22.5: Basel II, Basel III, and Dodd-Frank

Learning Objectives

- Will Basel II render the banking industry safe? If not, what might?

Due to the prevalence of banking crises worldwide and the financial system's increasingly global and integrated nature, international regulators, especially the Bank for International Settlements in Basel, Switzerland, have also been busy. Their recommendations are not binding on sovereign nations, but to date they have obtained significant buy-in worldwide. America's financial reforms in the 1990s, for example, were influenced by the so-called Basel I recommendations of 1988. Almost all countries have complied, on paper anyway, with Basel I rules on minimum and risk-weighted capitalization. *Risk-weighting was indeed an improvement over the older capitalization requirements, which were simply a minimum leverage ratio*:

Capital assets

So the leverage ratio of the following bank would be 6 percent (6/100 = .06, or 6%), which in the past was generally considered adequate.

Some Bank Balance Sheet (Millions USD)	
Assets	Liabilities
Reserves \$10	Deposits \$80
Securities \$10	Borrowings \$14
Loans \$70	Capital \$6
Other assets \$10	
Totals \$100	\$100

Of course, leverage ratios are much too simplistic because a bank with a leverage ratio of only 4 percent but with a diversified portfolio of very safe loans would be much safer than one with a leverage ratio of 10 percent but whose assets were invested entirely in lottery tickets!

The concept of weighting risks is therefore a solid one. A bank holding nothing but reserves would need very little capital compared to one holding mostly high-risk loans to biotech and nanotech startups. *Bankers, however, consider the Basel I weights too arbitrary and too broad*. For example, Basel I suggested weighting sovereign bonds at zero. That's great for developed countries, but plenty of poorer nations regularly default on their bonds. Some types of assets received a weighting of .5, others 1, others 1.5, and so forth, as the asset grew riskier. So, for example, the following assets would be weighted according to their risk before being put into a leverage ratio:

Reserves	\$100,000,000 × 0 = 0
Governments	\$50,000,000 × 0 = 0
Commercial loans	\$600,000,000 × 1 = 600,000,000
Mortgages	\$100,000,000 × 1.5 = 150,000,000

And so forth. But the weights were arbitrary. Are mortgages exactly half again as risky as commercial loans? Basel I basically encouraged banks to decrease their holdings of assets that the regulations overweighted and to stock up on assets that it underweighted. Not a pretty sight.

In response to such criticism, the Basel Committee on Banking Supervision announced in June 2004 a new set of guidelines, called Basel II, initially slated for implementation in 2008 and 2009 in the G10 countries. Basel II contains three pillars: capital, supervisory review process, and market discipline. According to the latest and greatest research, *Rethinking Bank Regulation* by James Barth, Gerard Caprio, and Ross Levine, the first two pillars are not very useful ways of regulating banks. The new risk weighting is an improvement, but it still grossly oversimplifies risk management and is not holistic enough. Moreover, supervisors cannot monitor every aspect of every bank all the time. Banks have to make periodic call reports on their balance sheets, income, and dividends but, like homeowners selling their homes, they pretty up the place before the prospective buyers arrive. In more developed countries, regulators also conduct surprise on-site examinations during which the examiners rate banks according to the so-called CAMELS formulation:

C = capital adequacy

A = asset quality

M = management

E = earnings

L = liquidity (reserves)

S = sensitivity to market risk.

A, M, and S are even more difficult to ascertain than C, E, and L and, as noted above, any or all of the variables can change very rapidly. Moreover, *much banking activity these days takes place off the balance sheet, where it is even more difficult for regulators to find and accurately assess*. Finally, in many jurisdictions, examiners are incorrecty compensated and hence do not do a very thorough job.

Barth, Caprio, and Levine argue that the third pillar of Basel II, financial market monitoring, is different. In aggregate, market participants can and in fact do monitor banks and bankers much more often and much more astutely than regulators can because they have much more at stake than a relatively low-paying job. *Barth, Caprio, and Levine argue persuasively that instead of conceiving of themselves as police officers, judges, and juries, bank regulators should see themselves as aides, as helping bank depositors (and other creditors of the bank) and stockholders to keep the bankers in line*. After all, nobody gains from a bank's failure. The key, they believe, is to ensure that debt and equity holders have incentives and opportunities to monitor bank management to ensure that they are not taking on too much risk. That means reducing asymmetric information by ensuring reliable information disclosure and urging that **corporate governance** best practices be followed.Frederick D. Lipman, *Corporate Governance Best Practices: Strategies for Public, Private, and Not-for-Profit Organizations* (Hoboken, N.J.: Wiley, 2006).

Regulators can also provide banks with incentives to keep their asset bases sufficiently diversified and to prevent them from engaging in inappropriate activities, like building rocket ships or running water treatment plants. Screening new banks and bankers, if regulators do it to reduce adverse selection (omit shysters or inexperienced people) rather than to aid existing banks (by blocking all or most new entrants and hence limiting competition) or to line their own pockets (via bribes), is another area where regulators can be effective. By focusing on a few key reachable goals, regulators can concentrate their limited resources and get the job done, the job of letting people look after their own property themselves. The market-based approach, scholars note, is most important in less-developed countries where regulators are more likely to be on the take (to enact and enforce regulations simply to augment their incomes via bribes).

U.S. implementation of Basel II was disrupted by the worst financial dislocation in 80 years. Intense lobbying pressure combined with the uncertainties created by the 2008 crisis led to numerous changes and implementation delays. As of writing (September 2011), the move to Basel II had barely begun in the United States, though full implementation of yet newer regulations, Basel III, are currently slated to take effect in 2019.Pierre-Hugues Verdier, "U.S. Implementation of Basel II: Lessons for Informal International Law-Making," University of Virginia School of Law Working Paper (30 June 2011). papers.ssrn.com/sol3/papers.cfm?abstract_id=1879391

In July 2010, the U.S. government also attempted to make the financial system less fragile by passing the Dodd-Frank Wall Street Reform and Protection Act. Over the next several years, the law mandates the creation of a new

- Financial Stability Oversight Council;
- Office of Financial Research;
- Consumer Financial Protection Bureau;
- advanced warning system that will attempt to identify and address systemic risks before they threaten financial institutions and markets.

It also calls for:

- more stringent capital and liquidity requirements for LCFIs;
- tougher regulation of systemically important non-bank financial companies;

- the breakup of LCFIs, if necessary;
- tougher restrictions on bailouts;
- more transparency for asset-backed securities and other “exotic” financial instruments;
- improved corporate governance rules designed to give shareholders more say over the structure of executive compensation.

Despite the sweeping nature of those reforms, some scholars remain skeptical of the new law because it has not clearly eliminated the problems associated with TBTF policy, bailouts, and other causes of the financial crisis of 2007-2009.

KEY TAKEAWAYS

- Basel I and II have provided regulators with more sophisticated ways of analyzing the adequacy of bank capital.
- Nevertheless, it appears that regulators lag behind banks and their bankers, in part because of agency problems within regulatory bureaucracies and in part because of the gulf of asymmetric information separating banks and regulators, particularly when it comes to the quality of assets and the extent and risk of off-balance-sheet activities.
- If scholars like Barth, Caprio, and Levine are correct, regulators ought to think of ways of helping financial markets, particularly bank debt and equity holders, to monitor banks.
- They should also improve their screening of new bank applicants without unduly restricting entry, and set and enforce broad guidelines for portfolio diversification and admissible activities.
