



Viewpoint: Basel II Will Not Unify Global Rules on Capital

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By Christopher Whalen

During his recent testimony before Congress about the Basel II capital accord, Comptroller of the Currency John C. Dugan said, "The new regime is intended not only to align capital requirements more closely to the complex risks inherent in these largest institutions, but just as important - and this is a total departure from the existing capital framework - it would also require them to substantially improve their risk management systems and controls."

Mr. Dugan also said that this would be accomplished by using "a common framework and a common language across banks" to help regulators quantify aggregate risk exposures, make informed supervisory decisions, disclose meaningful risk information to markets, and make comparisons in ways that simply cannot be done today.

These two revealing statements illustrate why the capital accord is really about helping regulators understand the banking industry, rather than improving risk management.

The common language to which Mr. Dugan refers may help regulators in overseeing the activities of U.S. banks, but unfortunately the language of Basel II will be slightly different for each participating bank and country, thus defeating the primary goal of unifying global bank capital measures.

Contrary to his claim, selecting one language to gauge global capital requirements is surely one thing that Basel II will not achieve. Led by the United States, which itself has changed the Basel II proposal to cater to domestic political pressures, each of the nations participating in the effort is embracing its own set of accounting definitions, benchmarks, and reporting requirements. As it stands today, a major international banks must be ready to report different versions of metrics in the different jurisdictions in which it operates.

When Mr. Dugan talks about "a common framework and language across banks," he refers to the updated disclosure proposed in the notice of proposed rulemaking published Sept. 25 in the Federal Register. The notice provides a series of schedules for regulatory reporting and guidelines for the banks to use in preparing these reports,

which will be submitted along with quarterly call reports.

The schedules list various types of risk exposure, including corporate, sovereign, and retail, all of which are familiar to students of Basel I, as well as the now ubiquitous over-the-counter derivatives.

While the risk benchmarks proposed by regulators seem reasonable, most bankers say the categories bear little resemblance to the way the banks price and manage risk.

In a discussion for this article, one senior banker said to me: "In banking today, we measure the relative risk of an obligor and the value of collateral and guarantees to come up with the economic rationale for a transaction. The only time we divide credits into 'buckets' like corporate, sovereign, or retail is for regulators. It is simply not the way we manage our business."

Another New York credit risk manager highlights the system in Basel II terms.

"The Pillar I requirement of calculating ratings for obligors and thereby the level of economic capital required is easy enough, but it is the supervisory review and the market discipline of Pillars II and III which are problematic for banks," the manager said. "The latest Basel II proposal still is remarkably light on specifics when it comes to how the different benchmarks are to be calculated and then disclosed to the public. Neither we nor the regulators understand the question, thus answers are elusive."

Several bankers I spoke to about Basel II, all of whom requested anonymity, complain that it gives banks too much leeway in how regulatory risk benchmarks are calculated, belying Mr. Dugan's statement that it will allow useful apples-to-apples comparisons.

The notice of proposed rulemaking is filled with questions from regulators to banks about whether they would prefer to use their internal definitions of risk factors, rather than the consistent, if arbitrary, regulatory measures articulated in the proposal.

For example, say that a bank has a loan to a private company where a third party has provided a guaranty as to the loan's repayment. Under Basel II, depending on the preference of the bank's managers, the guaranty can be used to affect the loss given default for the loan or the probability of default. In this example, the expected loss and resulting risk-weighted assets calculation would be the same in either case, but the components in the calculation are different, thus skewing any comparisons focused on either loss given default or probability of default.

In another question, regulators ask whether the banks would like change the definition of loan default, a basic piece of financial terminology that ought to be settled business by now.

To appease critics on Capitol Hill, regulators are bending over backwards to placate the industry, turning the Basel II process into an entirely subjective exercise. Asking, rather than telling, the banking industry how to fulfill disclosure requirements is bad public policy, but such is the reality of the Washington political equation.

To illustrate how far off track the Basel II process has wandered from the original vision of unifying global capital rules, consider the definition of a loan default in the European Union versus the United States. The Europeans are more conservative, charging off the loan's full amount without considering offsets such as the value of collateral or third-party guarantees, as is the custom here. This divergence of definitions apparently will continue under Basel II, rendering comparisons between banks in these markets meaningless.

When regulators on either side of the pond attempt to compare the results of their respective banks under Basel II, deeply entrenched differences in accounting and risk methodology will render the results no less opaque than regulatory metrics today. And within each country, the difference between the language of Basel II and the way in which banks manage risk will likewise obstruct clear understanding.

Until the global banking industry finds a way to bridge the gaps among risk management practices, accounting rules, and regulatory disclosure, the full promise and potential of Basel II will remain merely a hope.

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