Basle III: A Progress Report

Ever since the 2008 banking crisis, the Basle Committee on Banking Supervision (BCBS) has been engaged with developing models and regulatory framework aimed at capital adequacy of the financial intermediaries to prevent another crisis. One unintended consequence of the last three decades of the Anglo Saxon ideology of financial liberalisation has been the increase in frequency of financial crises: the savings and loan crisis in the US in the late 1980s/early 1990s; the balance of payments crises in Mexico, Asia, Brazil and Russia in the 1990s, and in Argentina in 2000-01; the 2007-08 crisis in the mortgage securities market in the US. Would Basel III and the sharply increased capital charges for the banking system prevent, or at least mitigate, the next banking crisis?

It is customary to separate major risks for banks as under:

- market/price risk in the trading book;
- credit risk in the loan book as well as the counterparty credit risk in the derivatives book;
- liquidity risk; and
- operations risk.

While BCBS has come out with ever more complex models for measuring these, and prescribing capital charges based thereon, the process is still evolving. To give one example, it was reported earlier this month that BCBS is thinking of scrapping the decade old advanced measurement approach (AMA) for operations risks, as the AMA has not worked as intended. A new approach is expected later this year. As for the models for measurement of market risk, which depend on the historical volatility of price movements and their correlations, the problem is that these are rarely stable. One example: intra-day fluctuations in the price of the benchmark 10-year Treasury bond in the US, exceeded 5 standard deviations a dozen times in less than three years. To be sure, the models are to be subjected to stress tests to see whether they work under extreme conditions. But the most sophisticated mathematics may not be adequate when measurable risks turn into non-quantifiable uncertainties; when the “Minsky moment” arrives.

Earlier this month, the BCBS came out with the Ninth Progress Report on Adoption of the Basel Regulatory Framework, and seems generally satisfied with the progress achieved: it is hopeful that most of the major economies would have proper regulatory frameworks and capital standards in place before the end of the decade. However, one wonders whether the commitment of policymakers to tighten banking supervision is wavering. One example: a few months back, the head of Britain’s Financial Conduct Authority was sacked by the government for being too strict with banks. One wonders whether we are going back to “light touch” regulation of financial services, which was a major factor behind the 2008 financial crisis. Markets are supposed to have short memories: do governments too suffer from the same disability?

This apart, the very complexity of some of the rules framed is daunting. The so-called Dodd-Frank Act in the US, aimed at tightening the regulatory framework, was passed five years back. One of the more publicised provisions is the ban on commercial banks’ undertaking “proprietary trading”. As *The Economist* reported recently, the relevant clause in the Act is just 165 words long but the regulators concerned have produced a 900 page preamble and a 71 page operational rule! Chances are that the wording has been influenced significantly by bank lobbyists and their lawyers, to leave enough loop holes for the banks to exploit. In any case, the dividing line between proprietary trading, which is banned, and market making, which is permitted, is extremely thin.

The complexity of the framework can be gauged from the list of capital requirements whose progress was recently reported by BCBS: capital conservation buffer; countercyclical buffer; standardised approach for measuring counterparty credit risk; securitisation framework; capital requirements for bank exposures to central counterparties who guarantee settlements; leverage ratio; liquidity coverage ratio; net stable funding ratio; etc. etc. And, there are separate principles and methodology prescribed for systemically important banks. No wonder the European Central Bank gave itself four more years to review the system!

If only knowledge of mathematics were sufficient to manage the banking system safely, Basle III would surely take us to that *Nirvana.* But is it? As economist John Kay wrote in a recent article (Financial Times, October 7), “*use of algebraic symbols and quantitative data”* only give a façade of certainty. In the process, are we overlooking the need for an equal emphasis on a qualitative approach to analysing risk?

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