Basel II: time for action

Despite some lingering issues, the main points of contention around the revised Basel II capital Accord have been resolved, and implementation seems more certain than it has for several years. David Rowe argues it is time to stop hoping it will go away and get on with the inevitable effort required to comply

Humans always find change painful, which is why procrastination is as perennial as grass. Organisational life exhibits similar behaviour. Most major organisational challenges are met with a series of emotional reactions not unlike those associated with death and dying. The first reaction is denial: "Are they nuts?", "It will never happen", "It's too far in the future to worry about it". This is followed by periods of confusion, anger, distress and eventually acceptance. I certainly saw, or to be more honest I personally exhibited, this series of emotions in response to the challenge of dealing with the introduction of the euro. I suspect the one exception was the Y2K problem, where no-one could argue with the claim that "No extensions will be allowed"!

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Certainly Basel II has elicited all the above reactions over the years. As recently as two years ago it was not hard to find those who insisted the revision process was bogged down and Basel II would be abandoned. With the release in June of the 'final' version of the proposal, it is now obvious that the rumours of the death of Basel have been greatly exaggerated. Clearly we are entering the end-game and the time for acceptance, be it happy or grudging, has arrived.

Progress and a quibble

The Basel Committee on Banking Supervision has done a remarkable job in the past 15 months of resolving the most serious areas of contention both with the banking industry and among participating countries. Perhaps the biggest and most important step is in the treatment of expected losses. Previously the Committee insisted on continuing to use the existing definition of Tier 1 and Tier 2 capital in the present Accord. This definition includes credit loss provisions in actual Tier 2 capital. The logical corollary to this is the need to include expected losses as part of the minimum level of required regulatory capital. This treatment is at variance with standard practice in modelling economic capital, which focuses exclusively on unexpected losses. More importantly, it also has implications for equitable treatment across banks in business lines such as retail credit cards, where expected losses are absorbed immediately out of current earnings rather than being provisioned in advance. The June proposal withdraws the inclusion of general loan loss reserves in Tier 2 capital and generally excludes expected credit losses from required capital.

The Committee also expresses an openness to possible future revisions to the Accord even before its initial implementation. One very welcome area mentioned is in the treatment of potential future credit exposure to trading counterparties (*Risk* September 2003, page 109). Here they indicate that joint work has begun with the International Organization of Security Commissions to address this and other issues.

Another area mentioned is the issue of 'double default' (*Risk* June 2001, page 72). The Committee says recognition of double default is necessary but remains cautious about weighing the potential implications of any proposed solution. This is complicated by a clear intention not to permit full recognition of portfolio-based credit modelling prior to implementing the new Accord. Credit portfolio modelling involves full recognition of the statistical interaction of default behaviour among multiple entities. Hence recognition of double default is clearly a first step towards defining how such analysis will be allowed to enter the regulatory capital regime. In particular, rules will have to be established as to how correlations among two entities involved in a double default will be specified. Once defined, the inevitable next question will be why these rules cannot be applied more broadly in the full portfolio context.

One somewhat worrisome point is the potential for host supervisors to insist, as a matter of course, on a subsidiary-specific operational risk capital charge that does not reflect any diversification benefits of the larger banking entity. While on the surface this seems reasonable, it flies in the face of the intended treatment for credit risk capital.[1] For credit risk, a high degree of diversification is assumed in setting the risk weights in what is constrained to be an additive calculation of regulatory capital. Since these same risk weights are applied across all entities in a banking group, including local subsidiaries, the benefits of diversification are assumed to apply at all levels.

It is odd to deny diversification benefits for the relatively small operational risk capital requirement while allowing them for the much larger credit risk capital requirement. A concern is that this restriction will discourage banks from devoting the time and money needed to develop an advanced measurement approach to operational risk that creates internal incentives for actual risk reduction. In extreme cases, supervisors always have the option to demand additional minimum capital under Pillar II of the Accord. This seems to me to be the appropriate place for dealing with cases where recognition of op risk diversification across the full organisation results in an unrealistically low requirement for selected subsidiaries.

Time for action

Despite some continuing debate over the details, it now seems clear that Basel II has gained critical momentum. Hoping it will 'just go away' is not a responsible posture at this point. The time has come for serious planning and concrete action if implementation is to be accomplished in something short of crisis mode. ■

[1] *The author is indebted to Mark Lawrence, chief risk officer of ANZ Bank in Melbourne, for pointing out this inconsistency*