

# CSFI

## CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

5 DERBY STREET  
LONDON W1J 7AB

TEL: 020 7493 0173  
FAX: 020 7493 0190

**Basel II: A roundtable discussion on the recent CEPS report, with Erik Musch (PwC), Rym Ayadi (CEPS), Maria Nieto, (Banco de Espana) and Dr Mathias Schmidt (Solvay Business School) held Wednesday, July 16, 2008 at Innholders' Hall, 30 College Street, London, EC4R 2RH, from 12.30-2.15pm**

The report's genesis was in the quiet before the storm when it was 99% certain Basel II would be implemented. Since then everything has changed. The first speaker said the question many were asking was how could banks make such a mess of these new instruments in such a short time. He was amazed both at the size of the writedowns and at the fact that banks and regulators had thousands of people working on risk management. What had they been doing? The speaker set out the broad context for the CEPS report. These new instruments were never tested in adverse conditions. The book, Black Swan, shows that risk management should be more about possible consequences of extreme events rather than mathematical models. There is a need for institutional reform that gives real teeth to financial stability regulators. Lastly the issue of liquidity risk needs to be addressed.

The second speaker looked in more detail at some of the report's findings about how Basel II should be implemented in the light of the real-life stress test of 2007 and 2008. Firstly there had been bank failures in the midst of turbulence because they had failed to assess and manage a host of risks and how those risks were interconnected, and because they overestimated the advantages of securitisation while failing to see both liquidity risk and problems with incentives. Secondly the current arrangement of the three-pillar framework of Basel II was not the answer and should be integrated better. Pillar one, which sets minimum capital requirements, uses a "silo" approach towards managing three risks, credit, market and operational, that do not match international banking groups' assessment of a greater range of risks. Pillar two, the supervisory review process, should be given more importance as it covers all risks including a bank's management, internal governance and supervisory process. It should allow banks to develop their own risk management strategy in accordance with its risk profile and operating environment. In other words it involves judgement. Pillar one, complemented by pillar two, should determine regulatory capital. Lastly the first two pillars should be the foundation for the use of third pillar that seeks to inculcate market discipline. Rules of disclosure of information can only be made once the risks that emerge from pillar two are known.

The third speaker looked at how this fitted with the EU Capital Requirements Directive (CRD). The issue was whether the CRD guaranteed prompt prudential supervision. It is a step in the right direction but falls short of enabling structured early intervention, she said. One challenge is to increase the scope of co-operation, which needs more details fleshed out. In terms of convergence across the 27 member states, the Committee of European Banking Supervisors (CEBS) has produced guidelines which will be crucial in promoting a consistent and coherent application. In terms of information sharing there is a powerful need to develop standards on minimum regulatory capital, intra-group exposure and on

own-funds in excess of the minimum requirement. So far it is too ad hoc and needs to be more systematic. It is a shame it has retained the rule on secrecy that will make the creation of EU databases impossible.

A crucial question is the fit between the CRD and pillar two. The fourth speaker said there was need to move from a capital requirements directive to a risk directive, in meaning as well as name. Currently people think of the CRD as a pillar one issue but capital adequacy ratios do not measure a bank's health. Supervisors should look to ensure that institutions preserve assets within their overall capital. They should also be given guidelines on internal governance within banks. Lastly there should also in future be an explicit requirement to manage strategic risks.

The first speaker said regulators should take time rather than seek quick solutions. Banks had a chance to prove their products are superior and failed. Regulators have to do more than say "we failed, let's try to improve things this time". The second speaker said the way forward was to restore the link between the three pillars of Basel II. Looking at pillar one means only looking at one set of risks. Several members were sceptical of the usefulness of the report. One said he was amazed there was no reference to accounting, given that accounting models were often closely linked to the business model and finance model. Another doubted that regulators were ever likely to cooperate given the failure of the tripartite arrangement in the UK. The fact was that experts saw the possibility of a crash as far back as 2006 yet no one did anything about it.

The first speaker said that this was a strong reason for the need for a pan-European regulator. Another member said the credit crisis was caused by an extreme tail risk that was impossible to calibrate. The first speaker agreed but said that the way forward was to take that into account as part of the overall judgement. Another member suggested having a simple capital requirement ratio, which would probably encourage a crisis at some point, but then have a reaction function to deal with that. One way, another member said, would be to insist banks put up capital that was held in a third party account as a contingent sum in case of a crisis.

Where then is the process going? This will be a major issue for the next Parliament and the next Commission, the fourth speaker said. The third speaker said Ecofin would become involved and that ministers would realise the CRD was the most accessible weapon to hand. There was a danger that politics would merge into banking supervision, which made it even more vital for regulators to implement Basel II in a fundamental but proper way. There was a lot of scepticism around that the table that that would really happen.