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Mind the Basel Gap

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The financial crisis signalled the need for a real paradigm shift in prudential regulation, but this apparently has not yet happened. It is now evident that boards and senior management of banks had great difficulty in appreciating the magnitude of the risks being taken in their market departments, and actually understood the implications of those risks even less. This is likely to become even more the case after the current proposals for bank's capital adequacy regulation are implemented. In their response to the crisis, policy-makers and regulators seem intent on further complicating the already complex maze of financial market rules by amending existing rules on the fringes.

The Basel capital adequacy rules, which were implemented in the EU with the capital requirements Directive, serve as the centrepiece of prudential regulation of the banking sector. Initially proposed in 1988, the rules were substantially amended in 2005, generalising the use of credit ratings for risk weightings in the external ratings-based approach, and the use of internal models for more advanced financial institutions. Basel sets a minimum capital requirement of 8% for the banking book, but the differentiation of risk weightings prevented supervisors from noticing the growing degree of leverage in the financial system. For example, the Belgian bank Dexia, an early casualty of the crisis, had a Basel tier 1 ratio of 11.4% in June 2008, but a core capital ratio of only 1.6%! In the context of the current crisis, a key weakness in the risk-weighting system of the Basel framework is the strong bias towards real estate. Capital charges for mortgage lending stand at half that applied to commercial loans, and can go to 35% for residential mortgages. In response to the crisis, these core rules are not being fundamentally reconsidered, but rendered even more complex in a host of amendments.

What amendments are on the table or under consideration?

- **5% for securitisation or 'skin in the game'**. A first proposal to amend the Basel directive has been under discussion since June 2008. It requires banks in credit risk transfer products to hold at least 5% (initially 10%) of the securitisation issuance, to provide the right incentives in 'originate and distribution' activities. This amendment is counterproductive as it undermines securitisation and forces banks to increase their balance sheets, whereas they should be reduced. Provisions of the 2004 MiFID (Markets in Financial Instruments Directive) already require banks to take "all reasonable steps" to "prevent conflicts of interest from adversely affecting the interests of its clients", and these could apply to securitisation activities. Additional elements of the amendments, which were adopted by the EU in April 2009, include tighter rules for large exposures and rules on special 'hybrid' capital items.

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- Additional rules on **executive compensation**. A consultation was launched at the end of April 2009, following the agreement reached at the G-20 Summit, introducing the obligation for credit institutions and investment firms to establish and maintain remuneration policies and practices that are consistent with effective risk management. Generally speaking, remuneration should not encourage excessive risk-taking and be in line with the long-term objectives of the firm. Payment of bonuses should be deferred. Excessive remuneration packages can lead to extra capital charges. In our view, such rules are difficult to set at European level, because of the large differences in labour and tax law. Moreover, they can easily be circumvented they are impossible to enforce.
- **Increased capital requirements for the trading book** and higher capital charges for certain securitisation positions, as proposed by the European Commission on 13 July 2009. Capital charges for trading positions would at least double, and securitisation positions would have same risk weight as in the banking book. Re-securitisation exposures, such as CDO's, should be completely deducted from capital, rather than be risk-weighted.
- **Dynamic provisioning**. Not yet formally proposed but under discussion for quite some time is a requirement for banks to build up extra capital buffers in good years, which could be used in bad years. The size of the buffer would be calculated as a percentage of the total outstanding loans and of doubtful loans, as is currently practised in Spain. The July 2009 Council of Finance Ministers meeting urged the European Commission to come forward with proposals on the subject. The problem, however, is that no EU-wide harmonised definition of doubtful loans exists at present.
- **Special liquidity requirements**. Also not yet formally proposed, but under consideration by regulators are harmonised liquidity requirements for EU-based banks. Liquidity regulation is not regulated at EU level, but is left to the member states, which use qualitative or quantitative requirements, or a mixture of both. These requirements were also imposed without distinguishing between branches and subsidiaries of host-country financial institutions. The danger is that EU harmonisation may set a quantitative requirement, without sufficiently talking into account the differences in risk profiles of banks.

What would a true paradigm shift consist of? The pillars of Basel II could be kept: capital requirements, supervisory review and market disclosure. But the risk-weighting system and the use of internal models should be scrapped in favour of a simple transparent capital requirement.[1] Dynamic provisioning can be a useful addition. Moreover, the balance between the different pillars needs to be strengthened. Liquidity requirements should be addressed under the second pillar of the supervisory review, i.e. left to the discretion of supervisors as depending upon the risk profile of the bank, but applied on a European-wide basis. Market disclosure is not taken seriously enough in Europe, as the debate surrounding stress tests demonstrates. In addition, external risk audits should be carried out by external firms and be submitted to supervisors, and disclosed in an annex to the annual report. As banks' risk management practices left much to be desired, an external assessment by specialised firms of these internal controls and procedures would be a useful addition to the control by supervisory authorities.

Other elements of the paradigm shift would be the introduction of a narrow banking system, or the application of a 'safety net' with depositor protection to a limited part of the banking system. Everything else falling outside would be subject to pure free market forces. In addition, to avoid 'too-big-too-fail' and domino effects, strict anti-trust and competition policy rules would be imposed on the financial system.

More interesting proposals for the fundamental reform of the capital adequacy system in banking could be conceived, but to our knowledge, they have not surfaced. Given the depth of the financial crisis and the huge policy failures, more new thinking should be devoted to the future of prudential regulation.

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[1] Carmine di Noia and Stefano Micossi, *Keep it simple: Policy Responses to the Financial Crisis*, CEPS, 2009.