Paradise on the Rhine

View of Basel from Klein Basel
Home of a noted carnival

*Fasnacht*, Basel’s carnival
And a famous modern art fair.

Art Basel
And, more pertinent for present purposes, the BIS

BIS Secretariat Building, Aeschenplatz, Basel
The BIS “brand”

- The BIS is the banker’s bank for the world’s central banks.
- It also houses several committees or secretariats which, while not formally part of the BIS, are closely associated with it.
- Although it has no formal regulatory power, it is a powerful de facto regulator.
Three Features of Basel

1. Financial Stability Forum
2. Club of Central Bankers
3. Risk-Based Capital Standards
The FSF's mandate:

- to assess vulnerabilities affecting the international financial system;
- to identify and oversee action needed to address these; and
- to improve co-ordination and information exchange among the various authorities responsible for financial stability.
Financial Stability Forum

The FSF, comprised of powerful members and identified with the prestigious Basel process, created an impression that someone was watching the store – leading to possible complacency by other government and private sector actors.

But the FSF is underfunded, has no line authority, and is not independent of the CBs whose monetary policies created much of the risk.
Although the FSF has met frequently, it failed to identify the risk of U.S. subprime securities, or more generally the threat posed by excessive credit during the mid to late 2000s.
Club of Central Bankers

The BIS operates as a “club” of central bankers.

“The BIS is a forum for discussion, policy analysis and information-sharing among central banks and within the international financial and supervisory community.”

- General annual meetings of CB heads from around the world.
- Central bank research hub.
- International journal of central banking.
- Central Bank Governance Forum.
Central bank presidents have nice private offices at the BIS and many of them gather at the Annual General Meetings.

Alan Greenspan was in Basel on 9/11/2001 – and couldn’t get back to the country.
Club of Central Bankers

Like any club, this one is dominated by a few leading members, the heads of the Fed, the ECB, and the Bank of England being the leaders.
Club of Central Bankers

Conventional wisdom of the central bank club:

- The primary and most important goal of CBs is to maintain price stability.
- CBs should operate with substantial independence from the political branches.
- Independent CBs with price stability are the best protection against financial instability.
- CBs should not intervene to respond to apparent asset bubbles (Greenspan doctrine).
But this wisdom may have been flawed.

The Fed flooded the U.S. market with credit from 2002-2006, arguably without a good reason do to so other than the fact that inflation was well controlled. This appears to have been a cause of the U.S. housing market bubble.

CBs did not attempt to stop housing bubbles in countries where they developed (the UK, some Eurozone countries, the US).

Did the Basel process discourage independence of analysis or action among central bankers and bank regulators?
Risk-Based Capital Guidelines

Basel I was perhaps the most successful initiative in the history of financial regulation. It was so successful that many countries implemented it even though they were not signatories of the Basel Accord.

Basel II carried forth the process with a much more complicated, nearly impenetrable, but apparently very scientific set of guidelines which had been vetted by top regulators and many government and private sector commentators for years. Something this complicated and precise has to be good, right?
Risk-Based Capital Guidelines

But Basel I and Basel II contain several features which, in retrospect, appear potentially problematic.
Most importantly, the guidelines give talismanic importance to capital. They suggest that if a bank has adequate risk-adjusted capital, there is little to fear.

But risk-adjusted capital is NOT a leading indicator of problems at a bank, and is NOT an absolute protection against financial distress or failure.
Risk-Based Capital Guidelines

All of the U.S. banks that have run into trouble during the current financial crisis had perfectly fine risk-adjusted capital ratios until shortly before they collapsed.

Indymac’s capital ratio was over 10% only two months before its failure, for example.

Capital is a lagging, not a leading indicator of problems at a bank, and should not be relied on by regulators as a protection against financial distress.
An atavistic reliance on capital is embodied in the deep structure of U.S. bank regulation.

For example, the prompt corrective action system is tied to capital. The apparent success of this system may have caused regulators to ignore warning signs of trouble that did not show up in the capital ratios.

Capital is also used for other purposes (e.g., whether banks are allowed to accept brokered deposits, permitted affiliations under GLB Act, permission to expand interstate). Indymac was a major consumer of brokered deposits in the several years before its failure.
Risk-Based Capital Guidelines

Basel uses the 8% ratio as the gold standard for adequate capitalization.

But there is no clear empirical support for this number. It was simply pulled out of a hat during the negotiations between Japan and the United States prior to the original Basel accord.

The 8% ratio was retained in Basel II simply because it had been used in the earlier accord.
Risk-Based Capital Guidelines

Basel I also assigns a 50% risk weight to 1-4 family home mortgage loans. It assigns a 100% risk weight to commercial loans.

“Loans fully secured by mortgage[s] on occupied residential property have a very low record of loss in most countries. The framework will recognize this by assigning a 50% weight to loans fully secured by mortgage on residential property. . . .”
This means that a bank needs to hold less capital for a home mortgage loan than, say, a loan to Microsoft or ExxonMobil.
Risk-Based Capital Guidelines

The 50% risk weighting for mortgage loans encouraged banks to make more such loans.

Perhaps more importantly, Basel I’s favorable treatment of home mortgage lending created the impression that mortgage loans were the gold standard for private lending – creating complacency about underwriting standards and risk.
Risk-Based Capital Guidelines

Basel II allows banks to use credit ratings as the basis for reserving capital against certain assets.

Some of these credit ratings proved unreliable in retrospect.

More significantly, the guidelines endorsed the use of credit ratings and thus encouraged market participants and regulators to view credit ratings as generally highly reliable. CDO and CMO market relied heavily on flawed credit ratings.

The guidelines embedded the role of credit rating agencies without taking account of the potential lack of reliability in these firms’ estimates of default risk.
Conclusion: Blame Basel?

Did these features of bank regulation associated with the Basel brand contribute to some of the current market turmoil?