Basel II and the sub-prime blow?

Peter Andresén looks at how Basel II could have softened the sub-prime crisis and how it may help in commercial real estate

As financial institutions prepare for the Basel II regulations in Europe, the crisis in the US sub-prime mortgage sector and its knock-on effect on world markets have illustrated why it is so important to implement the principles of the new capital adequacy regulations across all financial institutions. Although Basel II came in too late to prevent the crisis in the retail mortgage sector, the commercial real estate sector historically lags the wave of retail defaults by a year, so there may still be time for good risk measurement to soften the blow.

Basel II represents a major revision of the international standard on bank capital adequacy introduced in 1988. It lays out a comprehensive framework for setting regulatory capital and implementing advanced risk management.

Three pillars form the foundation of the Basel II accord:

(i) Minimum capital requirements and rules on how to calculate the increased capital to be held as the risk of assets increases
(ii) A well defined supervisory review process that provides increased power to regulators
(iii) Market discipline requirements for greater transparency through increased disclosure requirements.

The new and improved Basel II accord defines three categories of risk that must be considered for calculating minimum capital requirements: credit risk; market risk; and operational risk.

Furthermore, the accord provides an incentive to improve internal risk measurement practices. Financial institutions can qualify for three different tiers of Basel II compliance: standardised, foundation and advanced. Each successive tier requires more stringent risk management practices, with the most advanced approach providing the lowest capital requirements. Qualification for these tiers is dependent on the institution's dedication to risk measurement. For each portfolio of assets that it holds, each institution must choose the methodology that best suits the asset class and calculate the capital that it must hold to protect against market risk. The better an institution understands its risks, the less capital it will have to hold to cover the unknowns.

Structured debt

The sub-prime crisis has its roots in the relaxation of financial institutions' underwriting standards. This was particularly evident in the residential mortgage market where the relaxation of standards was fuelled by an appetite for continually increasing returns, and the emergence of new structured debt products and credit derivatives, such as collaterised debt obligations (CDOs). These structures allowed institutions to sell the assets, and thereby the risk, to investors in packaged securities. The complex structure of these packaged securities allowed them to be rated as investment grade by the credit rating agencies, despite the fact that the underlying assets were predominantly sub-prime. When sub-prime default rates in the residential market experienced a slight increase, some investors were 'surprised' to realise that their investment-grade CDO tranches were affected, and a massive sell-off ensued. The apparently over-optimistic rating of some of the facilities has led to strong criticism of the credit rating agencies and their alleged conflict of interest. This has led to an indirect criticism of Basel II because institutions under the standardised approach would have to rely more heavily on the ratings provided by the agencies.

However, the more critical issue with respect to the Basel II regulations has been the suggestion by some critics that the current CDO debacle is evidence that the regulation is not aligned with today's modern markets. It has been suggested that it cannot satisfy the requirements of capital measurement for the highly complex structured products being offered, and hence should not be implemented.

Such criticism seems a bit premature as the regulation is not yet in operation for most banks. If anything, the preparation by some of the larger financial institutions may have cushioned the impact. Many have been moving towards more advanced risk management systems driven by the incentives that the Basel II accord offers, in particular, lower capital requirements for those with good risk measurement systems.

One could speculate that had Basel II been in place during the current sub-prime crisis, many financial institutions would potentially not have relied on the ratings provided by the credit agencies. Instead, they could have referred to proprietary models that would have better aligned the rating of the securities with the creditworthiness of the underlying assets. If the CDO debacle can teach us anything, it is that the risk assessment process failed to be effective, through no fault of Basel II. The risk profile of these complex products was rarely assessed in enough detail and on the occasions they were understood, the risk officer's voice was not loud enough when the underwriting took place.

Sound principles

Therefore the principles of the Basel II regulations are sound and address many of the issues exposed by the subprime crisis. Whether the detailed rules meant to implement these principles are always as sound is another question, but these are meant to be refined over time. As people point the finger of blame, it was only a matter of time before Basel II came under scrutiny.

The irony is that had Basel II been implemented at the institutions involved in making the sub-prime loans, they and the market would have better understood the risks they were running. Had it been in place with the institutions investing in the CDOs, they would have been better capitalised and less vulnerable to default. Basel II and its principles of improving information about risk are a good step forward in improving the stability of the financial markets. The next test is whether the risk measurement methodologies developed for Basel II are sufficient to guide banks in restructuring their portfolios, before the effects catch up and are felt in commercial real estate. **MFG**

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