

THE FUTURE OF BANKING REGULATION: BASEL II AFTER THE CRISIS

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PLAN OF THE PRESENTATION

1. THE FAILURE OF BANK REGULATION
2. RISKS WERE NOT CORRECTLY ASSESSED BY REGULATORS
3. NEED TO REFORMULATE THE OBJECTIVES OF BANK REGULATION
4. SOME REFORM PROPOSALS

1. FAILURE OF BANK REGULATION

1.1 THE BASEL PROCESS

1.2 REGULATORS HAVE GROSSLY UNDERESTIMATED HOW MUCH CAPITAL WAS NEEDED BY BANKS

1.3 AN ILLUSTRATION: NORTHERN ROCK

1.1 THE BASEL PROCESS

- 1988: Basel Committee for Banking Supervision (BCBS) established prudential regulations (Basel I) to promote safety and soundness in the international banking system and maintain a level playing field between countries. Basic ingredient= minimal capital requirement for banks.
- 2004: after a long revision process, BCBS published a new framework (Basel II): much more complex, gives a lot of discretion to national banking supervisors.
- Just before the crisis, in June 2007: most large banks held much more capital than required by Basel II.

1.2 REGULATORS HAVE GROSSLY UNDERESTIMATED HOW MUCH CAPITAL WAS NEEDED BY BANKS

- Since the beginning of the crisis, major banks have been forced into massive recapitalizations, both by private investors and governments all around the world.
- In spite of huge public support : more than 20 bank failures and generalized confidence crisis, freeze of liquidity markets, credit crunch and most probably worldwide recession.
- Banking supervisors have grossly underestimated the level of capital needed by banks to prevent such a crisis

1.3 AN ILLUSTRATION: NORTHERN ROCK

Northern Rock : one of the first banks to anticipate Basel II.

Business model: borrowing in short term wholesale markets, investing in long term mortgage products.

In spite of huge transformation risk, their capital requirement was reduced by Basel II!

Testimony of Northern Rock CEO in the UK Treasury Committee after the bailout:

Question: « why was it decided, a month after the first profit warning (July 2007), to increase the dividend at the expense of the balance sheet? »

Answer: « Because we had just completed our Basel II... process and under that, and in consultation with the FSA,... we had surplus capital. »

1.3 AN ILLUSTRATION: NORTHERN ROCK(2)

- By June 2007, just as the crisis was to break, Northern Rock had total assets of £113 billion and shareholders equity of £2.2 billion.
- Risk Weighted Assets (RWA) under Basel II was £19 billion (16.7% of total assets), compared to £34 billion under Basel I (30% of assets).
- Total regulatory capital: £1.52 billion
- In the end, British authorities had to inject £23 billion, i.e. 15 times the amount of regulatory capital required by Basel II!

2. RISKS WERE NOT CORRECTLY ASSESSED BY REGULATORS

2.1 TRANSFORMATION RISK WAS IGNORED

2.2 NOTION OF VALUE AT RISK IS MISPLACED

2.3 SYSTEMIC RISK WAS NOT TAKEN INTO ACCOUNT

2.4 MODEL RISK WAS NEGLECTED

2.1 TRANSFORMATION RISK WAS COMPLETELY IGNORED

- The idea that banking risks can be reduced to asset risks is just wrong
- Back to basics (Banking 101): first source of banks' fragility is TRANSFORMATION
- How come the very sophisticated apparatus designed by BCBS does not even mention it?

2.2 NOTION OF VALUE AT RISK IS MISPLACED(1)

Basel II: based on the notion of Value At Risk (VaR)= capital buffer needed to limit a bank's probability of failure to some threshold

- May be appropriate for bank managers who aim at a certain rating, typically associated with maximum probability of failure.
- May be appropriate for bank shareholders, who are protected by limited liability: do not bear the losses above and beyond bank's capital.

2.2 NOTION OF VALUE AT RISK IS MISPLACED(2)

Notion of Value At Risk is inappropriate for regulators:

- Losses in excess of a bank's capital are typically covered by public authorities: need to incorporate these losses into regulatory risk measures (Tail VaR)
- Monitoring banks one by one is not sufficient: a situation where 2% of banks fail every year can be acceptable, certainly not a situation where all banks fail together every fifty years
- Need to measure banks' exposure to macroeconomic shocks, as well as banks' bilateral exposures

2.3 SYSTEMIC RISK WAS NOT TAKEN INTO ACCOUNT

Systemic Risk was in theory a major preoccupation of banking regulators:

In practice: not a single specific measure against systemic risk in Basel II!

Urgent need for supervisors to assess banks' exposures to systemic risk:

- Macroeconomic shocks
- Global disruption of financial markets

2.4 MODEL RISK WAS NEGLECTED

- In finance, mathematical models have to be used with a grain of salt: limited predictive power, subject to regime changes and endogenous risk (herding behavior, bubbles).
- The use of complex mathematical formulas by the BCBS is just ridiculous: too simple to be true, too complex to be verified by outsiders.
- Risk management is more of an art than a science: better to cover all risks with rules of thumb than just one or two risks with very complex models and forgetting the rest.

3 NEED TO REFORMULATE THE OBJECTIVES OF BANK REGULATION

- Prudential regulation is not meant to tell banks how they should manage their risks.
- Its main objective is simply to identify soon enough the « bad sheep » (i.e. the banks that endanger their deposits or the financial system), and to curve their behavior before it is too late.
- Macro-prudential regulation (how to protect the banking and financial system) is probably more important than micro-prudential regulation (how to limit individual bank failures) but has not received proper attention yet.

4.REFORM PROPOSALS

4.1 STRONG INDEPENDENT SUPERVISORS

4.2 SIMPLER BUT BROADER REGULATIONS

4.3 CRISIS MANAGEMENT SYSTEMS

4.1 STRONG INDEPENDENT SUPERVISORS

- Main reason why banking crises are recurrent: governments cannot commit not to bail out failing banks
- Bankers take too much risk, anticipating public support in case of problems
- Need to set up strong supervisory agencies that have the power to curb the behavior of « black sheep » before it is too late (e.g., special bankruptcy law for banks)
- Need to protect supervisory agencies from pressure by politicians and lobbies

4.2 SIMPLER BUT BROADER REGULATIONS

- Regulations should not be seen as recommendations for bankers but instead as early warning systems, forcing supervisors to intervene before it is too late.
- Regulations must be simple, in order for supervisors to be accountable.
- However they must cover the whole range of banking risks and, also include macro-prudential measures.

4.3 CRISIS MANAGEMENT SYSTEMS(1)

- Other banking crises will occur in the future.
- It is important to specify ex ante how these crises will be managed, instead of improvising under pressure, like in the current crisis.
- Crisis management necessitates the collaboration between banking supervisors, Central Banks, governments, and international institutions.
- As much as possible , « who does what when » has to be agreed upon in advance

4.3 CRISIS MANAGEMENT SYSTEMS(2)

- During « normal times », resolution of banking problems must be done without intervention of central banks and governments. Market discipline must be used as a complement to supervisory action.
- During « crisis periods » these « principles » break down: liquidity support by central banks and capital injections by Treasuries are needed, markets do not work well.
- Special institutional features have to be designed, precisely because exceptional measures have to be taken during crises.