



# Capital Markets

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## Basel II – Will Banks Change Their Minds?

By Dr. Ashok Hegde

Sub prime difficulties faced by both sell side and banking conglomerates are now questioning the existence of the core pillar of the Basel II accord. It is ironic that within 3 years of the second report of the Basel Committee, chartered to strengthen global banking practices on sound principles of Credit, Operations, and Market Risk Monitoring, is itself coming under pressure from its large member banks. The sound principles and guidelines debated at length in board rooms and banking corridors have proven inadequate in dealing with pricing and rating issues of new instruments in the credit markets.

According to the Basel II report, 2006, total risk weighted assets are determined by multiplying the capital requirements for market risk and operational risk by 12.5 (i.e. the reciprocal of the minimum capital ratio of 8 percent) and adding the resulting figure to the sum of risk weighted assets for credit risk (reference: international convergence of capital measurement and capital standard – Bank for international settlement publication, June 2006). According to the principles advocated by Basel, banks can identify risk based on their internal rating mechanism. The committee advised the usage of two important mechanisms to measure the risk associated with advances and operations. The first is the Internal Rating Based (IRB) approach and the second is the Advanced Measurement Approach. These approaches are expected to help banks identify any operational failures or associated risk on capital. This would have helped banks to understand the probability of specific events and its impact on tier-one and tier-two capital structure. It now appears that these tools have served the banks little to mitigate the probable event risk – not because they are inadequate but because players overlooked the risk while focusing on other business priorities like higher fees and returns. This eventually undermined the importance of risk mitigating strategies.

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Credit defaults are now attributed to faulty ratings by the rating agencies. Banks have created securitised instruments by mixing bad loans and advances with good quality assets. Further, players have created derivative instruments in the credit markets linked to these asset classes. These higher fee earning instruments with larger spread are parked as off balance sheet transactions. When it comes to credit derivatives and financial instruments based on mortgage backed securities, it appears that industry players have overlooked the importance of deeper analysis of their exposure in worst-case scenarios. Deals were stuck at rapid speed based on the available ratings which did not take the contamination effect into account. Lower interest rates, higher liquidity, availability of better ratings, and relentless pursuit for alpha have all played an important role. An inadequate framework for pricing and valuing the deals further reduced the clarity on the exposure in the event of default. These aspects are now debated at length. It is astonishing to know that most banks that have significant exposure to sub prime markets have little knowledge about their overall risk exposure. Figures are changed at regular intervals to reflect their own discovery process. Further, banks are now faced with a decline in housing markets and vanishing demand for these asset classes. Considering the expected loss amounting to US \$ 94.3 billion, it is likely that the Basel II accord itself will come under tremendous pressure. Within the industry, it is now feared that few of the large banks which are looking for a bail-out may even opt out of the Basel II compliance – even though this move could potentially increase the cost of funds thereby impacting on their own rating further.

*The table below indicates the rapid decline of asset quality and return among some of the*



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leading global banking conglomerates.

Holding Company	Economic Capital (\$)	Tier 1	EC/Tier 1 RBC	RAROC (%)
Bank of America	70849433	101563808	1.7	4.61
JPM Chase	388382823	81198866	4.8	-0.21
Citigroup	284168148	75483168	3.8	2.35
HSBC	36245,022	10980690	3.3	0.02
Bank of New York	20374059	6007244	4.4	-2.78
State Street Corp	45544356	5266010	8.7	-0.20
PNC Financial	20785231	7989002	2.6	2.75

A low or negative risk-adjusted return on capital or RAROC may indicate higher risk associated with poor quality of assets and return on equity  
 Source : Federal Deposit Insurance Corp/The IRA Bank Monitor, June 30, 2007

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The Basel II accord suggests the use of an internal model to employ current market data to compute current exposure. It also prescribed that when using historical data to estimate volatility and correlation, at least 3 years of historical data be used. And it is required to update this information quarterly or more frequently, if warranted by market conditions. However, since bad loans and good advances are mixed to get better external ratings on the basis of consistent cash inflow, deals have increasingly been struck on faulty pricing and valuation. These are the primary reasons why even sophisticated risk managers across banks are currently grappling to calculate the exposure unbundling. A contamination, which was originally thought to be the recipe for better business acumen, is now questioning the fundamentals of world financial markets structure. For the first time in the 70 years of banking history banks are now unwilling to lend to each other in the inter bank markets. Faced with the new reality, intervention by central banks is increasingly sought by the players as well as policy makers to control the greater risks. Though there will be some more ripples before the verdict is out on Basel II compliance by the banks, rumours of many banks' inability to meet the prescribed norms of tier 1 capital requirements as per the accord has merit in it. I believe that it is the single most important challenge faced by the Basel committee .

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