



Don't shoot the messenger

Basel II never regulated any of the institutions that packaged or sold subprime housing loans to gullible investors. **Dr. Markus Krall** argues that countries should focus on Basel II to bring more transparency and trust to the credit market.

Models in our minds that used to explain reality falter under the pressure of change. Assumptions that have long been taken for granted are not valid anymore. The ways we explain the world and thus make our decisions are put into question.

As people look in disbelief at how long-held convictions about the stability of our economic system, the wisdom of financial institutions and the workings of institutional setups are falling apart, they face an intellectual challenge. It can best be summed up with the sentence: "What can I still believe?"

In times like these, with certainties crumbling all over the place, people are looking for orientation and guidance. This situation is a dangerous one for several reasons. Number one: in turbulent times, every decision we make has long-lasting consequences. Number two: our analytical

framework is damaged. Number three: it's a big opportunity for people who, with hindsight, have known it all the time (but have not told us before) to throw half truth, flawed analytics and old prejudices at decision makers and actually get a hearing.

One of these flawed approaches has come to the surface in the recent discussion about Basel II. This framework has been developed in the last 10 years to introduce more transparency regarding risks taken on by banks, link those risks to the capital needed to make banks safer and encourage and incentivise these banks to improve their standards of risk measurement, management and control.

Substantial amounts of money have been spent to achieve this objective, especially by European banks, but also by many institutions in the GCC countries, emerging Asian economies and, yes, some American banks as well.

This is where people who always knew better jump in to say: "Basel II has been around for a while, banks have invested in it, yet it did not help prevent the crisis. So let's give up on it and not continue. And, oh, by the way, the European bank regulators are not pursuing it anymore, so why should we?"

This refrain is common these days and is a good example of how a lack of information combined with a flawed analysis leads to an even more flawed conclusion with the potential to do damage to the banking system and the financial sector's ability to prevent future crises. Why make such a strong statement?

The crisis vis-à-vis Basel II

Let's take a brief look at the origins of the crisis. Who originated all those mortgage loans that turned out to be much riskier than anticipated? US mortgage banks.



Were they regulated by Basel II? No, they weren't, because driven by a strong lobby in the US political institutions, Basel II was not seen as relevant for them and they were not subject to the framework.

Who packaged those loans into ever-more-complex securitised papers, slicing and dicing them, leveraging them up, adding a bit of complexity here and there and then selling them to investors all over the globe? Investment banks, mainly from the US. Were they regulated by Basel II? No, because Basel II was introduced only for commercial banks over there (large international ones), not investment banks.

Who put a stamp of approval on those assets, called "investment grade", "AAA" and "AA"? Rating agencies like S&P, Moody's and others. Were they regulated by Basel II? You know the answer already.

You could now, with some justification, ask why all those commercial banks in Europe, Arab countries and other places, as well as investors from all over the place, were not able to spot the risk. Weren't they regulated by Basel II after all? Should they not have had tools in place to understand what they were doing? And why did it fail there?

This is a valid question and one that allows us to identify where the problem was. That is, if it was the Basel II framework, the lack of speed in its implementation or the gaps that were left in some places. It also helps to raise the next point: can the framework be improved going forward?

Looking at European banks, the picture that emerges is quite clear. Most banks introduced Basel II driven risk control infrastructure for those parts of the portfolio that they originated themselves. Loans handed out to small and mid-sized companies, corporate entities, real estate development and project and leveraged finance are all covered by this. Regrettably, they did not apply the same rigor on asset classes that were covered by external agency ratings, because those were deemed good enough to replace banks' own view on the risk of those assets.

In part, banks were encouraged to handle it in that fashion by their regulators who had put the same trust into the (unregulated) agency ratings as their clients, the banks. The Basel II framework itself never supported this. The rest is history.

Status of Arab banks

Looking at Arab banks, we can, with all due respect for the efforts recently undertaken, not state that there are many who claim to be compliant with a Basel II internal ratings based approach in terms of having implemented the infrastructure required. How can you claim that a tool you don't even have should have given you a warning signal on an asset class that was never subjected to the rigorous risk analysis that any mortgage loan to a home owner would have been subjected to? The argument is simply weak.

Even the large banks in the region do not claim to have moved their level of sophistication to what is called a Basel II internal ratings based advanced approach. Some investments have been done, but much is still missing. Many essential obstacles, like the lack of industry-wide data and credit bureau information on borrowers, are only now in the process of being addressed on a national level.

Much more work is needed to create risk


transparency for banks. Everybody has an interest to create that transparency, although not everyone seems to understand the implications. Banks need this transparency to steer their portfolios, to control their risks and to be able to avoid future large losses of the kind and size that have left the world economy in this mess.

Regulators and governments need this transparency to understand systemic risk in the financial markets to make better and more targeted monetary and economic policy decisions. They need clarity, for example, on what is really necessary to stabilise the banking system. Does anyone really believe that this can be achieved with less transparency instead of more?

Investors and private savers need this transparency because they want to be sure that they entrust their savings with stable institutions that know what they are doing with their money.

Companies and firms need this transparency because banks will not be able to extend credit to them or even to each other if they cannot make a scientifically sound judgement on the risk that is involved with every loan they hand out.

It is a lack of trust that starves the credit market at this very moment. This lack of trust is ultimately the expression of a lack of information and transparency.

Basel II is far from perfect. But it is the best chance we have to improve the international banking system's transparency and get this crisis under control in the medium term. If anything, Basel II should not be stopped or delayed; it should be accelerated and existing gaps should be closed as quickly as possible. This is, by the way, exactly what European regulators are doing. More thought needs to be invested in how to strengthen the framework and what the government and supervisors can do to help banks move forward to improve their risk management capabilities. In times like these, leadership is required. 

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