STRIKING THE RIGHT ACCORD?

THE AUTHORS OF THE NEW BASEL ACCORD FACE THE TOUGH TASK OF TRYING TO PLEASE EVERYBODY IN THE GLOBAL BANKING INDUSTRY, SAYS **IAN MULLEN** OF THE BBA.

The international banking regulation agenda is currently dominated by a single significant item – reform of the 1988 Basel Capital Accord. A reform justifiably billed as the most significant development in international banking regulation for the past, and hopefully the next, decade.

The original 1988 Basel Accord was a relatively simple document, developed within a narrow mandate and published into a less complex world. This simplicity is fundamental to the Accord's widespread adoption and to its success as an international capital standard. It is also fundamental to its current failings, the 1988 Accord having been made redundant by changing banks, markets and risk management practice. A new Accord, it was agreed, was needed.

This new Accord is being built to a very different mandate to the first, and will be launched into a very different and more demanding environment. For example, the original Accord had a well-defined scope of application – by G10 supervisors to the banking books of internationally active G10 banks.

In revision, the Committee is a victim of its own success and a changing world. While the Committee formally retains its original mandate, it acts in the knowledge that the new Accord must, at least in principle, be applicable by more than 100 countries that signed the original, and to a much wider range of firms. If that were all it would be enough, but to recount familiar themes, banking since 1988 has become more complex, more competitive and more global.

PERCEIVED PRESSURES. Against this background, the mandate the Committee set itself was challenging. The new Accord would have to maintain the level of current capital in the global banking system, enhance competitive equality, increase risk sensitivity and offer banks incentives to improve their risk measurement and management. These have not always proven to be complementary objectives, with the trade-off between the competing commitments to deliver consistency and flexibility generating a particular pressure. Taken together, changes in the mandate and the environment presented the authors of the next Basel Accord with a considerable challenge. It was always, therefore, unlikely that the successor Accord would be a simple thing.

The reform process began officially in June 1999 with the publication of an outline consultation paper. This was followed by a second paper in March 2001, and will be concluded with a recently announced third-stage consultation exercise early next year. The objective is now to publish a new Accord toward the end of 2002. Implementation is scheduled for 1 January 2005.

The effort devoted to this exercise by the Basel Committee and the global banking industry has been, and will be, considerable. At each stage to date, the industry response has been substantial and the Committee has demonstrated a welcome capacity to listen and amend. In consultation, the BBA alone has formed nine distinct working groups involving upward of 150 members. This effort was replicated globally – our response was just one of more than 250 submitted to date.

The costs associated with implementation will far exceed this. Some estimates suggest that industry implementation costs will exceed the spend on Y2K compliance. The costs for supervisors will vary relative to their current practice – ranging from re-tooling, to rebuilding national supervisory practice. In combination, no exact figure can be calculated. However, it is certain that globally, from start to finish, thousands of man-years and millions of dollars will be spent in developing and implementing the new Basel Capital Accord.

The headline structure of the new Accord is simple, based upon three well-known pillars:

- the first focuses on minimum capital requirements: how much capital you have to hold for what risk and how you make that calculation;
- the second pillar deals with supervisory review of your own capital allocation and creates a framework within which banks can be required to hold capital in excess of the minimum; and
- the third details new disclosure requirements that are intended as the basis of a process of market discipline that directly supports the supervisory objectives of systemic stability.

The Committee always emphasises that all three pillars should be given equal weight, but the industry invariably concentrates upon the first, as it has the most direct impact on the cost of doing

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business. It is here that much of the detail resides; some of the detail is devilish indeed.

Which brings us to the red tape. In theory, the new Accord marks a watershed in the use of internal risk assessment as the basis of regulatory capital calculations. The internal ratings-based approach to credit risk is the prime example of this new approach. In essence, banks will be allowed to base their own regulatory capital requirements, to varying degrees, on their own assessment of risk.

In the foundation internal ratings approach, this is restricted to an internal estimation of the probability of counterparty default, with standard rules given for the estimation of loss given default or exposure at default. In the advanced approach, banks are able to value all three risk factors on the basis of their own internal risk assessment models and data. Progression from foundation to advanced is dependent upon banks meeting minimum regulatory standards across the range of the internal ratings processes, but with a special focus upon the availability of minimum historical data. This basic model is then taken as the blueprint for all elements of the banking book and all banks. In theory, this creates a system in which banks can base their calculation of regulatory capital upon the output of their internal risk management systems.

In reality, the absence of an objective means of validation, or a common policing function or authority, has led to an attempt to create a consistency of outcome through the definition of standard inputs to, and standard operation of, the regulatory model.

The result is a model that, although founded upon simple basic structure, has evolved into a complex structure of rules that attempts to approximate a very variable reality. When applied across the full scope of the Accord, which matches the full scope of the financial markets, and the participants in those markets, the result of this trade-off is the level of complexity evidenced in the second Basel consultation paper.

THE COST OF COMPLYING. The downside to a new Accord founded on this basis is very real. Not surprisingly, the banking industry has most immediately focused upon the costs of compliance. This is not the cost of bringing their internal risk systems up to standard, but rather the cost of bringing internal systems into line with the regulatory model. Many firms are suggesting that this will include building a parallel regulatory capital system.

This is of itself a concern. However, in addition, it is also doubtful whether a detailed rules based approach will deliver the Committee's own objectives. Competitive equality may well be the first casualty of an opaque new Accord with increased opportunities for arbitrage and regulatory forbearance, stemming from a reliance on input standards that are impossible to police, rather than internal processes and a test on the output by the bank and the regulator. A further likely impact will be to decrease future flexibility, due to the inherent complexity.

A similar issue arises in the EU where any Basel Accord will have to be translated into a Directive. Echoing the debates around the Lamfalussy report, the European banking industry is concerned that the full detail of Basel will be written up into legislation. This would render a complex structure rigid.

AN ALTERNATIVE APPROACH. As an alternative, a framework approach to EU banking regulation in general, and a new regulatory capital Directive in particular, is being advocated. This would involve, as with Lamfalussy, the articulation of a framework Directive that would define the enduring principles, objectives and structure of the new regime. Beneath this would sit a body of detailed rules and guidance that would be formulated during the legislative process, but open to regular amendment by a Committee made up of national supervisors within the mandate given in the Directive.

It is important to note that all those involved have an interest in this second-level process being open, transparent and accountable. The great gain is, of course, that this would introduce a flexibility into the process which previously has not been present. In an environment in which evolution is an objective of Basel, and market innovation proceeds apace, this capability will become increasingly important.

In both Basel and the EU, the essential issue is how to accommodate this variety of participant, practice, market and product within a single regime. There is an increasing concern that any attempt based upon a common detailed rulebook will fail. Basel, and the industry, should consider what is deliverable in terms of consistency, and how flexible they are prepared to be. This does not require a radical revision of the work done to date. The framework and essential principles are correct. Rather, it would require a re-ordering of what is already available and a reinforced focus upon the essential objectives of the Accord. Basel was after all intended to support the international banking industry rather than create its regulatory twin.

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