

COMMENT

## **Basel II should not be the end of the story:**

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25 June 2004

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Tomorrow the Basel Committee on Banking Supervision is to publish the final version of **Basel II**, its new capital adequacy standard for international banks. It has been a long time coming. For the best part of a decade we have been consulting (three formal consultative papers), proposing, researching, testing (three impact studies and one more on the way), delaying and revising the rules that will be the framework for regulating the world's financial institutions. The implementation date has been pushed back again and again, most recently to 2008.

Rulemakers, regulators and banks may feel a sense of relief that the end is in sight. It has certainly been an arduous, time-consuming process. But the lesson to be drawn from it is that, even when **Basel II** is implemented, the changes that made it necessary - and also so hard to finalise - will still be taking place.

A hundred years ago, bank risk management and regulatory evaluations were entirely subjective. Reasonable men made considered judgments. But the 20th century called for technocrats who could give a formal definition to things. Basel I was an enormous advance; in many countries there was nothing before it was adopted in 1988.

As the century came to a close, however, the rules for bank regulation were found wanting because of the rapid pace of institutional and market innovation. There were too many new things on the bank balance sheets and too many new activities in the banking business.

**Basel II** was supposed to remedy these shortcomings and set the standard for the 21st century. But its architects have found it hard to keep up with the pace of change. They are struggling with the measurement of risks in financial instruments that did not exist when they began work. Structured debt obligations with multiple tranches have risks that are far more difficult to judge than the simple possibility that the issuing entity defaults.

In our complex and changing world, capital adequacy standards for banks and other financial institutions should be subject to continuous scrutiny and development. The Basel committee, or some successor organisation, should be as much a part of the world's financial landscape as the International Monetary Fund. It should have authority to adjust the regulatory framework without having to reopen the tedious **Basel II** efforts to reach consensus. It should also continuously review the use of the capital adequacy rules by national regulators and the contribution of the new accord to reducing financial risks around the world.

The idea that rulemaking should be a continuous process that keeps pace with the evolution of the financial sector is embedded in the original plans for **Basel II**. From the very start, the proposals included a set of capital requirement rules (in

the so-called Pillar 1) and two other sets of principles that have received much less attention. Pillar 2 calls for subjective evaluation of the rules, in the light of changing business practices, by national regulatory authorities, and Pillar 3 calls for the public release of better information on bank risk.

As the date of implementation nears, there needs to be a shift in emphasis away from the details of rulemaking (Pillar 1) and towards the subjective and judgmental aspects of regulation covered by Pillars 2 and 3. Yet so far there has been virtually no discussion from Basel about how such a flexible structure will be managed. The rulemaking phase is about to come to an end without there being any clear formulation of how banks and regulators are to respond to emerging problems or specification of which international body will provide an early-warning system to head off such difficulties.

Sooner rather than later, a bank will claim that it satisfies the rules for minimum capital as formulated and therefore should not be subject to further scrutiny. Regulators, exhausted by the complexity of the rules, may be inclined to agree. Plainly, that would be an absurd state of affairs. What is needed is recognition of the fact that complex rules call for greater emphasis on regulators' discretion. The adoption of a new Basel accord should not be the end of the story. Financial sector regulation for the next century should include a mechanism for continuous review of the rules. At the same time, regulators must show a greater willingness to make judgment a working part of the supervisory framework. One wonders whether the agencies that are rushing to codify and adopt **Basel II** on time for the latest deadline are preparing themselves for these tasks as well.

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