AMSTERDAMSE SCHOOL VOOR SOCIAAL WETENSCHAPPELIJK ONDERZOEK

FOR SOCIAL SCIENCE RESEARCH

The Political Economy of Basle II: Private Interest vs. Public Good?

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Who said this?

"Merchants and master manufacturers are, in this order, the two classes of people who ....by their wealth draw to themselves the greatest share of the public consideration [..T]heir thoughts, however, are commonly exercised rather about the interest of their own particular branch of business, than about that of the society [..]. The interest of the dealers… in any particular branch of trade or manufactures, is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition, is always the interest of the dealers. [..] The proposal of any new law or regulation of commerce which comes from this order ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention."

No, not Karl Marx.

Adam Smith

The Wealth of Nations 1776
Book I, Chapter XI

Questions

- What were the political economy origins of the accord?
- What is its likely (ongoing) impact, for whom?
- Is Basle II likely to contribute to financial stability?
- To reflect upon: is there a connection between policy input and the outcome?

Basle II: whence it came (1)

- Rapid changes in financial system; Basle I as ‘blunt instrument’ developed in ‘Olympian Detachment’; over time B-I of decreasing relevance to bank and systemic risk management (a new approach needed)
- Basle I provides further incentives to securitize credit; banks’ market risks not covered
- BCCI, emerging market, Barings & other crises » need for better internal risk management
- Strong financial sector lobbying from major banks: liberalization, market access, innovation, use of VaR models in risk management

Basle II: whence it came (2)

- Market risk amendment (1996) and EU CAD; IIF etc. general lobby successful, IIF paper on market-based supervision
- G-30 Report (1997), *Global Institutions, National Supervision, and Systemic Risk*, recommends market-based supervisory approach and the Basle Committee adopts it
- Supervisors admit to having few other ideas
- Market-based supervisory approach directly reflects private sector preferences, enhances competitiveness of most sophisticated players
- *Reminder*: Basle Committee membership = G10 countries but affects most of global banking markets; fairly narrow & closed policy community in terms of public-private interaction

* B-II proposed by "the dealers" & bought by supervisors: little non-financial sector input; virtually no developing country input; approximates policy capture

Basle II: where it went (likely impact) 1

- Basle Committee's QIS 5 review of the 3 approaches in pillar 1, other research on impact: increases in loan costs for low-rated borrowers, e.g., SMEs & small banks
  - This was partly the intention: higher risk = higher capital charge
  - Negative impact on their competitive position via cost of capital, adjustment hurts
  - But these institutions of less systemic importance than large banks, lower risk?
  - Close bank-client relationships may provide better information
- Provides incentives to obtain ratings, so good for ratings agencies business… (perverse incentive)
- Was best for large banks who proposed it; advanced approach will reduce their capital charges and enshrines internal models as primary tool of supervision in systemically important banks
- Thus a redistributive impact on the developed country sector in favour of institutions at heart of current problems

Basle II: where it went (likely impact) 2

- Poorer countries particularly:
  - Cost of capital already high and flows 'uphill'; under Basle II cost may rise, reducing access to financing
  - *Average* cost effects small, but lower rated & poorest countries are most adversely affected
  - B-II affects low rated and poorer OEDC countries too (this was part of the intention, but adjustment hurts)
  - Effects to date underestimated as data relied on external ratings; internal ratings have more dramatic effect
  - Portfolio diversification gains not fully taken into account
  - **More volatility and procyclicality in external financing » increasing herd behaviour? (Also applies to developed markets)

Contribution to financial stability? (some problems)

- Can ratings agencies be employed as agents of public supervision? (issue is not just sub-prime, but they missed Peso, Asian and other crises too…); how objective?
- Agencies in difficult position: they are responsible to private clients but also have public responsibilities in supervision
- Policy disagreements to sort out: how much disclosure? Complexity and emerging market finance? National confidentiality laws? Implementation: which banks (US vs. EU)?
- Overly complex? Is it really a standard? (well, we *do* have a complex financial system…)
- Market approach and 'aggregation problem': individual sound banks do not a sound system make… it is also about interconnectedness
- Arguably, advanced IRB approach *encourages* the very risk management practices which underpin the current crisis

Contribution to financial stability? (some doubts)

- Paradoxically then, potential inattention to systemic risk: all banks vs. 'systemically important' banks?
- Systemically important, most complex banks are cut the most slack, may be seriously undercapitalized
- Supervision should be by nature *counter*cyclical, but the impact of Basle II more likely *pro*cyclical as it employs market incentives
- Research findings indicate negative impact on cost of capital and volatility of capital flows to developing countries
- This could mean increased likelihood of emerging market crises

Where too (1)?

- Don’t scrap Basle II (its not the moment…), build on it but less emphasis on facilitating market processes and efficiency, more on stability and precautionary principle » *banks* show *supervisors* and the public new practices/products are OK
- Revise the decision-making process, broader stakeholder input » better balance between public and private interests, more comprehensive view of supervisory policy
- Onus should be on banks (who use other people’s money) to explain and disclose what they do and its potential impact on stability (precautionary principle again)

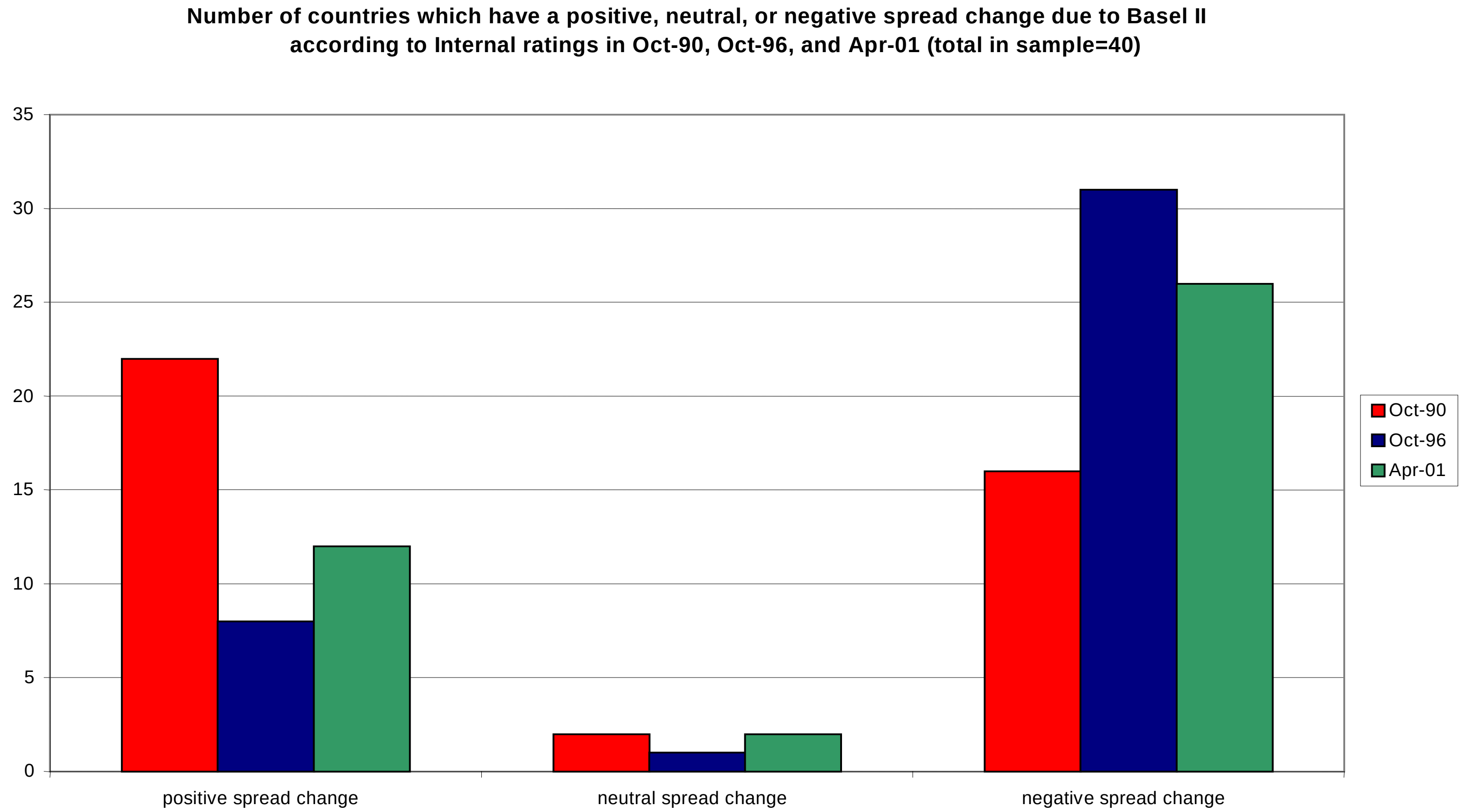
Where too (2)? Capitalization and precautionary principle

- Evidence suggests banks were cut too much slack (capture?). If Basle II also encourages risk management practice underlying crisis, biggest problem is perhaps *combination* of the two = severely undercapitalised banks
- Either: i) allow high level of slack on capital reserves, but tough attitude on securitised risk management & products (precautionary principle: banks must show it helps systemic risk management)
- Or: ii) low level of slack/higher reserves and tolerance of new products and risk management techniques (banks may do it but costly)
- Option ii) probably easier, less impact on product innovation, but options can also be combined

Where to (3)?

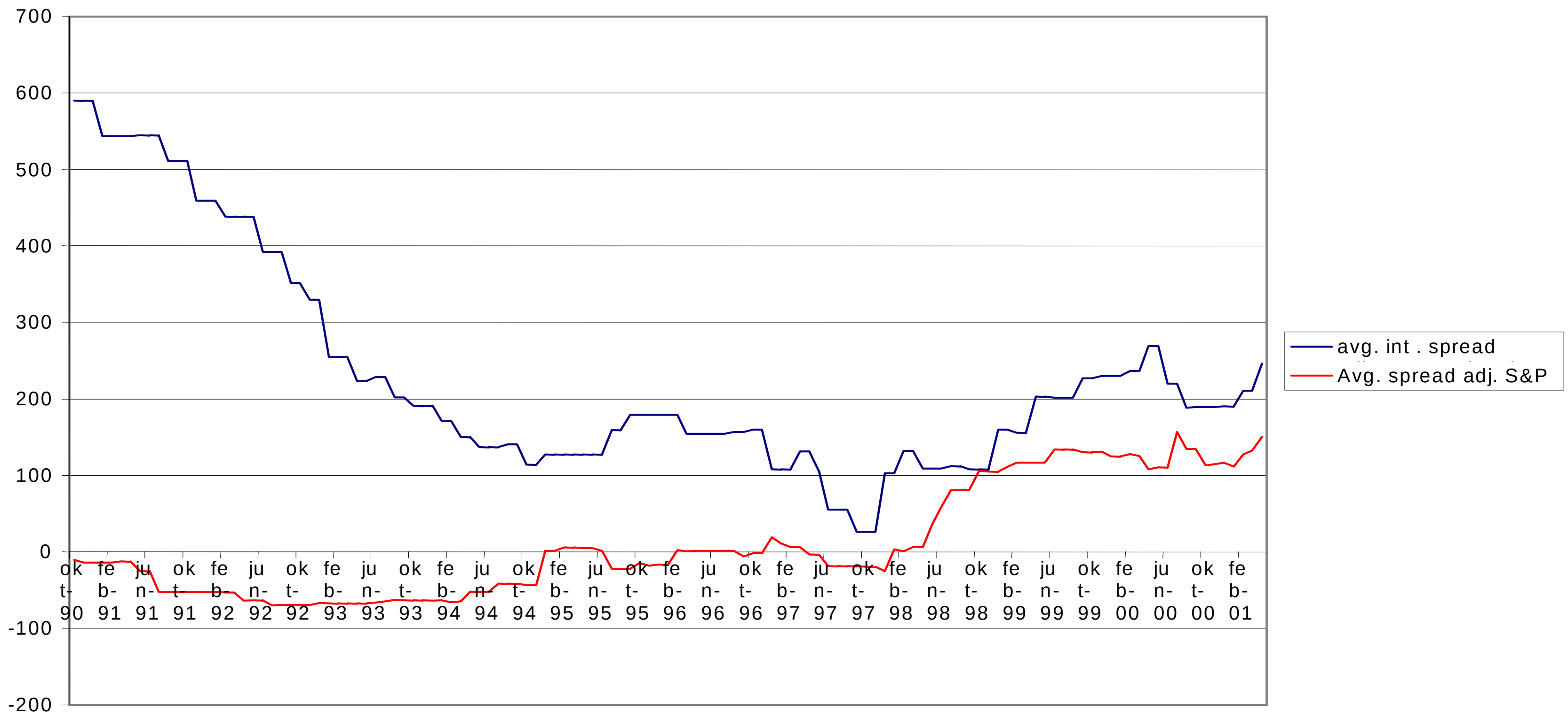
- Continue to use models, good internal risk management cannot hurt, but more robust look at what they *actually* tell us (correlation says little about nature of relationships, models depend on what you put in them), and to what extent they contribute to *supervision*, particularly monitoring of systemic risk
- Consolidated supervision of course must look at financial institutions in their entirety, but also at the system in its entirety…
- *Join the dots*! financial supervision, credit and business cycles and (pro)cyclicality, monetary policy, asset bubbles… these are all interrelated. Functional compartmentalization a problem…. Also cross-border compartmentalisation.
- Regulation, financial supervision, and macroeconomic picture are linked!

For better rated countries' spreads do not rise



But external ratings underestimate: internal ratings imply spread increase

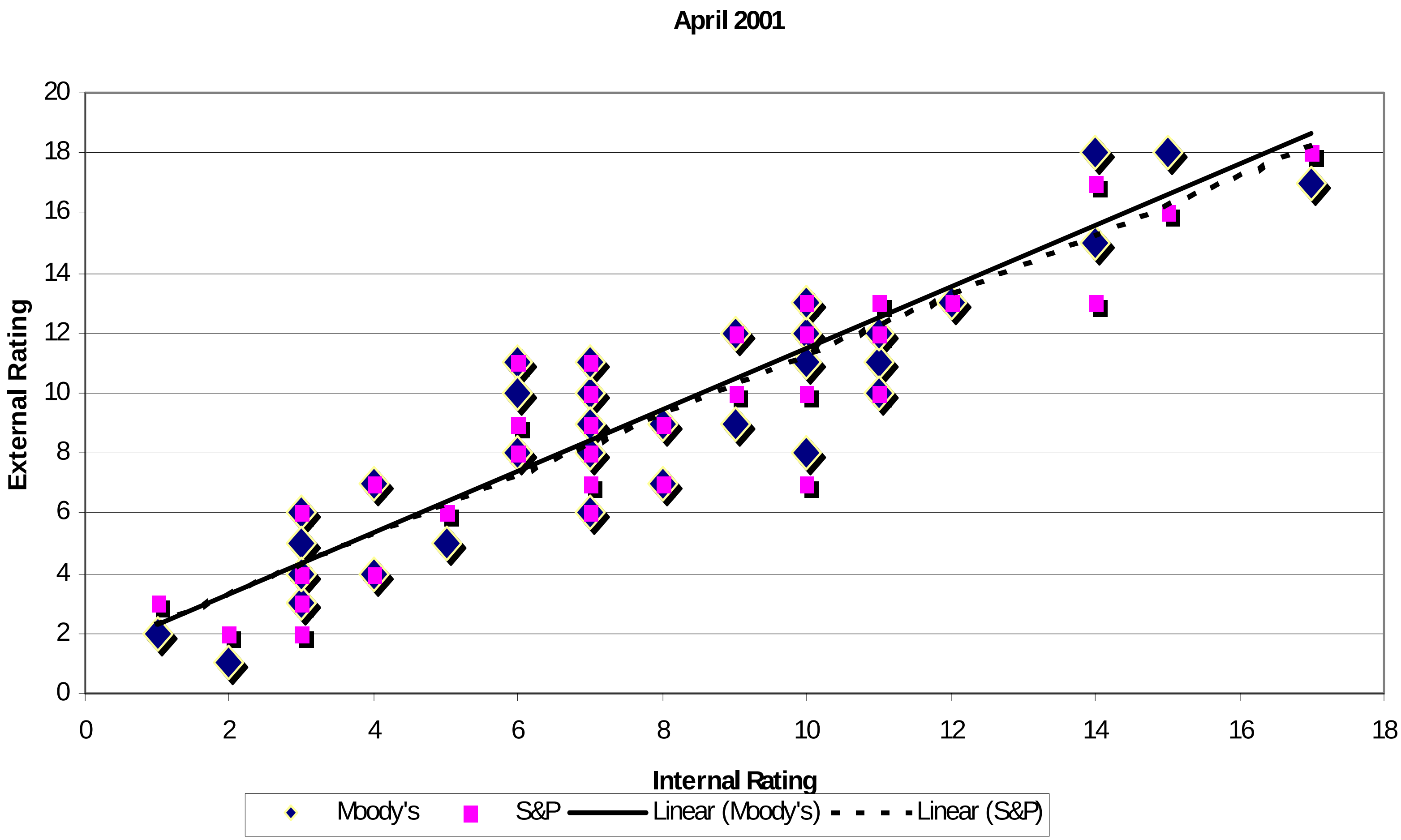
Average spread change in basis points under Basel II to produce risk adjusted return under Basel I based on S&P and Internal ratings



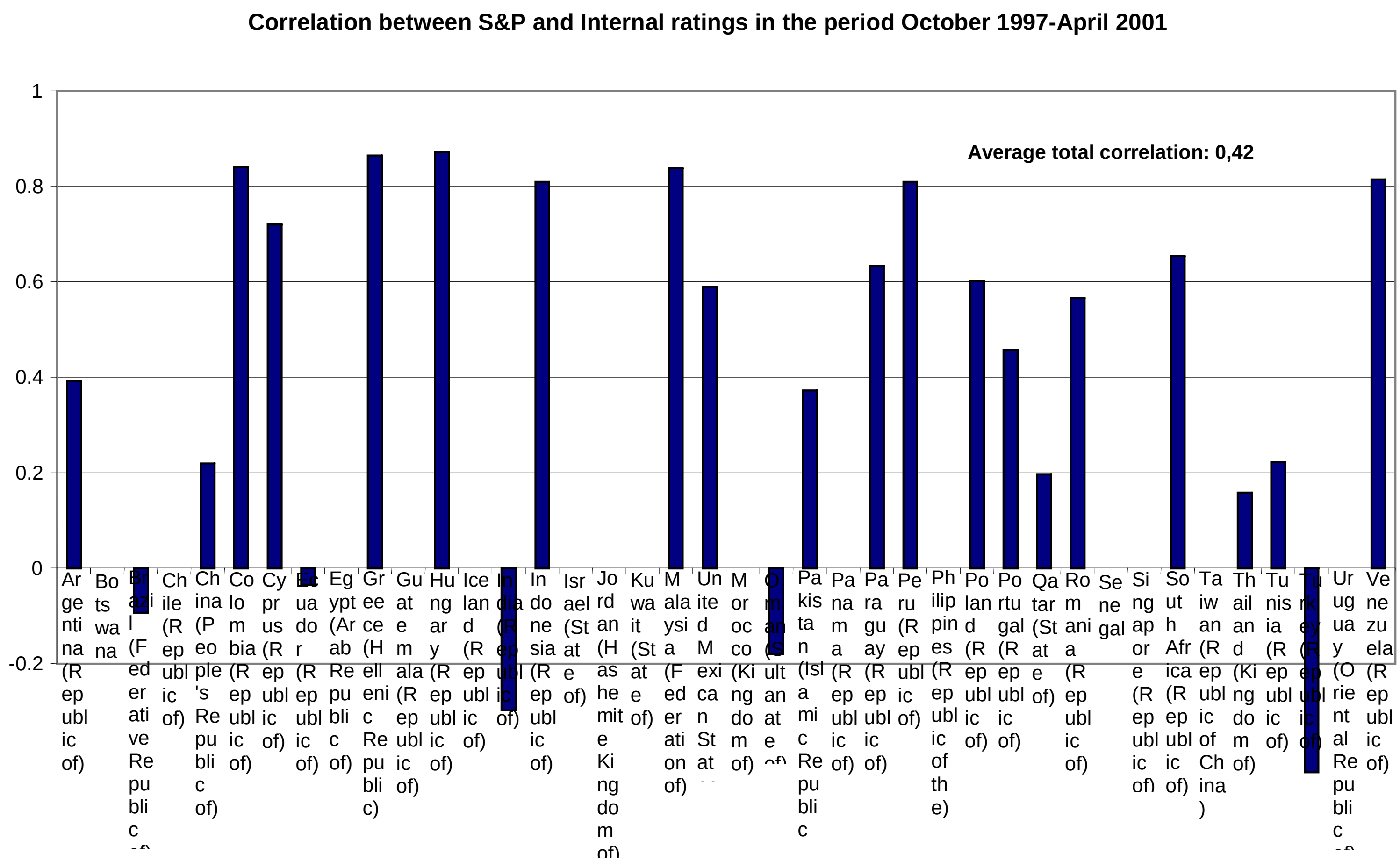
Impact of Basel II on poor countries: volatility and procyclicality

- More volatility and procyclicality in external financing
  - B-II encourages market/price based risk measures
  - B-II encourages use of similar models, VaR-models
  - Both can lead to more herd behavior
- Greater use of internal ratings may aggravate problems
  - IRs appear more quick to adjust than ERs
  - Variance of IRs higher than IRs: 0.99 versus 0.48
  - IRs somewhat more procyclical than ERs: correlation with GDP of 0.40 versus 0.36

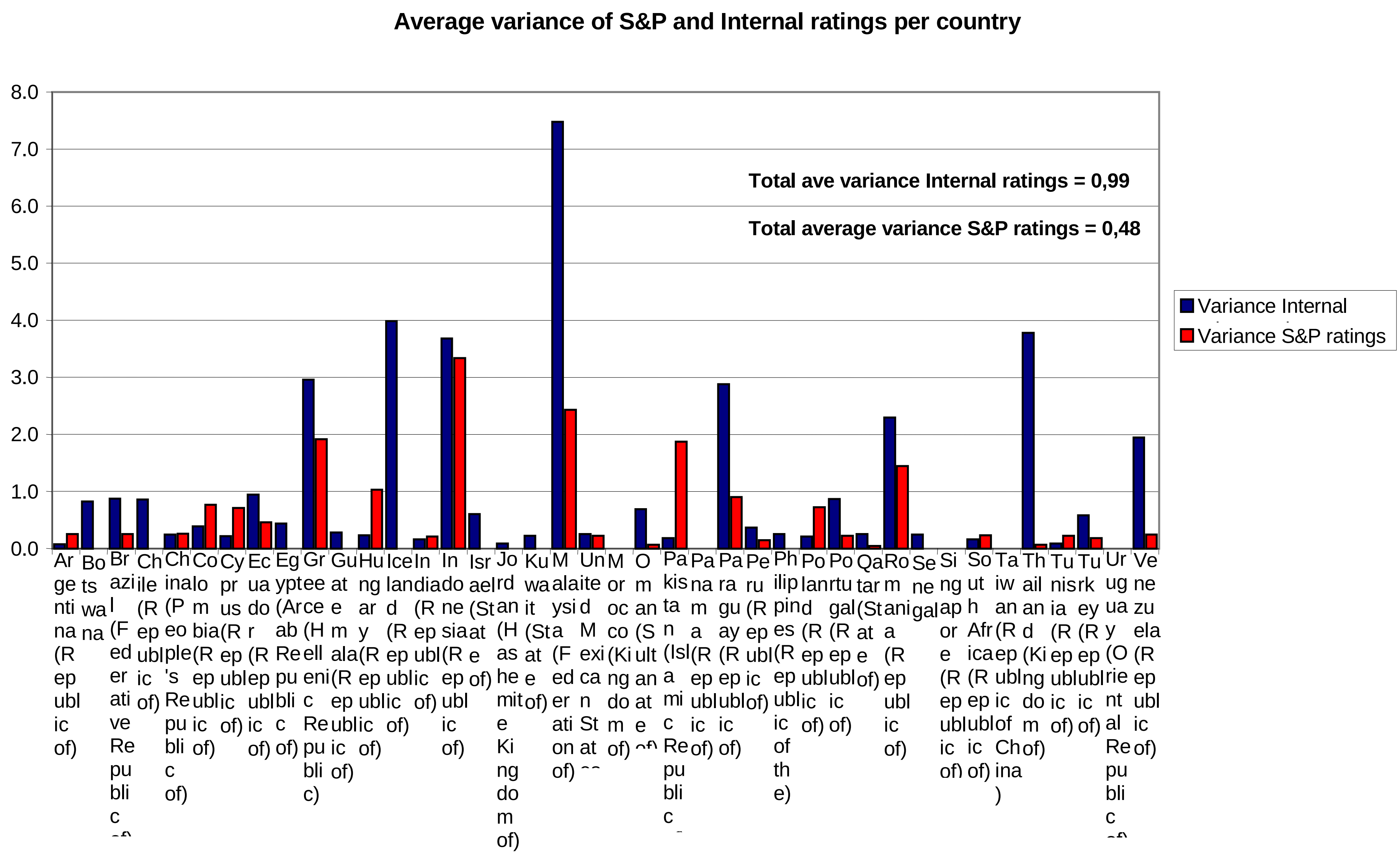
ERs close to IRs across countries



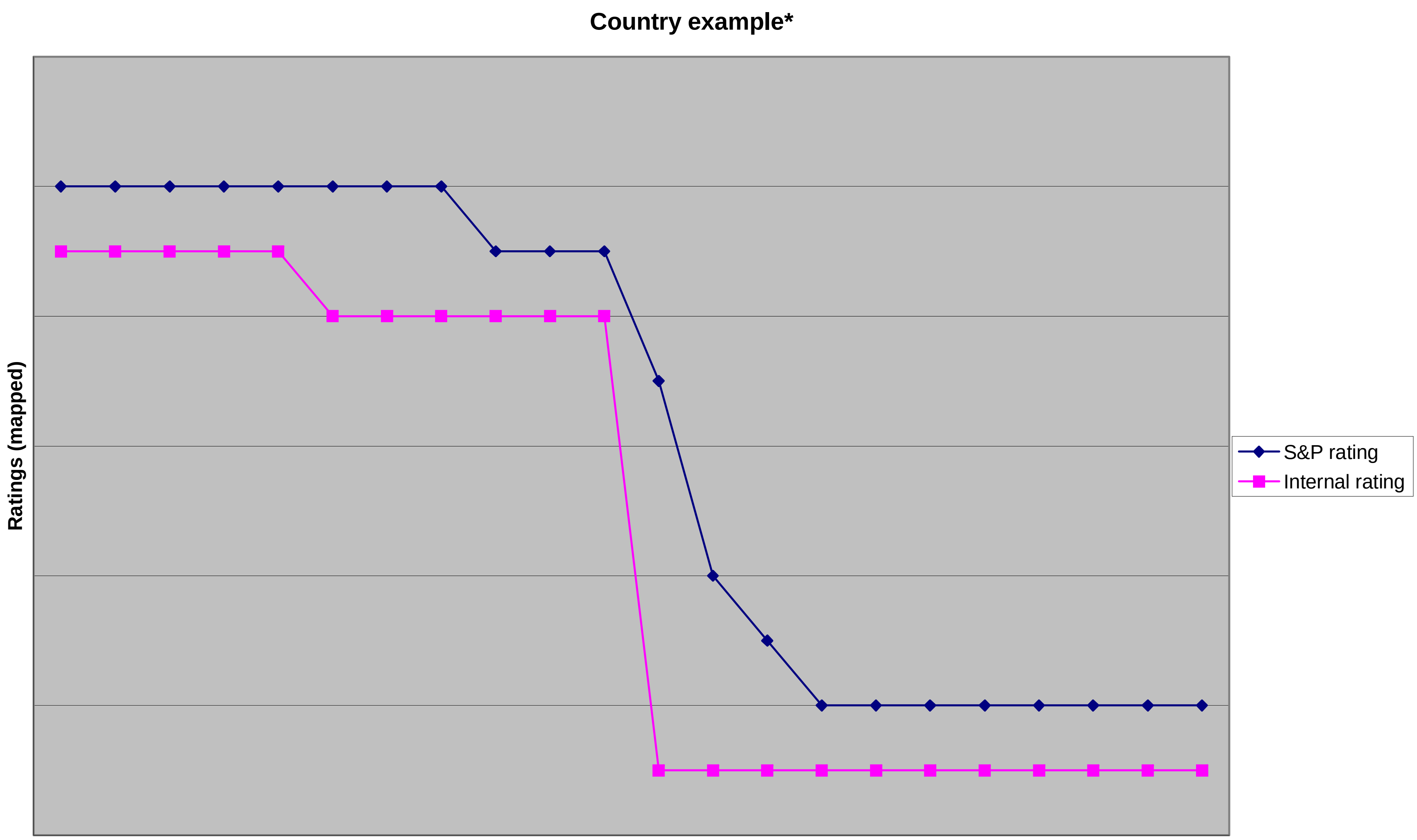
But over time correlation not perfect



And variance of ERs higher than that of IRs



With large differences in times of financial crisis



* Mapping is done using correlation estimates. Rating of 15th of month is considered rating of the month

Leading to different migration matrixes: external ratings more even

Rating to	18	17	16	15	14	13	12	11	10	9	8	7	6	5	4	3	2	1
18	100																	
17		100																
16			100															
15			6	88	6													
14					98	2												
13						98	2											
12						1	98	1										
11							3	93	3	3								
10							1	2	97									
9									3	97	0							
8										1	97	1						
7											1	98	1					
6													95	5				
5													1	91	4	3		
4														2	98			
3																96	4	
2																	93	7
1																12		88

Internal ratings have more (and further) off-diagonal transitions

Rating to	18	17	16	15	14	13	12	11	10	9	8	7	6	5	4	3	2	1
18																		
17		100																
16																		
15				100														
14					100													
13				4		96												
12					3		90		3		3							
11								97	3									
10					1			2	95	1								
9							1	1	2	96	1							
8										3	93	3			1			
7											1	98	1					
6										0		1	95	1		1		
5													1	95	3	1		
4												3		3	92	2		
3															2	96	1	1
2																25	75	
1													2			4		94