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Expert Analysis

Capital Standards: Can 'Strong' Yet 'Simple' Peacefully Coexist?

By
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The capital regulations proposed by the Bank for International Settlement's Basel Committee grow ever more intricate. From the original 1988 Basel I Accords[1] to today's Basel III capital standards, complexity has grown to the point where some veteran bankers and their regulators may at times not always fully understand the rules, or the risk parameters and assumptions in a bank's asset portfolio.

In an effort to stem the tide of ever-increasing complexity, on July 8, 2013, the Basel Committee issued a Discussion Paper "The regulatory framework: balancing risk sensitivity, simplicity and comparability" to the public for comment.[2] Comments are due Oct. 11, 2013, and internationally active banks should take advantage of the opportunity to advise the committee on the effect such complexity has had on their operations and compliance. This month's column will discuss major points of the discussion paper and the questions the Basel Committee is soliciting from commenters.

Background

The financial crisis that began in 2008 caused the international banking regulators to see the shortcomings in the regulation of banks, and to introduce a range of reforms to strengthen the banks to make them more resilient and to be better able in the future to withstand the shocks to the financial system that hit during the recent financial crisis. In addition to the Basel III capital adequacy proposal,[3] there were additional proposals that also were meant to shore up the system, among them, a capital surcharge on systemically significant banks,[4] minimum liquidity requirements,[5] a leverage ratio (a requirement familiar to U.S. banks but not to many banks headquartered outside the United States),[6] and a new framework for measuring and controlling large exposures.[7]

The Basel Committee now has become concerned that pursuing the objective of strong risk sensitivity has led to another risk—an inability to reach an "appropriate balance between the complementary goals of risk sensitivity, simplicity and comparability."[8]

The Basel Committee in June 2012 established a task force to review the Basel Capital framework and develop recommendations aimed at achieving the aforementioned "balance." The Task Force on Simplicity and Comparability undertook this formidable task and submitted to the Basel Committee a report that provided a range of recommendations, which are set forth in the discussion paper. At this stage, the committee is not proposing adoption of any of these recommendations, it wants to first receive comments from the public, especially stakeholders such as banks, before deciding whether to proceed with any of the proposals for reform recommended by the task force.

In the Beginning

In order to set the context for the remainder of the discussion paper, the Basel Committee set out its definitions of simplicity, comparability and risk sensitivity.

Simplicity has two components: A capital standard is simple if it is clear, can be understood with reasonable effort by affected persons and is clearly expressed in straightforward language. A capital calculation process is simple if data is retrievable from the bank's current systems; the calculations do not require a large amount of data input; the calculation can be made without a need to use advanced mathematics and statistics; and the calculation can be easily verified by third parties such as regulators or auditors.

Comparability refers to being able to apply the capital standard to banks with identical risk portfolios and achieve the same result, which would change only when the underlying risks change. Conversely, banks with different risk profiles should reach capital calculations that accurately reflect the differences in risk.

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Risk sensitivity has two components: a risk-sensitive standard that makes distinctions based on the characteristics of individual exposures or transactions, and a risk-sensitive standard that can differentiate in advance between risk profiles in order to distinguish those bank risk profiles tending to result in a more sound bank and those bank risk profiles tending to lead to failure.

Unintended Consequences?

While strengthening the capital requirements for banks, Basel III also added to the overall complexity of those requirements, which has led in part to problems of compliance for banks, and of effective supervision for regulators. Not every banker or regulator is well-versed in the intricacies of the advanced risk management analysis that is needed to understand the internal models of some of the world's largest banks. The Basel Committee has seen the consequences of such

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complexity and now sees that a "reasonable balance between simplicity and risk sensitivity" is critical to the success of the overall Basel capital framework.

Potential adverse consequences of the current complex Basel III framework raised in the discussion paper included the following.

• It has become more difficult for bank management to fully understand the regulatory regime.

• Banks face increasing challenges in capital planning.

• The complexity of the calculation framework may be leading to less accurate risk assessments.

• The current framework has created regulatory gaps and opportunities for arbitrage.

• The complexity of the current calculation process has undermined the ability of supervisors to effectively assess the capital adequacy of banks and undertake an effective review of the capital management process at a bank.

• The increasing complexity is making consistent and comparable implementation of standards more difficult to achieve.

• The current framework has been hampering banks in their efforts to understand their own risk profiles, thus undermining market discipline.

Striving for Simplicity

The task force developed several recommendations, such as the following, that are aimed at achieving more simplicity and comparability while at the same time continuing to maintain a strong risk sensitivity regime.

• Developing a standardized framework for indicators of risk sensitivity, and simplicity and comparability which would be used to assess policy proposals; the appendix to the discussion paper includes suggested potential indicators for assessing the three objectives in the context of any new policy proposals;

• Enhancing public disclosures so that investors can more accurately compare risk-weighted assets among different banks;

• Enhancing transparency by requiring banks to regularly disclose the result of application of its internal models to a standardized hypothetical portfolio of assets;

• Using additional standards to assess and compare banks' financial positions and resiliency, such as historical price volatility, price-to-book ratios and the ratio of non-performing assets to performing assets;

• Strengthening the utility of the leverage ratio beyond that being implemented as part of the Basel III framework;

• Adding more benchmarks to mitigate the consequences of complexity and make capital ratios more comparable;

• Reconsidering the linkage between internal and regulatory models in order to de-incentivize bank personnel from potentially gaming the system by underestimating risk weights;

• Developing more uniform standardized supervisory oversight that limits an individual country's ability to make changes in the basic framework;

• Improving the accessibility of Basel Committee documents by providing one place on its website from which readers can access the entire capital framework;

• Determining the need for a different approach to evaluating the balance of the factors in the Basel III framework such as, for example standardizing a single form of capital (tangible equity) and a single measure of risk (tangible risk);

• Further reducing future banking risks and complexity, such as by placing supervisory controls on the pace of development of highly complex and innovative financial instruments, by restricting activities that are not designed to promote traditional customer-oriented banking business, by improving bank resolvability, and by reducing global and domestic interconnectedness.

The question remains whether strong capital adequacy standards and simplicity can peacefully coexist. From now until Oct. 11, banks may submit comments responding to the recommendations made in the discussion paper.

Questions for Commenters

In seeking a reduction in complexity while at the same time preserving the strong regulatory regime, the Basel Committee poses five specific questions to the public.

Q1. Does the current framework, with its reliance on the risk-based capital at its core, appropriately balance the objectives of a capital adequacy framework, which the Basel Committee describes as (i) a sound minimum standard of capital adequacy for internationally active banks which also can be applied to smaller institutions; (ii) a well-understood measure of capital adequacy that is comparable across banks and over time; (iii) a reasonable level playing field between banks; (iv) reflecting consideration of the effects of capital requirements on banks' risk-taking incentives; and (v) improved risk measurement and management within banks?

Q2. Are there other objectives that should be considered in reviewing the international capital adequacy framework?

Q3. To what extent does the current capital framework strike the right balance between simplicity, comparability and risk sensitivity, given the costs and benefits that greater risk sensitivity brings?

Q4. Which of the potential recommendations to improve simplicity and comparability offer the greatest potential benefit in terms of improving the balance between the simplicity, comparability and risk sensitivity of the capital adequacy framework?

Q5. Are there other ideas and approaches that the committee should consider?

Conclusion

The current complexity of the capital adequacy standards may be perceived by some as a problem of the Basel Committee's own making. To its credit, the committee now sees the need to strike a better balance between strong capital standards on the one hand, and the ability of those standards to be understood clearly and applied with a minimum of difficulty on the other hand. However, the question remains whether strong capital adequacy standards and simplicity can peacefully coexist. From now until Oct. 11, banks may submit comments responding to the recommendations made in the discussion paper.

Internationally active banks in particular are urged to take advantage of this opportunity to educate the Basel Committee on their experiences in implementing the capital standards and related requirements at their institutions, and in handling the high cost of compliance. This is the banks' chance to get in now on the ground floor of these simplification efforts. It is unknown when they will have such a chance again.

1. Basel Committee documents may be accessed at www.bis.org.
2. See http://www.bis.org/publ/bcbs258.htm.
3. See http://www.bis.org/bcbs/basel3.htm.
4. See http://www.bis.org/publ/bcbs207.htm.
5. See http://www.bis.org/press/p130107.htm.
6. See http://www.bis.org/publ/bcbs251.htm.
7. See http://www.bis.org/publ/bcbs246.htm.
8. Discussion Paper, p. 1.