COMMENT

The brace position

The time has come for regulators to insist on minimum standardisation for the calculation of risk-weighted assets, says **Michael Foot**

I argued in *Financial World* in June that, despite numerous refinements, the "braces" that Basel 3 provides to try to limit risks on banks' balance sheets were too complex and remained inadequate.

In July, the Basel Committee came out with its latest proposals. These seek to address one of the main problems that even supporters of Basel think important: risk weighted assets (RWAs). RWAs, which are at the heart of the risk framework, have been calculated by different banks in quite different ways. As things stand, two banks with identical assets can come out with different results for how much they "weigh" and, therefore, how much capital they need as a minimum. Given the competitive pressure on banks to pare capital needs to a minimum, it is hardly surprising that some have vied with each other to produce lower RWA numbers.

Let's have a consistent solution so that banks can plan properly

The new proposals from the committee, set out in the discussion paper *The regulatory framework: balancing risk sensitivity, simplicity and comparability,* are open to comment until 11 October.

They start from a widely agreed point: ideal capital requirements would be (a) simple, (b) comparable across banks and jurisdictions and (c) give sensible ex ante and ex post measures of the "real risks" to bank capital posed by different types of asset. But they quickly go on to acknowledge, rather mournfully, that it is not possible to have all three, so trade-offs must be accepted. From that, they offer a smorgasbord (if you are "pro") or a kitchen sink (if you are "anti") of ideas for how and where to set those trade-offs now and in the longer term.

The paper is only 25 pages long and worth a quick read. But the short-term analysis boils down to three basic questions:

1) How far do we really want to go in promoting simplicity over the other objectives of comparability and sensitivity to what risks really are being run?
2) Can markets do a better job than hitherto of analysing complex data and comparing banks' positions relative to their peers? Or will demands for "more" data just produce a mass of frighteningly complex information, some of which – if not read carefully – could provide at least as much potential for market fear and volatility as it provides worthwhile information?
3) How far should regulators go, nationally and internationally, to compel banks to provide information that is comparable between institutions? In the process, how far should regulators constrain the freedom that banks with good internal models have had to weigh themselves, rather than have the regulators set and oversee the settings on the scales?

The committee also notes that "in the long run" a number of approaches to capital adequacy could be developed that are very different from Basel 3. Examples cited include:

- tangible leverage, where there would be one single measure of capital and one single measure of risk;
- a leverage ratio combined with greater standardisation;
- a pre-commitment approach in which banks would commit to keep their capital above some specified minimum multiple of their volatility of income.

Put another way, we are invited in the short term to consider ways of patching up one problem with Basel 3 and in the longer term to think about the contents of a Basel 4. A less kind way of putting this would be that we are offered yet further "pick your own" options for the current version of Basel 3 and the chance to start thinking further about what the next generation of belt and braces might look like.

The time, surely, has come for regulators to insist on minimum standardisation for the calculation of RWAs, though, given the range of assets that banks can and do hold, this will be no five-minute task. As I argued in June, regulators should then plump for the belt and braces they are prepared to live with for the coming years. In time, there may be a case for planning for Basel 4. But for now, let us have a consistent and externally imposed solution so that banks can plan properly for what they must make work.

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