



frontiers in finance supplements

Did Basel II fail?
An Australian perspective on recent criticisms

September 2009

FINANCIAL SERVICES

In the aftermath of the global financial crisis (GFC), questions on the lips of many risk managers and regulators include one of the most obvious: “did Basel II fail?” Paul Lichtenstein and Bradley Gluck examine this from an Australian perspective

Some market commentators and opponents to regulatory intrusion (sidestepping the role of governments in bailing out sinking banks) propose the view that Basel II has failed. The thrust of their argument is that if Basel II had worked as it was designed to, the extent of strain on the global financial system at the peak of the crisis would not have been as severe as it was. Banks should have been better able to cope with the losses that infected the global banking system. The argument continues that, it clearly failed, and the cost of implementation has been more an exercise in regulator appeasement than investment in fail-safe risk management practices for the benefit of the individual bank or the wider financial system.

In order to assess the legitimacy of these assertions, it is worthwhile to look at such claims and to discuss their accuracy to establish whether Basel II had any role in creating (or failing to mitigate) what is known as the GFC:



Basel II was intended to create an environment where sub-prime loans could not be originated in such a reckless fashion. Its capital rules did not do their job.

To answer this, one should revisit one of the contributory sources of the problem. The sub-prime loans underpinning the crisis were originated in the United States of America, a country where various lobby groups delayed Basel II implementation until 2008 for regulated banks, largely as a result of political positioning. Pillar One of the Accord is designed to link the quality of originated loans to capital requirements – the riskier the loans, the higher the capital requirement. However banks that originated what were to become toxic sub-prime loans, were not subject to Basel II requirements and thus were not subject to the risk-

sensitive capital framework of the Accord. It would, in our opinion, be harsh to judge Basel II to be ineffective since it had not been fully or appropriately adopted.

It could be argued that even if Basel II had been implemented in the US prior to the eventual crisis, it might not have catered for the risk of sub-prime loans. The reason for this is the rating models adopted by the Accord require between 5 and 7 years of history to rate potential loan risk. The period of time this data history would have captured was a sustained period of low defaults and appreciating assets and would have reflected only one-half of a full credit cycle. The ability of rating models to cover a sufficiently long period of time to incorporate maximum through-the-cycle information is currently in the spotlight for both banks and regulators.

The capital requirements set out by Basel II did not protect the banks from the losses incurred via securitization of toxic assets.

Banks adopting Basel II in a number of cases were not protected by their capital buffers from the mountain of losses associated with derivative products that had sub-prime loans as underlying assets. There are two aspects to this point that should be explored to create the correct context. Firstly the distribution sources of a number of the toxic assets were US investment banks, which were not subject to Basel II rules. Basel II was not designed to protect against losses emanating from investment portfolios – it was designed to protect banks from losses incurred as a result of conducting traditional retail, commercial and wholesale lending. Secondly whilst there is a legitimate criticism

to be leveled at Basel II around the limited capital requirements for instruments held in the trading book, it should not deflect attention from the fact that banks should have held additional capital to make up the deficit over and above regulatory capital requirements.

The Basel II Accord is not, and never was, designed to be a substitute for internal risk capital. Many banks were able to circumvent holding capital in the pursuit of returns by holding derivative instruments in the trading book – and this was done to the fullest extent possible. Internal risk models used by some banks severely underestimated the scale of inherent risk residing in such portfolios. This was in part due to a lack of conservatism in the internal risk measurement tools and due to high complexity in instrument

structures of new products. Whilst it is a shortcoming of the Accord to have not closed this gap, these banks are guilty of relying on rating agencies to determine the risk of the purchased instruments, rather than performing their own risk analysis.

What is clear is that many banks continue to outpace regulations in the development of new products; however the ability to understand the new risks does not necessarily keep pace with this innovation. In the case of the derivative products i.e. collateralized debt obligations (CDOs) and credit default swaps (CDSs) at the centre of the GFC, the banks relied on rating agencies to provide that risk understanding. However many rating agencies also failed to understand the risk intricacies of the products flooding the market at that time. The net result was a false sense of security by banks in ratings applied to the instruments in question, leading to under-capitalization and a move away from risk-return based decision behavior. The issue of how this will be avoided in the future is currently on the agenda of regulators around the world

Basel II promoted pro-cyclicality, and thus amplifies the destructive impact upon capital.

Although not strictly related to the credit crisis, this view appears to be gaining popularity since; the argument that Basel II promotes high capital levels in recessionary periods, and low capital levels in periods of sustained economic prosperity. The issue is that when a period of economic prosperity does reverse its course suddenly, probability of default (PD) mirrors the change and leaves banks requiring more capital in a market where conditions for such initiatives are unfavorable. Basel II has been criticized for amplifying the damage to financial systems by assuming banks had access to willing financial markets in this scenario.

However in the case of the GFC, the result of the market reversal from prosperity to

recession was swift, and banks had not prepared for such an eventuality. It can be argued that given the overwhelming scale of losses from sub-prime assets, access to willing investors was irrelevant during the global credit crisis; governments were barely able to fund the magnitude of required bailouts from loss exposures. What cannot be refuted is that banks and regulators have the perfect opportunity now to address this issue for the future – and this is slowly being demonstrated via new guidance papers being issued by the Basel Committee on Banking Supervision (BCBS) vis-à-vis “Enhancements to the Basel II framework”.

There is considerable room for discussion on this topic between banks and regulators. The FSA in the UK has already recommended a counter-cyclical buffer to be created for protecting against future downturn-initiated capital squeezes. The next stage of discussions is likely to revolve around using point-in-time or through-the-cycle PDs, and around how long a credit cycle can practically be for modeling purposes.

If Basel II is not at fault, why is it being updated?

This article has discussed some of the obvious criticisms of Basel II in the aftermath of the high-tide of the global financial crisis. However there should be no doubt that there are areas of the Basel II Accord that are lacking and contributed either:

- Explicitly (whether it be via regulators failing to implement with a stronger hand or simply that the Accord failed to account for specific risks), or
- Implicitly (via bankers exploiting the gaps in capital to amass vast positions in derivatives instruments).

The latter effectively nullified the intent of Basel II to tie risk-taking activities to capital levels, leading to the current state of financial stability.

Regulators in Europe have acknowledged as much, and have begun reforming regulation via the Turner Review and a commitment to play a much more forceful and involved role in ensuring banks adopt regulatory guidelines and to report all risk exposures in normal and stressed conditions. This includes extending regulation to investment banks and hedge funds, both of whom were previously beyond the regulatory regime. Gaps in the coverage of Basel II in terms of treatment of assets in the trading book are also going to be narrowed and capital buffers to counter pro-cyclical volatility of capital are also likely.

The Basel II Accord was by no means perfect prior to the GFC. However placed in the proper context, it is our belief that it is inappropriate to lay blame at the doorstep of the Accord itself. It is more correct to question the role of politically sensitive regulators and ultimately some bankers keen on pursuing return first and managing risk later.

For more information please contact:



Paul Lichtenstein

Partner

KPMG in Australia

Tel: +61 3 9288 6420

e-Mail: plichtenstei@kpmg.com.au



Bradley Gluck

Manager

KPMG in Australia

Tel: +61 2 9295 3965

e-Mail: bradleygluck@kpmg.com.au

The views and opinions expressed herein are those of the authors and do not necessarily represent the views and opinions of KPMG International or KPMG member firms.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2009 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative.

Designed and produced by KPMG LLP (UK)'s Design Services

Publication name: Did Basel II fail? – An Australian perspective on recent criticisms

Publication number: RRD-160824

Publication date: September 2009