



## Basel II: delays and criticism

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In January 2001, the Basel Committee published a proposal for a new Capital Accord which, once approved, would replace the agreement that has been in effect since 1988. This proposal, which involves modifying the system on the basis of that which currently governs most banks in terms of risk control, has been named Basel II. The Committee's intention is to provide models that are more comprehensive and risk-sensitive, and which enable organisations to manage their resources more efficiently.

The offer is based on three principles that allow banks and supervisors to correctly assess the various risks with which financial institutions have to deal. These principles are: the minimum capital required; a review of supervision; the market's internal discipline.

It is thought that the definitive document will be available at the end of this year, as Basel II is still only a preliminary draft. At present, it has been stated that 2005 would see the Accord come into effect. However, it seems that there will be a further delay and that the Accord is unlikely to become applicable before 2006.

The Committee attributes these delays to the quantity and quality of the enquiries received since early in 2001. However, it is highly likely that reasons of a more political nature are also involved, despite the fact that Andrew Crockett, managing director of the Bank for International Settlements (BIS), has adopted an aggressive stance towards certain political leaders, asking them to keep out of the matter and not to interfere with the banking sector's reform process. In any case, the continuing delay in drawing up a final text is logical, as the initial proposal made by the Committee in January last year has already undergone several modifications, as can be seen in the working papers of the BIS. This is comprehensible, given the ambitious nature of Basel II.

The new Capital Accord can be described as ambitious for several reasons. The first is that it covers more levels of risk than before. Previously, the terms credit risk and market risk were applied, but Basel II also refers to operational risk, an issue to which it gives great importance and which has been one of the main sources of criticism.

Banks' scope of action and possibilities are also increased. With this, I refer to the three principles upon which Basel II is based: The first of these is the minimum solvency ratio. In 1988, with the Capital Accord, this ratio was set at 8%. Basel II introduces flexible criteria and increases the scope of action for financial organisations where establishing this ratio is concerned. It will allow banks to adapt terms and conditions on the basis of the level of risk involved in transactions. The method for calculating credit risk will, in turn, be developed further. There are two proposals, the first being to adhere to a standardised model, similar to the current one but more risk-sensitive; while the second is a model based on each bank's internal rating (IRB). In the case of the IRB, there are two models. The methodology suggested to the banks for calculating the credit worthiness of each borrower, referred to as basic, consists of calculating the associated degree of probability of non-payment, along with other external variables. The results would be used as input data for calculating potential future losses.

Another of Basel II's principles is the supervision process. The supervisors will be responsible for risk control systems as well as for assessing the manner in which banks calculate the suitability of their assets. The proposal underlines the importance of each institution developing a risk management and control process, taking into account its specific characteristics and the environment in which it operates. Finally, we come to market discipline. The BIS proposes the disclosure of effective information and makes recommendations regarding various aspects, including the way in which banks calculate the suitability of their assets and the methodology to be used. The new set of measures offer a greater capacity for discerning between various risk levels.

Despite the Committee's objectives and good intentions, three elements of the proposal have been highly criticised. One of these is the exaggerated importance given to operational

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risk. It was originally proposed that 20% of investments be earmarked for coping with this type of risk. A flood of complaints led to the review of this point and, in a working paper published in September 2001, the figure was lowered to 12%. However, this percentage is not definitive. It is the central banks who will have to establish the definitive rules. Whatever the case, in the working paper in which the reduction of operational risk to 12% was referred to, a rather interesting door was opened to combat this risk, namely insurance. Holding reserves on investments in order to be able to deal, for example, with the destruction of information due to the malfunction of the financial institution's database, constitutes "self-insurance". So, why not have real insurance instead of having to mitigate operational risk through capital?

Another of the most controversial aspects has been the general tendency of the new Accord to favour large entities as opposed to small entities. When the solvency issue is taken care of, all the related elements seem to reap benefits: large financial institutions as opposed to small or medium-sized organisations, large companies as opposed to their small and medium-sized counterparts, developed economies as opposed to the emerging ones, and the highs of the economic cycle as opposed to the crises. The incentives for improving the risk control system and capital assignment sensitivity in terms of the quality of the risk are the two mechanisms that produce this asymmetry. Institutions capable of developing the more sophisticated systems will be able to save up to 13% in terms of capital consumption in the first two years, even if they issue loans with the same levels of risk. As this represents a high cost, only the large institutions will find the incentive justified.

The scale factor requires a more in-depth analysis. As opposed to the 1988 accord, the assignment of capital has been made more flexible on the basis of risk classification. Indeed, this rigidity was one of the main criticisms of the old method. However, if the degree of flexibility is too great, the application of the measures proposed by this Accord will accentuate the differences, making it compulsory to assign more capital than necessary. The problem lies in the fact that there is an exaggeration in the calibration system. The following serves as evidence thereof: if a bank issues a loan to a company with a risk category of AA only €1.6 per 100 of this investment will be consumed. However, if the category falls to A, €4 per 100 will then be consumed (whereas the real need for capital as a consequence of the changes in the probability of loss due to failure to comply may only require just over half). In the case of dropping to the following category, €8 would be consumed, while another step down (B+) would involve the consumption of €12.

One of the components of the price of the loan is the funding covered with own funds. These funds are notably more expensive than their external counterparts, and this factor will affect the price. An excessive assignment of capital will therefore produce an excessively high price. However, the price will not be alone in suffering the consequences of such an assignment. If the availability of capital is an effective restriction for the bank, it will be able to loan more money to companies with a high rating than to those with a rating in the B categories.

Extrapolating this principle, developed countries with larger banks and greater portfolios of large companies will be able to lend more with the same capital than countries with emerging economies; small and medium-sized companies will be at a disadvantage and small banks, although solvent, will operate in lower categories than their larger peers, resulting in the credit they obtain by way of a counterpart also being more costly.

The third most highly-criticised element of Basel II is its pro-cyclic effect. When the economy suffers the effects of a crisis, there is a general fall in companies ratings; there are more organisations whose ratings are falling than whose ratings are rising. If we take into account the fact that the weighting to be applied depends on the categories in question, we will find that there would be an automatic contraction of credit, and hence a slowing up of investments at the worst moment possible. As a consequence of the complaints received, a trend towards reducing the initiative's pro-cyclic nature and favouritism towards larger entities can be noted in the more recent working papers. However, we shall have to wait for the definitive version of the New Accord until such time as the Committee deems it suitable to publish it. **bt**

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