BASEL II AND THE SOUND OF MOVING GOAL POSTS

Once upon a time, US regulators thought they could keep their approach to implementing Basel II pretty simple.

Their big idea was that only a few large and internationally active US banks needed the sophisticated approaches introduced by Basel II, and that all these banks should adopt the Advanced Approaches for credit and operational risk measurement. The rest of the industry could stay with Basel I, or a mildly updated version of it (Basel I-A), and needn't be overconcerned with the complicated capital adequacy reforms foisted on all European banks.

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Knock one – Basel II and Basel I-A are joined at the hip. In December, the US regulatory agencies approved an extension of the comment period for their Basel II implementation proposals so that the deadline will coincide with the Basel I-A comment period. This sounds like a minor adjustment, but it was a tacit acknowledgement that the regulators' desire to treat Basel II and Basel I-A as distinct issues was optimistic – they are joined at the hip.

Given the regulators' emphasis on rules-based minimum capital amounts, any flaws in the risk sensitivity of Basel I-A will lead either to dents in the competitiveness of smaller banks versus the Basel banks or, if the Basel I-A rules underestimate risks, a worrying kind of adverse selection. Under this scenario, certain kinds of risky assets might flow from sophisticated Basel II banks (that measure the risk correctly) towards small Basel I-A banks that are less well equipped to carry the risk but that would gain capital benefits from doing so.

Joined-up thinking on the comment period is sensible but may not solve this more fundamental problem.

Knock two – Basel II banks aren't all the same. Regulators have also invited comment on whether they should allow some of the bigger banks to adopt Basel I-A or the Standardized Approach to Basel II, rather than forcing all larger banks to adopt the Basel II Advanced Approaches for determining risk-based capital.

Again, it's a move that blurs the originally sharp separation between the Basel I-A crowd and the Basel II elite, driven by the desire of some larger banks to avoid the costs of complying with rules they see as over-elaborate.

Knock three – Non-credit risks affect simpler banks too. In their latest calls for comment, the regulators have also opened up the question of whether any banks that are allowed to adopt the Standardized Approach should also be made to address operational risk.

It's difficult to argue with the logic of this. Operational risks have been the cause of some of the more notable failures by financial firms in the past 15 years. But regulators should avoid adopting simplistic rules for operational risk and, instead, set out some broad principles that will not distort operational risk management practice as it matures.

This all points up a larger tension in the US approach to Basel: rules-based versus principles-based regulation.

At SunGard, we think that regulators should

focus their attention on building a principles-based target capital regime for all banks, rather than a rules-based minimum capital regime.

Instead, so far US regulators have emphasized rules-based Pillar I of Basel II and Basel I-A, sidelining much of the principles-based thinking in Pillar II. Pillar II is potentially the most revolutionary and important part of Basel II because it proposes a more objective, economic approach to assessing target capital levels, without any link to minimum capital requirements.

Banks would perform their own comprehensive internal analyses of their risk profiles and link them quantitatively to their target capital levels – in other words, an 'Economic Capital' approach.

The implicit contract with supervisors is that examiners would review the banks' risk modeling techniques, parameters, and inputs to ensure that the risk assessment is comprehensive and accurate, but would not subjectively override the outputs of those models in negotiating target capital levels.

In making their final changes to Basel II implementation and Basel I-A, regulators can still swing the pendulum back a little towards a principles-based, Pillar II-driven system of capital regulation. Importantly, this would make it much easier for supervisors to incentivise banks to improve data gathering and internal risk management systems as the banking industry evolves.

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