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The Changing Face of Regulation

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THE CHANGING FACE OF REGULATION

Dennis Cox is the Chief Executive of Risk Reward Ltd, the LinkedIn Global Risk Forum and chairs the Chartered Institute of Securities and investment Risk Forum based in London. In this second in a series of articles on this subject he discusses the changing face of regulation and what are the likely outcomes from the current process. The limited global vision is particularly highlighted and the changing roles that are required.

Let us remember what has happened and how we are where we are. Basel 2 was intended to be a more risk sensitive version of Basel 1 incorporating capital requirements for operational risk and recalibrating the capital requirements for credit risk. Drafted originally in 1999 its implementation has been globally rather slow so that we are still in the position ten years later that implementation in many countries is still at an early stage.

In developed markets we may well be discussing stress testing and pillar 2 disclosures, whereas in other markets the actual requirements have not event been published at this time.

Then we had the liquidity crisis which led to a credit crisis as bank liquidity forced a reduction in available credit. Of course Basel 2 did not deal with liquidity; indeed it was not addressed at all. Separate papers have subsequently been produced to develop thoughts and ideas for the management of liquidity risk, many of which are little more than a retread of older papers.

So we are now looking to make major changes to Basel 2 in terms of what people are calling incorrectly Basel 3. The changes are unlikely to be published as a new Accord; rather they are likely to represent a revision to the existing Accord. A consolidated revised final Basel 2 Accord will be published – just as there was a Basel 1 Accord with and without market risk.

The real question is what is really required? We can see that the commentators and central banks are debating what were the actual causes of the crisis, although this is also biased by public opinion. The resulting general view is that banks took on an inappropriate level of risk and that they were inadequately capitalised to deal with the stress events that occurred.

As I will seek to explain in this article, I take the view that the entire debate at the present time is missing the point and could result in sub-opt5imal solutions which have the effect of damaging the global economy.

The Cause of the Crisis

In my opinion the real heart of the crisis was government debt causing mispricing of assets in the global

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market. An unsustainable government borrowing requirement enforced a higher level of bank activity and policies globally encouraged the consequent activity.

Given that profligate governments are certainly one of the prime culprits, this would suggest we need better regulation of governments and to avoid banks holding the debt of their own country. Of course the entire debate is currently suggesting the contrary.

Are Banks under Capitalised?
In many ways this is the real question – yet it is difficult to answer. The original capital values set within Basel 1 really have very little intellectual underpin. Of course Basel 2 enables this guesstimate to be better calibrated without dealing with the issue.

If capital is for expected losses then this can make little sense – product pricing deals with such matters much more effectively. Could bank capital be set at a sufficient level to deal with stress based losses at a 99.9% confidence level? What that would mean is that the bank would need to maintain capital that would not be needed 999 times out of a 1,000. This would have the effect of building up global pockets of excess capital which increase the cost of borrowing and decrease global business activity. Insurance has the basic idea that the losses of the few are picked up by the many – what is being suggested here is that each firm has sufficient capital to pick up its own few and irregular losses. This is a major change in the original basis that the intention of capital was to prevent contagion rather than the failure of a single institution.

Since you cannot maintain sufficient capital for stress without causing major damage to the global economy and there is no logic in having capital for expected loss the result is that capital ends up being rather odd. It is neither expected, not unexpected. Since it cannot cover plausible events it really ends up addressing the expected unbudgeted losses. Whether this makes any sense is another matter.

So the real problem is that we do not know what should be the level of capital since we do not really know what it is trying to address. Is it just a picture on a wall or is it to be used for a rainy day? Well it may well be raining already.

So Where do we go from Here?
Basel 2 has much in it that is logical and helpful. It recommends improvements to risk management and modelling, to risk governance and reporting. All of this is welcome and, with some reservations, appropriate. What is really needs now is a detailed debate as to the purpose and requirements of capital, which would then lead to its calculation.

If we need the system to maintain capital to deal with stress events then some form of bank levy sounds appropriate globally. Such funds should not then be used to defray normal government expenditure; instead they should be transferred to a supranational agency to manage. The real alternative would be some form of insurance supported by requirements for living wills.

Otherwise all that we manage to achieve is a reduction in global activity and an increase in unemployment. Capital needs to have a real purpose. If you have a calculation that so much capital is required to meet a particular type of event and the vent happens the bank will not be able to use its capital. Using it would result in it breaching the capital criteria. It would bizarrely have to raise additional capital at exactly the time when it neither has the funds available or the ability to raise additional capital.

What we need is vision leading to action and a proper debate that will result in an optimal solution, not knee jerk reactions to perceived issues which are actually spurious.

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