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Basle III and "Bail-in"s

The recent budget provided for Rs 25,000 crores for increasing the capital of public sector banks; the Economic Survey has mooted the idea of using the Reserve Bank's balance sheet to help meet the Basle III capital norms; the RBI has also permitted banks to revalue real estate for the same purpose.

Few now recall that, when the Basle Committee on Banking Supervision started specifying capital adequacy norms for the banking system about 25 years back, the initial standard was very simple: 8% of assets which carry credit risk. The next step was the introduction of a capital charge for market and operations risks. Then came the 2008 crisis in global financial markets and Basle III has been a "work-in-progress" since then. The laudable objective of Basle III is to avoid the tax payer being burdened with having to bail out the banking system again. Much of the work has been completed and a few important factors have emerged:

- The capital charge has been increased significantly because, as a recent IMF report said, *"Had banks had sufficient buffers to absorb losses in the range of 15 to 23 per cent of risk-weighted assets, most* (recent banking) *crises would have been avoided - at least for advanced economies."* The report recommends even higher capital for banks in emerging markets -- as if the crisis had occurred in EMs!;
- The calculations use highly complex models; and
- Some recent incidents in Europe create question marks about implementation issues.

It is ironic that the revised models for measuring market and credit risks are based on the same principles as the models used by major banks before 2008 for measuring the same risks in their portfolios of mortgage securities!

Another issue is the sheer complexity of the models to be used for valuation of the trading book. A couple of examples: the recent *Fundamental Review of the Trading Book* (FRTB) document requires value adjustments for "exotic exposures" like "future realised volatility" – whatever it means. Another major change is a shift from "value-at-risk" (VAR) to "expected shortfall" – which too is based on the Gaussian distribution of price changes, and incorporates the risk of market illiquidity. It is beyond the imagination of this student of models in quantitative finance how the impact of liquidity on prices can ever be measured by models – as also the measurability of operations risk, broadly defined as failed internal processes, people and systems or from external events (PPSE). One imagines that the so-called “residual risk charge”, whatever it means, will take care of such issues. There are many issues in relation to measurement of the credit risk as well. What about the model risk itself, the biggest being psychological – giving the user a false assurance of safety?

Equally problematical is the composition of capital itself. There is additional Tier I capital in the form of Cocos (Contingently Convertible Bonds), which came into headlines recently (*The Other Side,* February 18), perpetual bonds which count as Tier II capital, etc: from the perspective of the investor, it is very difficult, if not impossible, to value such bonds. Who will invest?

One imagines that all the complexity and the increase in capital to comply with Basle III would be worthwhile if it could meet the laudable objective of the taxpayer not having to bail out banks in difficulties. But will it?

- If the increased capital is to be serviced, banks would need to earn adequate returns on the capital. And, the only way this could be done is by charging higher margins to the end-user of banking services, who is not very different from the taxpayer to help whom the whole structure has been created;

- If governments/taxpayers are not to bail out the banks, their creditors will have to be “bailed in”: equity investors; investors in cocos and perpetual bonds; holders of senior debt which does not count as secondary capital; and, finally, the depositors – together, they are not very different from a cross-section of the taxpayers who would otherwise have had to bail out the banks. No wonder the recent “bail in”s of bond holders by the Portuguese and Italian authorities have led to controversies and court cases.

Is Basle III really a “naked emperor”? Perhaps what Walter Bagehot, the Victorian economist, said in the 19th century, remains equally valid in the 21st: “*A well-run bank needs no capital. No amount of capital will rescue a badly run bank.”*

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