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CAN BASEL II ENHANCE FINANCIAL STABILITY?

A Pessimistic View

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Introduction

Over the next few years, the banking systems of most countries will come under the requirements of Basel II, which will replace the 1992 Basel Accord. This brief examines the contributions that Basel II might make toward reducing banking risk and financial instability, arguing that risk-weighted capital requirements and greater reliance on external ratings agencies will not do much to reduce the likelihood or costs of financial crises.* Rather, these crises result from other national and international sources of stability; the national and international financial environment is more important for the stability of financial institutions. The brief concludes with some policy recommendations to complement Basel II.

The Basel Accord and the Basel II Reform

The original Basel Accord, which took effect in 1992, provided risk-weighted capital requirements to be imposed on banks and their subsidiaries. The idea was that raising capital is costly and that linking required capital ratios to riskiness of assets would force banks to make proper risk-return calculations. Thus, a bank could choose either to purchase safer assets or to accumulate more capital against riskier assets.

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Because of perceived shortcomings in the Accord's system of capital requirements, the Basel Committee on Banking Supervision (BCBS) began to develop reforms that eventually became Basel II. The new regulations are quite complex, but rest on three pillars: minimum capital requirements, supervisory review, and market discipline (Guttman 2006). Each of these pillars, in turn, has several components. To simplify, pillar one allows greater flexibility in establishing required capital ratios. It creates many more risk classes than were defined in the 1992 Accord, and it allows larger banks to adopt "internal ratings–based approaches" and to rely on external ratings agencies to assess riskiness of assets. Calculated risk ratings are used, in turn, to calculate capital requirements. Pillar two addresses host-country supervision. Supervisors are supposed to work closely with their banks to monitor risk-assessment practices; they can require extra capital beyond Basel II's minimum if they believe that domestic economic conditions warrant it. Finally, pillar three seeks to increase the force of the market to discipline banks. Riskier banks will have to pay higher interest rates on their liabilities and will face lower equity prices. Basel II tries to increase transparency, specifying what information banks must provide to the market, a precondition to increasing market discipline (Guttman 2006). In sum, the Basel II reforms create finer classifications of risk and give banks greater freedom to generate their own risk estimates. Interestingly, the United States has decided to postpone implementation of Basel II, with a three-year transition period beginning in 2009, and to limit its application to between 10 and 20 of the largest banks—those with total assets of at least $250 billion or with foreign exposure of $10 billion or more (Cole 2006). For all other banks, the United States has proposed a modified version of Basel I that would create additional risk classes but otherwise leave the original provisions mostly intact.

Basel II and Banking Risk

It is difficult not to applaud the energy of the framers of Basel II, even while doubting the reform's effectiveness. There are several reasons to question whether the reforms will reduce banking risk.

Basel II is extremely complex, a result of several inherent forces. As Cornford says in his comprehensive review, "Much of this complexity has been due to the attempt to set global standards for the regulatory capital of banks at different levels of sophistication" (2005, p. 2). Further, any attempt to regulate behavior across a hundred nations generates charges of favoritism, which then lead to exceptions, alternatives, and more complexity.

By their very nature, rules and regulations are backward looking, trying to deal with past innovations and scandals, and cannot reflect future experience (Greenspan 2005). Much of Basel II seeks to codify current rules of thumb that guide good banking practice. This is supplemented by the introduction of market assessment of risk, in the apparent hope that external (private sector) credit-rating agencies can be counted on to deal with the changing financial environment and practices. The problem, of course, is that these agencies assess risk based largely on recent historical experience, and they can easily get caught up in current fad and fancy and whirlwinds of optimism and pessimism. As Cornford (2005) notes, the credit rating agencies did no better than public supervision in predicting recent crises such as the Asian Tigers crash.

Clearly neither capital nor risk-weighted capital, alone, is necessarily a good indication of the likelihood of bank failure. A bank with a currently lower (risk-adjusted) capital ratio but higher returns on assets will be better able to weather unexpected losses. What is more problematic is the possible perverse incentive set up by higher capital requirements. As Minsky (1986b) argued, competitive pressures force banks with higher capital ratios to seek higher returns—to increase return on equity. To the extent that risk weightings do not eliminate the higher net returns to overly risky assets, all things equal, banks with more capital need higher returns and thus riskier positions.

Capital is the cushion that protects the bank's creditors. However, capital cannot meet *unexpected* losses in the event of a major systemic financial crisis—which because it is unexpected cannot be incorporated into stress tests of internal models. Nor should banks be required to *individually* set aside provision for such systemic events, whether the provisioning is in the form of loan-loss reserves or capital, since such events are outside the control of the individual institutions and can only be resolved through government intervention. Indeed, many (most?) systemic crises might be blamed on mismanagement of the economy by the government. For example, the Asian Tigers crisis was largely triggered by insufficient international reserves held by nations operating with exchange rate pegs. In those circumstances, there was no reasonable capital ratio that would cover banks' losses.

One of the advantages of discretionary supervision over rules is that supervisors can try to deal with innovations that are not foreseen. Supervision can be flexible, carried out on a case-by-case basis, unlike regulations that prescribe and proscribe, largely responding to past problems (Greenspan 2005). However, supervisors can be captured by the financial services sector or constrained by politicians. Basel II provides guidelines for external supervisors as well as internal controllers, while also bringing in credit-rating agencies, all of which might help banks to resist temptation; however, that comes at a cost of reducing flexibility to deal with unforeseen situations.

Basel II seems to provide a compromise between government supervision and market discipline, but with something of a bias toward the currently fashionable beliefs that markets work better than government and rules work better than discretion. This approach relies too heavily on the faith that depositors, borrowers, and investors will react to market signals such as risk ratings and interest-rate differentials. Reliance on independent risk ratings and market-driven interest-rate differentials to punish excessively risky behavior appears quaint after the U.S. thrift experience, when depositors flocked to the riskiest institutions to reap higher interest rewards, and the institutions sought ever-riskier assets so they could service their costly liabilities.

In sum, does Basel II provide a more effective constraint on excessively risky credit growth than a simple 8-percent capital rule? Probably. Will Basel II encourage safer practices? Perhaps. Will Basel II reduce the cyclical nature of credit supply? Probably not.

The Importance of the Financial Structure

A more important question is this: Can Basel II substantially inhibit the creation of a fragile financial structure and tendency to crisis? Almost certainly not. There are forces working at both the national and international levels that lead to endogenously created fragility. As noted, Basel II cannot do much to counter the effects of success and euphoria that will reduce perceptions of risk simultaneously among borrowers, lenders, investors, regulators, and private credit-rating agencies. Many of the risk assessment practices in Basel II require calculation of default risk and cost of default based on the previous five (in some cases, seven) years of experience. This will provide misleading guidance precisely near the peak of the most dangerous speculative booms (real estate, high tech, capital investment), which can take five to 10 years to run their course. The force of the market induces participants to underestimate assessed risk at the most dangerous time; those who try to buck the speculative trend not only face lower returns but also doubts of their management skill and profit drive.

As Minsky (1975, 1986b) argued, even in the absence of obvious speculative excesses, there is a natural tendency for fragility to increase over an expansion, as innovation is rewarded and success breeds more risk-taking. This is why he put so much emphasis on "Big Government" and the "Big Bank" (central bank) to constrain the boom and soften the slump. Countercyclical movements of the budget would help to constrain swings of income—especially profits—and spending. Big Government deficits would fill private portfolios, including those of banks, with safe assets. Big Bank supervision in the boom, and lender-of-last-resort intervention in the bust, would help to stabilize financial institutions. New Deal–style institutions such as deposit insurance and separation of banking functions would help to protect depositors when financial institutions fell. Above all, Minsky insisted that continuously adapting regulation and supervision would be necessary to attenuate the tendency to fragility that is paradoxically generated by financial stability.

This brings us back to the national and international financial environment in which national and international banks operate. When this environment is favorable, banking is easy. During the U.S. "golden era" of the 1950s and 1960s, when financial institution failures were practically unknown, the rule followed by management was "three-six-three": pay 3 percent on liabilities, earn 6 percent on assets, and hit the golf course by 3 p.m. That began to change markedly in the 1970s, when "loan losses soared at many institutions," and many banks "experienced a tripling if not a quadrupling in losses compared to their historical average" (McConnell 1981, p. 353).

By the 1980s, financial institution failures were widespread. To be sure, mismanagement, fraud, and financial deregulation were involved in the 1980s thrift and banking crises. However, even if the Basel Accord and Basel II had been in place in 1980, it is not evident that they would have made any difference for the outcome of the worst U.S. financial sector crisis since the 1930s. The high interest rates during the U.S. and United Kingdom experiment in monetarism at the beginning of the 1980s, the following deep recession, the second energy crisis, the debt crisis of the less developed countries, the sharp appreciation of the dollar, the devastation of U.S. agriculture and manufacturing

sectors, and other national and global economic disruptions played a more important role than capital or reserve levels.

Policies to Enhance Stability and Sustainability

Greater transparency, better risk assessment, and improved supervision of banking are desirable but will not do much to enhance financial stability. What is more important is robust global economic growth. As Minsky (1979, 1986a) argued, the United States acts as the world's banker in the sense that its dollar-denominated liabilities operate as the asset for ultimate net clearing for many international transactions. This, in turn, requires the United States to run current account deficits to supply dollar assets. Of course, the United States is doing just that, on an unprecedented scale. The problem is that current account deficits might be unsustainable—not for the usual reasons given (U.S. solvency), but because they rely on deficit spending by the U.S. private sector (Wray 2006; Godley 2005). If U.S. households scale back spending, countries that rely on export-led growth could be in trouble. If their exports falter, their banks could experience rapidly deteriorating asset values.

The typical orthodox policies, such as lower costs, improved productivity, and freer trade, mostly redistribute shares of the global pie ("beggar thy neighbor"), helping one country at the expense of another. Only an expansion of the global pie will allow one country to improve its position without hurting another's. Increasing the growth of the pie will require relaxation of fiscal and monetary constraints around the world. This, in turn, is generally easier in the framework of flexible exchange rates. While a few mercantilist nations can accumulate dollar reserves sufficient to guarantee an exchange rate peg (or, even, to dollarize their economies), most nations cannot succeed at that game. In the absence of sufficient reserves, an exchange rate peg holds domestic fiscal and monetary policy hostage to the exchange rate. Floating rates and independent fiscal and monetary policy can provide the context for growth that conventional policies do not.

For the United States, policies to increase domestic employment, including policies to replace jobs lost to foreign competition, are necessary to restore income growth—a first step to reduce excessive reliance on debt-financed spending. Minsky advocated an employer-of-last-resort program, not as a temporary expedient to deal with the high unemployment that comes during deep recessions or depressions, but rather as a permanent policy to fight unemployment and poverty in a noninflationary manner (Minsky 1986b; Wray 1998). Such a program would also have strong countercyclical influences, with spending on the program rising when the private sector sheds workers.

At various times Minsky also advocated policies that would reduce inequality and lower the advantages enjoyed by the biggest firms and banks. Among other proposals, he backed a community development banking initiative that would increase the supply of financial services to underserved communities. Minsky favored policy to encourage consumption, while policymakers typically favor investment. Minsky believed that a high-investment economy is naturally prone to inflation and, more importantly, to instability. He also favored to-the-asset financing—linking specific liabilities to appropriate assets: "If banks concentrate on to-the-asset financing, then the short-term debts of business will lead to payment commitments that are consistent with business cash receipts. The bank debts of firms would be part of a hedge-financing relation" (1986b, p. 321). Elsewhere, he endorsed Levy Institute colleague Ronnie Phillips's (1995) revival of the "100-percent money" Chicago Plan. This plan would eliminate risk by forcing depository banks to hold 100-percent reserves against deposits. Essentially, this would go even further than New Deal–era reforms that separated commercial banking from investment banking, by creating another class of banks that would issue deposits but make no loans. Minsky also suggested that a uniform 5-percent asset-equity ratio for banks is desirable, not only to increase safety, but also to level the playing field. This proposal is consistent with Basel-type goals, although Minsky did not explicitly endorse risk-adjusted capital requirements.

In conclusion, Basel II represents an ambitious international attempt to reduce risk in banking and to decrease unfair competitive advantages across nations that could result from laxer banking standards. The accord could enhance national and international financial stability, although the effects are likely to be relatively minor, not because Basel II is poorly designed, but rather because it does not and cannot do much about the primary sources of financial instability. Complementary policies, including both microindustrial policies and macrostabilization policies of the sort that Minsky advocated, are needed to address the real potential sources of instability. Further, given increasing integration of global finance, it is impossible to ignore the importance of the performance of the global economy. And that is probably the most difficult nut to crack.

Note

* This brief is based on a presentation given at the international seminar "Global Finance and Strategies of Developing Countries: Main Trends after Basel II," sponsored by the Centre for the Study of International Economic Relations and the Institute of Economics of the University of Campinas, Brazil, March 13–14, 2006. The author thanks, in particular, Jan Kregel and Robert Guttman for discussion and insights.

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