

When is best practice good enough?

A dramatic change in banking regulation has been the move from prescriptive procedures towards 'best practice' risk management. Disagreements about how quickly the new approach can be applied to credit risk is central to arguments about revising Basel II. By David Rowe

Throughout much of the nineteenth century, banking regulation in most countries was fragmented and often ineffective. Gradually, a consensus emerged that the social damage from the failure of financial institutions and periodic monetary crises required stricter and more co-ordinated supervision. This view was reinforced during the great depression with the introduction of deposit insurance. At that point, the public sector, and ultimately the taxpaying public at large, had a clear financial stake in limiting such failures.

Banking regulation was strengthened in the early twentieth century on a 'command and control' basis. Detailed regulations were passed, enforced by periodic bank examinations. These regulations included preparation of detailed condition reports to be completed in specifically mandated ways, but such regulation has not been universally successful. The savings and loan debacle in the US in the late 1980s and early 1990s was a particularly notable example. Another is the continuing difficulty of rejuvenating Japan's banking sector, which is still mired in bad loans a decade after these problems first became widely recognised.

The original Basel capital Accord of 1988 was squarely in the spirit of the command and control tradition of banking regulation. It stipulated a definition of 'risk-weighted assets' that applied one of a small number of conversion factors to nominal credit exposures. These weights were based primarily on the legal form and domicile of the obligor. It then stipulated a rather expansive definition of 'capital' that included certain forms of subordinated debt not commonly viewed as equity, and required that actual capital, so defined, must exceed 8% of risk-adjusted assets.¹

The mid-1990s brought a landmark change with the introduction of a market risk amendment to the Accord. The original proposal, issued for comment in April 1993, continued in the prescriptive tradition. It said trading assets and liabilities, including off-balance-sheet contracts such as derivatives, were to be slotted into a pre-defined maturity grid. Then, a procedure was prescribed to translate these maturity bucketed aggre-



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gates into a measure of market risk. But the procedure was too crude to capture all possible forms of risk, so arbitrary constraints were included to be sure the risk estimate was not understated.

The universal reaction from active trading banks was that this procedure was crude, and fell far short of the risk assessment procedures already in production for internal monitoring and control of market risk. As is well known, the Basel Committee took these criticisms to heart. Two years later, it proposed allowing large sophisticated banks to use their own internal market risk assessment systems, subject to supervisory oversight, to calculate associated regulatory capital.

Dramatic step

It is hard to overestimate the magnitude of this change. It was a dramatic step away from a command and control mindset towards regulation based on adherence to best-practice risk management methods. While widely welcomed, this approach was a two-edged sword for the banks themselves. 'Best practice' is a moving target, and regulators are empowered under the new regime to insist on continuous improvement in methods and systems as theory and technology permit.

When the original revision to the Basel capital Accord was proposed in 1999, there was a clear regulatory consensus that credit risk models were not sufficiently advanced or robust to be used as the basis for calculating the associated regulatory capital. On that basis, despite protestations to the contrary, the Basel II proposal mandated a broadly prescriptive approach to measuring credit risk and its associated minimum capital.

The proposal focused primarily on a more risk-sensitive method for assigning weights to individual assets. Even here, many disputes arose relative to consistency of the risk weights across different types of exposures and various forms of risk mitigation. The biggest issue the proposal failed to address, however, was the risk-reducing impact of diversification. Clearly, the rationale for this omission was the complexity in capturing the effects of diversification and uncertainty surrounding the associated parameters, especially correlation coefficients.

Nevertheless, omitting diversification effects has opened a veritable Pandora's box of complexity. All sides of the debate will concede that enterprise risk is inherently a portfolio concept. Aggregate risk simply cannot be derived additively from the risk of individual components. The consequence of this for Basel II has been a tortuous process of parameter adjustments and special treatments to make an additive framework yield sensible total risk estimates.

To complicate matters further, credit risk modelling has advanced considerably during the more than four years that Basel II has been under discussion. From the start, the Basel Committee has expressed an openness to the use of internal credit risk models at some stage. Major banks are arguably at a point where their credit risk models can be viewed as approaching the stage of development that characterised market risk models in 1993-94. All of which leaves us with the dilemma of how best to proceed at this point in moving beyond Basel I, and this will be the subject of next month's column. ■

¹ Actually, the 8% requirement was phased in starting in 1988, and was not fully effective until 1992