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# THE BASEL III CONTROVERSY:

## *A critical assessment of the views of Australian regulators*

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*This paper critically examines the arguments put forward by Australian regulators in favour of Basel III and the Basel accords, more generally. We argue that Basel II contributed significantly to the global financial crisis (GFC) and the European crisis. We also suggest that Basel III is not a 'great leap forward' when compared with Basel II, its provisions will not make banks more resilient, its architects have not learned much from the GFC and that the international unification of banking regulation is a flawed idea.*

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In October 2010, the Basel Committee on Banking Supervision (BCBS) released a report entitled *The Basel Committee's Response to the Financial Crisis: Report to the G20* (BCBS 2010). The report announced the development of 'a reform program to address the lessons of the crisis' and laid the foundations of the Basel III accord, which is typically portrayed as a 'great leap forward' when compared to its predecessor, Basel II.

Australian regulators seem to be enthusiastic about Basel III (and its predecessors) and the international unification of banking regulation. For example, in a *Regulation Impact Statement*, Australian Prudential Regulation Authority (APRA) argues that 'Basel III addresses deficiencies in the Basel II framework' and that the adoption of Basel III would 'reduce the likelihood of the need for (and degree of) government intervention in any future financial crisis' (APRA 2012a). APRA Chairman John Laker has repeatedly declared that a 'stronger Australian banking system will emerge from the Basel III reform' (APRA 2012b). Officials from APRA and the Reserve Bank of Australia (RBA) have been exceptionally supportive of the rapid implementation of Basel III in Australia (see, for example, Edey 2011; Byres 2010, 2011).

Yet many economists and observers believe that Basel III does not solve the basic shortcomings of Basel II and that international unification of bank regulation does not work.

### **The Basel III Provisions**

Basel III is designed to modify Basel II by taking into account lessons learned from the GFC. The Basel III proposals aim to boost regulatory capital while modifying its definition to 'emphasise the quality,

consistency and transparency of the capital base' as well as making common equity the predominant form of Tier 1 capital. Another feature is the introduction of a countercyclical capital buffer to reduce the procyclicality of the banking industry. Basel III also requires the introduction of a (non-risk-based) leverage ratio as a 'supplementary' measure to the Basel II risk-based framework. The objectives behind the introduction of the leverage ratio are to: prevent the build-up of leverage in the banking sector; put a limit on the 'gaming' of the risk-based requirement; and address model risk.

The proposed liquidity provisions include the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) requirements. The LCR is the ratio of high-quality assets to projected 30-day net cash outflows in an acute stress scenario. The NSFR is the ratio of available stable funding — calculated by weighting deposits and wholesale funding by reference to their stickiness — to required stable funding (based on asset holdings etc.). Banks can meet these standards by changing their funding profiles, which makes them less vulnerable to liquidity shocks.

### **The views of Australian regulators**

One can get a feel for Australian regulators' views on Basel III from the writings and speeches of, among others, Malcolm Edey, the Assistant Governor (Financial System) of the RBA (Edey 2011) and Wayne Byres, the Executive General Manager (Diversified Institutions Division) of APRA (Byres 2010, 2011). Wayne Byres is also currently the Secretary General of the BCBS, replacing Stefan Water in January 2012.

Edey (2011) describes the Basel III proposals as a 'major re-think of the existing minimum standards

for international banking' and advocates the harmonisation of banking rules worldwide. He raises the interesting question of why Basel II did not prevent the GFC, suggesting that Basel III was a response to the lessons learned from the crisis. Byres (2010) suggests that the international harmonisation of banking rules is important given the global nature of the financial system. He defends Basel II by saying that it was implemented 'long after the seeds of destruction have been sown'. He finds it surprising that 'Basel II should be scrapped in favour of some less risk-sensitive measures'. With respect to Basel III, he argues that the accord 'is designed to make banks more resilient' by increasing the quantity and quality of capital, coupled with higher liquidity.

### **Proposition 1: Basel II did not cause the global financial crisis**

In their defence of Basel II, Edey (2011) and Byres (2010, 2011) echo the views held by the staff of the Basel Committee and the Bank for International Settlements. The Chairman of the Basel Committee, Nout Wellink, has argued that Basel II 'would have helped prevent the global credit crisis from occurring' and that 'it was a misunderstanding to say that Basel II would have allowed the risky practices among banks that triggered the crunch' (Wellink 2008). Like Wellink, the General Manager of the Bank for International Settlements, Jaime Caruana, suggests two reasons why Basel II had nothing to do with the crisis: (i) the crisis manifested itself in 2007 on the basis of imbalances that had built up prior to the implementation of Basel II; and (ii) many countries that have adopted Basel II did so in 2008 or later (Caruana 2010).

The proponents of Basel II seem to forget that the accord was actually approved in 2005 and that most banks were fully compliant by 2008. They also overlook two other important points, viz. that: the originate and distribute model, which was encouraged by Basel I and sustained by Basel II, made banks more reckless; and the calculation of regulatory capital on the basis of risk-weighted assets encouraged the accumulation (by banks) of triple-A collateralised debt obligations (CDOs) and sovereign debt (including Greek bonds). By assigning risk weights based on the rankings of the rating agencies and giving equal risk weights to the bonds issued by Greece and those issued by Germany, Basel II actually contributed to the advent of the GFC and the current European crisis.

The sanguine views towards Basel II — as expressed by Wellink (2008), Caruana (2010) and our own regulators — are not widely accepted. Whalen (2007) argues that 'we do not believe that the implementation of the Basel II proposal or anything that looks remotely like it would have alleviated the

ongoing collapse of the market of complex structured assets'. For one thing, Basel II was fixated excessively on capital adequacy, which is a 'lagging indicator of potential trouble' (Llewellyn 2010). Dolan (2010) points out that dozens of the world's largest banks, including many that (on paper) fully met the Basel II capital adequacy standards, were devastated by the crisis. He also suggests that Basel II allowed banks to overstate their true capital and understate the risks to which they were exposed. Blundell-Wignall and Atkinson (2010) also argue that 'the Basel risk weighting approach has allowed banks to expand their leverage almost without limit for all practical purposes'. Llewellyn (2010) points out that 'Basel II created incentives for banks to develop off balance sheet business and to shift credit risk', and that 'it was largely the Basel Capital Accord that induced banks to engage in securitisation and to develop credit risk shifting instruments'. Any prosecutor seeking the indictment of Basel II will not have a difficult job to do.

### **Proposition 2: Basel III is designed to make banks more resilient**

Australian regulators believe that banks will be made more resilient by the introduction of new capital adequacy rules as well as the liquidity and leverage provisions. In terms of the capital adequacy rules, we certainly agree with the proposition that redefining capital to exclude items that do not remotely represent or resemble capital is a positive move. However, redefining capital and raising regulatory capital requirements do not solve the problem that Basel III, like Basel II, is capital-based regulation — more like buying insurance to pay for the damage than avoiding the damage.

Another problem is the calculation of the capital ratio on the basis of risk-weighted assets. The risk weights are arbitrary, and the whole system boosts the procyclicality of the banking industry without solving the problem of regulatory arbitrage. On a macroeconomic level, the risk-based approach may have some adverse consequences for employment because it discriminates against small- and medium-sized firms. Since they are perceived to represent greater risk than big firms, banks will have the tendency to deprive these firms of credit lines.

The procyclicality of Basel II results from the calculation of the capital ratio on the basis of risk-weighted assets. As bank assets (loans in particular) are assigned higher risk weights during an economic downturn, banks are required to hold more capital, which weakens their ability to grant loans (and vice versa in the case of an upturn). This means that one of the proclaimed advances over Basel I (increased risk sensitivity) is counterproductive. It seems strange to design Basel II in such a way as to make

it procyclical, then trying to reduce procyclicality by introducing countercyclical capital buffers in Basel III. Because it is a product of the risk-weighted capital requirement, some economists argue that procyclicality can be reduced by calculating the capital ratio from total unadjusted assets, which Byres (2010) does not favour. For example, Goldstein (2008) suggests that one way in which countercyclical elements could be introduced into regulatory capital requirements is to make capital a function of the change in assets, not the risk-weighted level.

The introduction of a leverage ratio is a step forward, but the problem is that the leverage ratio is regarded (by the BCBS and our regulators) as being 'supplementary' or a 'backstop to risk-based requirements'. Blundell-Wignall and Atkinson (2010) point out that 'the leverage ratio should not be thought of as a backstop measure, given how effective [or rather ineffective] the capital weighting approach has been'. They go as far as arguing for the leverage ratio to be the primary 'capital control tool', pointing out that 'risk weighting and leverage ratio may not sit well together'. Charles Littrell of APRA admits that the use of risk-weighted assets 'understates true leverage' (Joye 2013).

To suggest that the leverage ratio is a supplementary tool to the capital ratio is somewhat strange, given that when a leverage ratio is in place, it implies a corresponding capital ratio. Furthermore, the leverage ratio is more objective, easier to calculate and more readily understandable than the risk-based capital ratio. While there is substantial empirical evidence for a negative relation between the leverage ratio and bank insolvency, there is no such evidence on how insolvency is related to the risk-based capital ratio (for example, Evanoff and Wall 2001).

Regulating liquidity is a step forward because low liquidity hampers business and may induce a run on bank deposits. The problem here is that the proposed liquidity provisions are rather complex in the sense that the liquidity ratios are difficult to measure. More serious is the fact that the net stable funding ratio (NSFR) is based on liabilities rather than assets, which is inappropriate. Furthermore, it is not clear how the liquidity coverage ratio (LCR) and NSFR are going to be reconciled, given that the former is asset-based while the latter is liabilities-based.

### **Proposition 3: Basel III incorporates lessons of the GFC**

It is unclear as to why the Basel Committee did not recognise the importance of leverage, liquidity, underwriting standards, and a variety of other factors mentioned by Stefan Walter, the former Secretary General of the BCBS, in his (ex post) diagnosis of the financial environment in the run-up to the

GFC (Walter 2010). If the view is that the crisis has demonstrated the importance of these factors, it is puzzling as to why several lessons of the crisis have been ignored.

One lesson that has not been learned is that capital-based regulation is inadequate and that risk-based capital regulation can produce disastrous results. A related lesson is that it is not a good idea to allow banks to use their own models to calculate regulatory capital and that it is hazardous to put too much faith in internal risk models in general, and value-at-risk models in particular. Yet another lesson is that we should not depend on the ratings provided by the cartel of ratings agencies. It is not clear why the BCBS still sees value in these ratings.

### **Proposition 4: Basel III is a great leap forward**

The perception that Basel III represents a major overhaul of Basel II is worth challenging. There are two considerations here: whether the flawed components have been carried forward and whether the shortcomings of Basel II have been rectified. The answers to these questions are 'yes' and 'no', respectively.

Blundell-Wignall and Atkinson (2010) argue that 'some of the most fundamental problems with Basel I and Basel II have not been dealt with [in Basel III]'. These problems include the model framework, regulatory and tax arbitrage and the need for more capital. And there are more: allowing banks to use internal models to calculate regulatory capital; reliance on rating agencies; the implementation problems; and the exclusionary and discriminatory aspects of Basel II. Despite the claims of Basel enthusiasts (including our regulators), Basel III is not (and neither should it be) about risk management. Like its predecessor, it is a pure compliance exercise.

### **Proposition 5: Banking regulation should be harmonised internationally**

Our regulators appear to reject the proposition that financial regulation, just like exchange rate regime choice, is (or should be) a domestic issue. Instead, they advocate the application of the same rules to banks in financial systems as diverse as those of Bangladesh, Somalia, Malta, Sweden and Saudi Arabia. Edey (2011) correctly argues that all countries benefit from financial stability but this does not imply that all countries should adopt a similar set of regulations. It is ironic that while Byres is adamantly against adopting country-specific rules, he admits that Australia was saved from the GFC, not because of international regulation but because of domestic policy measures.

Acharya (2012) argues that 'India should resist the call for a blind adherence to Basel III and persist with its (Reserve Bank of India's) asset-level leverage restrictions and dynamic sector risk-weight adjustment approach'. *The Economist* (2011) agrees with the views expressed by Acharya, arguing that it is not clear why banks in Third World countries should be regulated by Basel III when, in fact, they have tighter (and more effective) controls. With the help of an analytical model, Acharya (2002) had earlier found that when capital standards are harmonised across countries that have different rescue policies, the outcome is a 'regression to the worst regulation'.

A unified implementation of Basel III is not only undesirable but also impractical. Watt (2011) argues that 'when push comes to shove, though, there are worries individual regulators may tweak certain parts of the rules to suit their own banking sectors'. If, as Edey (2011) suggests, national regulators eventually set the standards as dictated by domestic conditions, the Basel rules become irrelevant. The RBA has already devised a unique 'Australian solution' to the problem of meeting the liquidity requirements of Basel III by creating a taxpayer-backed line of credit to make sure that Australian banks do not run out of cash. This is an Australian arrangement that actually defeats the purpose of the Basel III liquidity rules.

Any justification for using internationally uniform capital standards is more like rhetoric than economic sense and substance. The claim that the international implementation of the Basel rules is conducive to worldwide financial stability, as Edey (2011) argues, is doubtful because financial instability has been the rule rather than the exception since the mid-1980s when the Basel Committee started to flex its muscles.

## Conclusions

The enthusiasm of our regulators for Basel III seems to be unwarranted, to say the least. The proposed provisions of Basel III are problematic while failing to address the fundamental shortcomings of Basel II. If the Basel Committee has its own way, banks and regulators will keep on receiving new provisions for Basel IV, Basel V and so on. They are in for enormous regulatory fatigue and regulatory capture, respectively. The biggest losers will be bank customers who will foot the bill for the implementation of the Basel III provisions. They will also endure the consequences of future financial crises that will strike either because the Basel provisions encourage malpractices or, at best, because these provisions do not prevent crises or reduce their impact. ■

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