The Anti-Basel III Chorus: Throwing Out the Baby With the Bathwater?

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The news earlier this month that the finalization of the U.S. version of Basel III financial reform had been postponed indefinitely sent Wall Street and community bankers into ecstatic fits. While requiring community banks to implement the Basel III framework, which since its origins in the early 1970s has been focused on internationally-active banks and is very onerous, the same cannot be said for these capital requirements and big banks. No regulatory framework is perfect, yet financial journalists bear a responsibility to better understand the framework before they attack or adulate it.

In recent days, journalists' "Bring down Basel III" chorus has become so loud that Verdi's Anvil Chorus seems subdued in comparison. In a November 12 editorial "Escape from Basel," *The Wall Street Journal*, for example, is very critical about Basel III. Fair enough, in that an editorial is about putting forth an opinion. I use this editorial because it is illustrative of much of what most financial journalists write or leave out lately on Basel III.

In fact, there are parts of the editorial that are correct. For example, the *Wall Street Journal* states that Basel III's system of risk weights is complex. That is correct. For those banks which regulators permit to use the Advanced Internal Rating Based Approach, they get to use their own credit risk models to determine the credit risk drivers for the Basel credit risk capital formula, that is, probabilities of default (PDs), loss severities (LGDs), exposure at default (EAD), and maturities.

Large internationally active banks like this because they can use their own internal data to calculate their Risk Weighted Assets (RWAs) to predict expected losses and to then come up with the necessary cushion for unexpected losses. And indeed, those banks have a lot of flexibility, to say the least, in coming up with their own risk weights for their credit risk capital allocation.

Yet, seasoned bank examiners who get to examine many different banks are able to spot when a bank is often coming up with risk weights that are much lower than peers. While imperfect, this can serve as a deterrent to outright manipulation of risk weights. What the *Wall Street Journal* does not state is that if banks find that Basel III is too complex, it may because they have become so large and complex that they have lost sight of how to identify, measure, control, and monitor their own risks.

Also, what this editorial and many critics often do not mention is that Basel III is not supposed to be implemented overnight. Those countries that accept Basel III as part of their domestic laws have a suggested implementation timeline of 2013-18. It is important to remember that banks have had since 2009 to prepare for

Basel III. The Basel committee released draft rules, and banks and lobbyists had plenty of opportunity to critique the draft. Then when each country has been debating Basel III in its jurisdiction, banks have more chances to again critique the rules and make changes. The result has been a very watered-down version of what was proposed in 2009.

The *Wall Street Journal* editorial is incorrect contending that regulators do not understand capital calculations. This is a gross generalization. Increasing numbers of bank regulators, and internal and external auditors, in fact, in both the U.S. and abroad have had to learn the calculations as a requirement to conduct Basel risk based exams.

Also, what the editorial does not mention is that banks need to meet quite a host of requirements such as on corporate governance, data, and modeling before they are able to use their own internal data for credit risk drivers. Not all banks can use their own internal models and data to create their RWAs. The others use what is called the Standardized Approach where they use regulatory inputs for their credit risk drivers; the challenge with that framework is that it is a 'one size fits' all method and too simplistic.

It is important to note that most of the *Wall Street Journal* editorial and reports from other news organizations are based on RWAs which are used for credit risk measurement. The guidance for RWAs is in Pillar I, where most of the Basel accords math is. What most people do not write about is that Pillar I also gives guidance to banks on how to measure market and operational risks; the measurements guide the banks as to how much capital they need to allocate for unexpected losses due to those risks.

The *Wall Street Journal* states that Basel III has the improvement that it requires more capital banks. That's exactly what Basel III requires. Not only is more Tier I capital required under Basel III than Basel II, there is more emphasis on common equity as opposed to a whole host of other components which the U.S. fought against unsuccessfully since the early 1970s until 2010, when Basel III was finalized.

Also, Basel III has additional capital requirements in the form of conservation buffer, an anti-procyclicality buffer, and a SIFI buffer. All of these buffers, together with increased common equity and Tier I amounts, are designed to increase the safety of the global financial system and to make it harder for big international banks to get even bigger.

Capital Requirements (% of RWA)	Basel II	Basel III*
Minimum common equity capital ratio	2.0%	4.5%
Capital conservation buffer	–	2.5%
Common equity + capital conservation	**2.0%**	**7.0%**
Minimum Tier 1 capital ratio	4.0%	6.0%
Minimum total capital ratio	8.0%	8.0%
Total capital + capital conservation	**8.0%**	**10.5%**
Leverage ratio (non-risk-based)	–	3.0%
Countercyclical capital buffer (nat. discretion)	–	0 – 2.5%
SIFI capital buffer	–	?

**Fully phased in*

Moreover, in addition to having capital for credit, market, and operational risks, Basel III also now has capital requirements for liquidity and leverage which are much more than under Basel II. Importantly, the calculation for leverage is not risk based, which is a way to deal with RWA flexibility or outright manipulation.

Also, the *Wall Street Journal* editorial and most journalists do not mention Pillars II and III, which are very important but not neglected components of the framework. Pillar II provides amongst other things guidance to banks on how to conduct stress tests. Importantly, Pillar II also provides guidance to the regulators as to what they need to do proactively to insure that banks are well capitalized.

Pillar III provides guidelines for the banks to be transparent about their on- and off-balance sheet activities, especially for securitization. This pillar requires that banks disclose the quality of capital that they have, give details on Tier I and II, and to at least mention what methodologies they use to calculate their credit, market, and operational risk capital allocations. This information would be very useful for all types of investors, regulators, rating agencies, and financial journalists.

ARCHITECTURE OF BASEL II

Three Pillars

- Minimum capital requirements
- Supervisory review process
- Market discipline

Pillar 1
- Credit risk
- Operational risk
- Market risk

Pillar 2
- Banks review own capital adequacy
- Supervisros evaluate banks' assessments

Pillar 3
- Increases disclosure for enhanced market discipline

Is Basel III perfect? No, nothing ever is. Banks cannot have good risk management simply by managing to a number. Basel III is a very useful tool to improve banks' risk management but it is not the only one. Also, because countries are in different stages of the credit cycle and have different banking systems, not to mention different laws, it is impossible to implement and supervise Basel III uniformly and simultaneously. This flaw will always mean that whether it is Basel III or any that will come afterward, will fail to achieve its main objective of having uniform capital standards for banks to lessen global systemic risk and to minimize regulatory arbitrage.

It is incumbent that everyone brings down the shrillness over the debate of capital requirements and financial sector reform. We are all supposed to be on the same side; that is, we need a healthy banking sector in order to have a healthy financial sector, not mention a strong economy. One can try to "Escape from Basel," but financial regulation cannot be escaped, since institutions cannot supervise themselves correctly. By not properly explaining and considering all the aspects of Basel III, we risk doing our economy a disservice by throwing away the baby with the bath water.

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