Opinion **Financial Times**

Turmoil reveals the inadequacy of Basel II

By Harald Benink and George Kaufman FEBRUARY 27 2008

The turmoil in world financial markets, triggered by defaults on subprime mortgages in the US, raises questions about macroeconomic policy, financial stability and the design of financial regulation, including the new Basel II capital adequacy framework for banks.

The implementation of Basel II coincides with massive losses reported by some of the world's largest banks, requiring large-scale recapitalisations. The risk models that anchor Basel II are basically the same as the ones many of these banks have been using in recent years. Sheila Bair, chairman of the Federal Deposit Insurance Corporation in the US, recently noted that these models had important weaknesses which, in the light of today's market turmoil, were a flashing yellow light to drive carefully.

Basel II aims to address weaknesses in the Basel I capital adequacy framework for banks by incorporating more detailed calibration of credit risk and by requiring the pricing of other forms of risk. Under the Basel II framework, regulators allow large banks with sophisticated risk management systems to use risk assessment based on their own models in determining the minimum amount of capital they are required to hold by the regulators as a buffer against unexpected losses.

However, recent events challenge the usefulness of important elements in the Basel II accord. The need to recapitalise banks reveals that the internal risk models of many banks performed poorly and greatly under-estimated risk exposure, forcing banks to reassess and reprice credit risk. To some extent, this reflects the difficulties of accounting for low-probability but large events.

A more fundamental problem is that Basel II creates perverse incentives to underestimate credit risk. Because banks are allowed to use their own models for assessing risk and determining the amount of regulatory capital, they may be tempted to be overoptimistic about their risk exposure in order to minimise required regulatory capital and to maximise return on equity.

Bank capital-asset ratios are near historically low levels, typically at about 7 per cent of total assets (on a non risk-weighted basis). During the past five years, several so-called “quantitative impact studies” (QISs) have been conducted under the auspices of the Basel Committee on Banking Supervision to explore the consequences of shifting from Basel I to Basel II for large banks. These studies show that bank capital requirements will fall further for many banks when the Basel II rules are fully implemented. In the US, the QIS results indicate potential reductions in required capital of more than 50 per cent for some of the largest banks.

The turmoil on financial markets, which has caused large banks to take substantial losses and search for significant new capital, indicates that Basel II should not be implemented, if at all, without first making a number of important changes. We advocate the following improvements in order to correct some of its deficiencies.

First, we urge the Basel committee to conduct another quantitative impact study using observations from the recent turmoil before allowing banks to use their internal models for calculating regulatory capital.

Second, we advocate the additional adoption of a meaningful non risk-weighted leverage ratio requirement, as currently applicable in the US, to supplement Basel II risk-weighted capital requirements. Consistent with the FDIC chairman, we believe that it is important to have a minimal capital cushion in the banking system, even when risk-based Basel II capital rules indicate lower risk. Strong capital allows banks to recognise losses and put problems behind them in times like the ones we are now experiencing. And strong capital gives banks the flexibility to serve as shock absorbers to our economy during difficult times.

Third, we recommend that the Basel II approach using banks' own risk models should be complemented by a credible and effective form of market discipline. While Basel II contains information disclosure requirements, at the same time it fails to create incentives for professional investors to use this information in an optimal way. As long as professional investors holding bank liabilities have the perception that large banks are too big to fail – or that all deposits will be fully protected against loss, as in the Northern Rock case – they will have the idea that their money is not really at stake. This will mitigate their incentives to use the disclosed information. A mandatory requirement for large banks to issue credibly uninsured subordinated debt as part of the regulatory capital requirement could enhance market discipline, thereby mitigating banks' incentives to reduce capital.

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