risk supervision and disclosure. It's not going to allow banks to model credit risk in a way that takes into account portfolio effects such as diversification, despite positive noises from the regulators about doing so in the future.

Much less is it going to allow market, credit and operational risk capital to offset one another to some degree, though some bankers are pressing for a placeholder in the new proposals that might allow the industry to do this in the near future. And it doesn't much address the

convergence in risk management and regulation between the world's financial industries.

Most importantly, though, Basle II is not intended to change the aggregate levels of capital in the banking industry. Regulators freely admit they have no scientific evidence that the banking system presently holds the "right" amount of regulatory capital. But they say that since the last reform in 1988, there's been little reason to think that banks are reserving too much

capital. And they point to the near-miss of the Asian economic crisis as evidence that they need to keep the tank of capital in the banking system topped up. So when they fired up the Basle II reform process, they made a blanket commitment that the new proposals would not move levels of capital up or down much at an industry level.

That initial decision sums up the paradox of Basle II. As one regulatory foot moves forward towards risk measurement sophistication

and alignment of regulatory capital with the economic risks of individual institutions, the other is dragged back by instinctive conservatism, pragmatism about what supervisors on the ground will be capable of overseeing, and a fear of catastrophic systemic risks.

### Is your number up?

The tentative capital formulas crammed into the 541 pages of new proposals that the regulators released on January 16 were

## A. Disclosure and market discipline – Basle's big idea

MARKET DISCIPLINE IS one of the "big ideas" at the heart of Basle II. It's new, it's trendy and it should even be cheap. But according to Stephen Bland of the UK's FSA, a regulator who's been taking the temperature of bank reaction, it's liked by industry even less than the operational risk proposals. Speaking at a GARP seminar in London on April 19, he said that disclosure "wins the prize as the least popular thing to come out of the proposals".

Banks accept that they will be expected to disclose more about their credit and operational risks and how they manage them, but they are very unhappy with the level of detail and the disclosure templates put forward in the regulators' proposals.

The rationale behind the disclosure proposals is that, since banks are almost invariably ahead of the regulators when it comes to innovation, the best way to regulate a bank's capital adequacy is to leave it to the market itself. This does not mean taking an entirely *laissez-faire* approach to regulation, but allowing competitors, customers and counterparties to make informed decisions about whether or not to trade with a particular bank, based on its known exposures and the level of capital it holds to cover them. The regulator's function becomes one of making sure that the information is relevant, sufficient and comparable – while not so onerous as to raise costs or hobble a bank's ability to stay one jump ahead of competitors.

Tanya Azarchs, managing director in charge of US large and complex banks at rating agency Standard & Poor's in New York, welcomes the greater transparency that the disclosure requirements would give. "We see a disappointing level of reporting outside North America," she says. "In some countries, it's not even a requirement to disclose non-performing assets. One of the very positive elements to the new proposals is that if everyone had to abide by them, it would raise the standards across the board. That would be very welcome from an analyst's point of view."

But banks themselves are less happy, particularly outside the US. While most bankers contacted by ERisk broadly welcomed the concept of market discipline, they are much less keen on the idea of having to give away what they regard as proprietary information.

Michael Reinhart, head of credit risk control at HypoVereinsbank in Munich, says the bank would have to disclose too much for its liking under the new proposals.

"For our shareholders it would be information overload, and in some cases it would also be confidential information. A related point is that the regulators want us to disclose expectations for certain industry sectors. This could be dangerous for the sectors themselves. For example, if the big German banks all said they expected a certain sector to underperform, it could lead to a

crisis of investor confidence in that sector," he says.

Bankers are also generally unimpressed by the argument that their own analysts and traders will get to see equivalent information about their competitors. "Our internal credit analysts say they get enough information already in most cases," says one risk manager with a UK bank. "As far as bad debts are concerned, for example, we feel we know enough to make informed decisions. The main area that's difficult is off-balance-sheet items – exposure to foreign exchange and interest rate movements can be pretty opaque for non-US banks," but he does not believe this latter area constitutes an overwhelming argument for greater disclosure across the board. Banks also argue that the information might conflict with, or make redundant, disclosure requirements from other bodies, such as international accounting standards.

The regulators are already preparing their counterblast. They say that they designed the disclosure requirements with the input of equity analysts, and that it was never their intention to keep the average depositor or shareholder awake at night with complex risk data. They also say they don't see why the information should be so difficult for banks to put together, as it's a subset of information that they will require banks to supply anyway as part of the regulatory function. And

they point out that recent signals from international accounting standards experts suggest they don't see the Basle II requirements as conflicting with their ambitions.

But banks say collating and publishing the information in a defensible manner is a different problem to supplying information to a local regulator. Although many global institutions already gather and distribute this kind of information internally, other banks only do so on a disaggregated basis. For a bank operating through subsidiaries in several different countries, the costs of aggregating and publishing this data could be considerable – although the regulators might argue that this is an important risk management exercise that should be carried out, almost regardless of the cost.

S&P's Azarch agrees this is the nub of the problem. "The banks can do this – they already have this information for internal purposes," she says. "But the big question is: how much uniformity will there be in these ratings, not only across different jurisdictions, but even across banks in the same country? The direction is very commendable, but this has to be seen as a work in progress by Basle."

Meanwhile, the FSA's Bland says that while regulators expect to have to refine the concept substantially, they have no intention of removing what they regard as the innovative "third pillar" of their proposals. ■

## B. What Basle II will and won't do

AS THE US energy markets discovered recently, the law of unintended consequences is the only certainty in any big regulatory upheaval. But some things seem pretty certain:

*Basle II will mean:*

- A much greater variance in capital requirements between banks with different kinds of businesses, from retail to corporate;
- A more complex regulatory regime, with banks and national jurisdictions likely to vary much more in the regulatory capital rules they follow and the quality of their enforcement;

- A convergence, if incomplete, between economic capital (true cost of risk) and regulatory capital, and the introduction into bank regulation of many sophisticated risk concepts that will be the building blocks of future regulatory changes.

*That's because Basle II will:*

- Allow qualifying banks to use internal ratings and economic capital concepts to measure regulatory capital for credit risk;
- Set a specific charge for operational risk and allow qualifying banks to choose between more or less

sophisticated ways of measuring this;

- Oblige banks to release risk information to analysts that might affect bank share prices and credit ratings.

*But Basle II will NOT:*

- Alter the way banks set aside capital for market risk, or change the kinds of capital that count as regulatory capital;
- Allow banks to use internal portfolio models for either credit or operational risk – yet;
- Alter the total amount of capital that the banking industry sets aside, providing the regulators get their sums right.

important because they meant banks could begin to test the proposals' effects for the first time. Results showcased at an ERisk iConference in February<sup>2</sup> set off warning signals in the banking community on two counts. It seemed that there would be both higher absolute credit risk capital charges, and little incentive for banks to shift to the simplest internal ratings based approach to calculating regulatory capital for credit risk – the “foundation IRB”.

The problem resides in the way the risk weightings are structured and, particularly, the regulators' use of an artificial multiplier to push any risk total up by half as much again. This “1.5 multiplier” in the regulatory capital formula is designed to calm supervisory fears that banks might assign the wrong credit ratings to their customers, and that the total risk capital set under the novel scheme might prove inadequate.

But bankers say their credit analysts are already conservative when they assign ratings, and that any

irresponsible banks should be dealt with under the supervisory powers that already allow regulators to increase the regulatory capital required for individual institutions. This, of course, would put yet more pressure on the skills and capabilities of regulatory supervisors.

For the moment, the quantitative evidence about the proposals' effects is patchy and anecdotal, and regulators say that the early tests have concentrated on the impact of selected bank portfolios, such as corporate credit, and have ignored bank-wide effects. More formal studies of the quantitative impact of the proposals are due to see the light of day this summer – though it's unclear whether the regulators' tests will have been able to capture the full diversity of bank portfolios.

There are even more worries about the most novel element of the proposals: the regulatory capital that banks will be asked to set aside to cover themselves against operational risks, such as computer crime and trading frauds. At one

point in the deliberations over how to quantify operational risk, regulators say they felt themselves to be ahead of the industry in developing their methodologies – a position that no regulator finds comfortable.

But while there's been an explosion of interest among banks in modelling operational risk, the impact of the operational risk proposals is still far from clear. The debate is still in some ways stuck at first base.

The banking industry is asking where the regulators got their rule-of-thumb starting point that operational risk should account for about 20 per cent of total capital. And while regulators thought they had solved the problem of defining operational risk by adopting industry standard phrasing, banks are worried that the definition includes “indirect” losses from operational events.

Some bankers still harbour hopes that the shortcomings of the methodologies put forward for quantifying operational risk will embarrass the regulators into taking qualitative factors, such as the quality of the control structures at a bank, into account. The more advanced banks are likely to press for the ability to use sophisticated internal models of operational risk, as these would allow them to leapfrog the unsatisfactory halfway houses set out by the regulators.

Meanwhile it's becoming clearer that any approach to quantifying operational risk that relies on loss data will also have to take into account the “double-counting” problem. One simple but compelling example of this is that one bank's “credit risk” loss through a misvaluation of collateral might be

recorded by another institution as an "operational risk" loss, in the sense that it was caused by a failure of procedure.

Regulators are already trying to calm bank fears by saying their original pledge not to alter the amount of capital in the system stands. If they find that their first attempt at counting up credit and operational risks overshoot the mark, they will change the calibration of the quantitative methodologies so that aggregate capital levels remain stable. Their critics in the banking industry say the rule-of-thumb multipliers, floors, haircuts and risk weightings that the regulators have built into the proposals will make this kind of tinkering all too easy.

### No such thing as an average bank

Aggregate and average levels of capital aren't the real story, of course. It's becoming ever clearer that the amount of capital that different banks will be obliged to hold will be very different, depending on the nature of each bank's credit-related assets and business lines.

The regulators think the industry is generally enthusiastic about this "dispersion effect" of the new requirements – after all, it's a necessary feature of any risk-sensitive scheme in a world where banks take on business with very heterogeneous risk profiles. It will also remove many of the distortions and capital arbitrage opportunities of the present scheme.

The downside is that there will be as many losers as winners. Businesses that bring in assets associated with high credit ratings and that don't incur too much operational risk will tend to benefit from

the new rules, while those that are operationally risky or that have portfolios full of relatively lowly rated credits will find life more expensive.

There are also potential gains for retail banks if they can get the regulators to accept their view of retail credit risk. But as complaints from the European investment and stockbroking community have made clear, some institutions that previously incurred little in the way of credit risk capital charges fear being hit hard by the operational risk charge in the new proposals.

Another downside is that for some business lines, such as corporate lending, capital requirements are likely to become much more volatile over the economic cycle. Regulators have mentioned anecdotal evidence that, at the extreme, some banks might require double the capital in an economic trough that they do during a boom. More generally, there might be a 20-30 per cent swing in capital requirements from boom to bust.

Banks have pointed out to regulators that this will exacerbate any "credit crunch" – periods when banks get worried that default rates are rising and put a brake on new lending. The regulators say they are mulling over the implications of this. As of April, they had not yet decided what their tolerance for this "pro-cyclicality" should be and were pointing out that, inevitably, dampening down pro-cyclicality will also dampen down the risk sensitivity of the rules.

### From requirements to branding

The regulators are keen that banks improve and standardise their

credit processes, as a trade-off for letting them feed their own risk data into regulatory capital formulas. But banks are saying that the regulators' credit process requirements are too inflexible and don't take into account the practicalities of how a bank is run or the varied demands of different kinds of credit portfolio. They'd rather keep the rules to the minimum, and have bank supervisors check the general quality of portfolio credit management in its business context.

The comments that the industry will send the regulators this May are likely to scrawl red ink around the idea that banks should never hold more than 30 per cent of their portfolio of credit risks in any one credit grade; that banks should react within a certain time to news of a credit deterioration for a specific entity; and that banks must review each rating within a particular period.

Another worry is that the regulators are trying to ensure banks adopt the new capital scheme right across their businesses and geographical locations. They have built some flexibility into their ideas that allows banks to stagger the implementation of the new rules, but are determined to try to prevent them from cherry-picking the new rules. They fear that a bank with a lot of business that would be penalised under the new risk-sensitive rules might shift that business to another operating unit or financial centre, where it had opted to comply only with the 1988 Basle Capital Accord or the most basic approach in the new rules.

By insisting banks roll out any new methodology to all or most of their businesses and centres, the regula-

tors hope to remove this potential for capital arbitrage. Meanwhile, banks say that the rollout provision is not very practical, given the realities of how major banks are organised and managed. In informal discussions, the regulators are already deploying their deadliest argument: if banks don't like the rollout provision, they must quickly come up with a better idea that also calms regulators' fears.

Regulators also point out that, while it will be a bank's choice how sophisticated an operational and credit risk methodology they choose, it's not a free choice. If regulators think a bank is hiding its true risk profile behind an inappropriate selection of capital calculations, they will use their supervisory powers to tell the bank to increase its capital reserves.

Also, regulators say, credit and equity analysts will soon spot sophisticated investment banks that choose to calculate their minimum capital requirements using simplistic methodologies, and the banks will pay a premium for stepping out of line with market expectations. Indeed, it's clear that the regulators are hoping that the more sophisticated schemes will become aspirational – the status symbol of a well-run bank.

### If regulators could fly

Regulators seem to have given up on the hope of achieving a "complete" document by the end of this year, particularly with regard to operational risk. They are talking now of reaching some kind of a natural "resting place" by then, in the hope that any principles established can be fleshed out well before implementation in 2004.

They point out that it might not make sense to think of international agreements on banking regulation such as Basle II reaching "closure" – with the pace of change in the world's financial industries quickening, there will be no more 13-year gaps between major reforms.

But this new-found flexibility and air of sophistication hardly squares with some of the realities of global regulation. The creaky way that the

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EU legislates has already put a brake on the implementation timetable that US bankers find hard to stomach (unlike many national legislatures, the EU cannot speed up law-making by passing primary legislation that can be easily amended by secondary legislation, or by delegating rule-making to secondary authorities).

Meanwhile, it's becoming clear that some national regulatory bodies at present don't have the capability to administer the more sophisticated options built into Basle II. Leading US regulatory bodies have said that they will "have to run hard" to make sure that they have the necessary skills and resources.

That implies that less sophisticated regulators in Europe and elsewhere – more than 100 countries presently conform to the 1988 Basle Capital Accord – would have to achieve some kind of take-off between now and 2004. At the same time that Basle task forces

are trying to convince the industry about the proposals, they are fighting a hearts-and-minds battle with local regulators worried about the staffing and cost implications of the new regime.

All this looked ambitious at a time when the economy was booming and banks had cash and enthusiasm to spare for improvements in their regulatory infrastructure. This spring, amid credit deterioration,

layoffs and strategic rethinks in the banking industry, the timetable and the creeping scope of the reform proposals began to look downright worrying. "The period for review is too short," complains one banker, "especially in the context of some regulations – for example, those on project finance – not being fully published yet. There are still extra papers to come out of Basle, yet the clock is ticking on the consultation period."

Now that the Basle II bandwagon's been painfully levered to the crest of a hill, however, a few comments from faint hearts won't stop it reaching the bottom. ■

### References

- 1 **The New Basle Capital Accord**, Basle consultative document, 16 January, 2001
- 2 **ERisk iConference on the IRB approach**
- 3 See also Basle II Internet resources