Managing Risk

BY CHRISTOPHER WHALEN

A skeptic's view of Basel II.

Since the failure of Penn Square Bank in 1974, successive chairmen of the Federal Reserve Board have attempted to protect the U.S. financial system from a "systemic" shock that might bring the whole game to a crashing halt. As my father, Richard Whalen, once told me after attending a meeting on Capitol Hill in the early 1980s: "It is the duty of the current generation to pass the bubble on to future generations."

The means of maintaining market stability have evolved since the 1970s even as the scope of the risks to the system have likewise multiplied. Since the October 1987 market break in particular, the Fed has provided any amount of funding demanded by the marketplace, using only the cost of credit as a policy tool, a tacit admission that any link between the dollar and tangible valuation measures is gone forever.

It may seem intellectually inconsistent for the U.S. central bank to at once encourage greater risk management by financial institutions while at the same time following regulatory and monetary policies that increase the probability of a systemic event, but that is a concise description of the Fed's role in America's political economy. No Fed Chairman can ignore the ultimate power of politicians to create fiscal chaos and Greenspan is a good enough politician to know it. But the Fed's own tendency toward statist rather than free market solutions has allowed the Fed to actually exacerbate America's financial problems.

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Regulators from the FDIC and the Office of the Comptroller of the Currency have continued to oppose the framework as unworkable and possibly even harmful to bank soundness. Indeed, sources inside the OCC say that the Fed's own examiners also oppose Basel II, but have been silenced by the globalist tendency that dominates the Board of Governors' research division.

—C. Whalen

Compromised politically, the "independent" Fed accommodates Washington's fiscal excesses even as it preaches the gospel of price stability. It encourages the growth of derivatives trading and other types of risktaking not traditionally associated with banking even as it pushes for higher bank capital levels and better internal controls through the Basel process. The economist priesthood at the Fed attacks Fannie Mae and other bloated government-sponsored entities as a potential "systemic threat" to the U.S. economy, while allowing the creation of goliath universal banks that pose similar risks.

The schizophrenic quality of the Fed's approach to its dual responsibilities for monetary policy and bank soundness is a good argument for getting the central bank out of the business of regulating banks, but we'll leave that juicy morsel for another day. At issue here is the latest set of bank capital rules being championed by the Fed, known as Basel II, and how these new rules square with the mandate from Congress to all regulators to measure and anticipate risk to the U.S. financial markets.

When the first Basel agreement was announced by the Group of Seven regulators in 1988, it set broad, relatively simple minimum levels of capital for banks based on a percentage of assets. This approach was focused on addressing market and interest rate risk. The Basel Accord followed the near-failure of several large U.S. banks and investment houses after the Third World loan crises of the 1980s and was the first consistent effort among the industrial nations to set uniform financial standards for banks.

Also at that time was born the informal policy of "too big to fail," under which the Fed and other regulators took extraordinary means to keep several money center banks afloat during the 1989–91 recession. With the renewed focus on capital adequacy fostered by Basel I, the U.S. financial system successfully navigated the 1989–91 real estate crash, although George Bush I did not. The Fed saved the bank, at least temporarily, by printing money, but set the monetary stage for the New Economy investment bubble later in the decade.

With Basel I, Wall Street began to accelerate the movement of assets "off balance sheet" to evade the very same capital requirements. The Basel Committee of bank supervisors was concerned about derivatives and off-balance sheet financing in the early 1990s, but the failure of Long-Term Capital Management in 1998 provided the first major warning that something was amiss. Within a year of the LTCM rescue, a flurry of proposals came forth from the Bank for International Settlements in Basel, Switzerland, in particular the June 1999 statement entitled "A new capital adequacy framework."

Under the Basel II proposal that has evolved since then and was announced this past summer, regulators have sought to address the vastly increased complex-

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ity of risk using what is called an "internal risk-based approach." Similar to the now-discredited practice of risk-based auditing, Basel II requires banks to calculate the precise risk profile of each major counterparty. Whereas in the past, large money center banks could use an estimate of, say, two standard deviations from the mean of loan losses to determine the adequate ratio of loan loss reserves to total loans, Basel II requires banks to identify which particular credits in a given loan portfolio are most likely to default.

Nobody would argue that the goals of Basel II are not entirely laudable, but it remains to be seen whether the analytical tools and methods currently employed by the banking industry are up to the task. The accompanying chart illustrates some of the top-level measures that Basel-compliant banks must be able to calculate using current data from the Federal Deposit Insurance Corporation. The banks must also calculate these risk measures for each different type of loans (mortgages, credit cards, commercial, and industrial) right down to the individual credit. The implied rating in the table is based on the overall performance of the bank's loan portfolio.

Holdings of derivatives by U.S. commercial banks rose to $76.5 trillion at the end of the first quarter of 2004, and this represents a 21.2 percent increase from $63.1 trillion for the first quarter of 2003.

Fewer than fifty banks in the United States will probably ever even attempt to comply with the Basel II standards due to the cost and the complexity. Perhaps this is why regulators from the FDIC and the Office of the Comptroller of the Currency have continued to oppose the framework as unworkable and possibly even harmful to bank soundness. Indeed, sources inside the OCC say that the Fed's own examiners also oppose Basel II, but have been silenced by the globalist tendency that dominates the Board of Governors' research division.

In 2001, we described how federal bank regulators were pushing regional banks to adopt a much tougher approach to anti-money laundering activities, this in cooperation with their ministerial cousins in Europe. In "Sneak Attack: A stealth campaign by U.S. regulators to turn private bankers into policemen" (*TIE,* May/June 2001), we wrote: "American cooperation with the OECD, which operates under the umbrella of the Financial Action Task Force, has extended to American bank regulators, who are eagerly imposing new guidelines on American banks in direct opposition to the wishes of the majority in Congress." In "Gunfight at the Basel II Corral" (*TIE,* Winter 2004), we described the political fight over Basel II on Capitol Hill and, incorrectly, predicted that the Fed's push for adoption of the New Basel Capital Accord would be blocked by opposition in Congress.

As we wrote last year, Fed Vice Chairman Roger Ferguson is the point man for the Board of Governors on Basel II and banking issues generally. Sources at the OCC say that Ferguson and the Fed Board's research unit are the intellectual champions of the Basel II framework within the Fed system, while officials within the examinations and bank supervision areas are skeptical, to put it politely. Going through the practical objections to Basel II from a risk management perspective would easily fill several volumes, so instead consider a list of issues from the ten-thousand-foot level:

First, the whole Basel II approach reflects a confidence in financial regulation and oversight that exceeds practical applications. As one bank noted in its comments on Basel II last year:

> *"Northern Trust recognizes that implementing a framework of this type must be done with rules that are well defined, rigorous, and enforceable. In the ANPR [advance notice of proposed rulemaking], the Agencies have sought to achieve these qualities by establishing standards that banks must meet in order to qualify to use Advanced Approaches in determining regulatory capital. Although Northern Trust accepts the need for a well-defined regulatory framework, the level of detail embodied in the standards alarms us. We are concerned that, rather than supporting the goals of the Accord, the standards mi-*

BANK UNIT	PROBABILITY OF DEFAULT Rated in approx. bond equivalent values	LOSS GIVEN DEFAULT In basis points per loan dollar	MATURITY In years for aggregate lending portfolio	EXPOSURE AT DEFAULT Expressed as unused commitments outstanding at time of default	SPECIALTY	HOLDING COMPANY
Bank of America, National Association	BBB	20 bps	7.78 years	62.5 percent	All Other > $1 Billion	Bank of America Corporation
JPMorgan Chase Bank	BBB	29 bps	4.69 years	86.9 percent	International Specialization	J.P. Morgan Chase & Co.
Citibank, National Association	BB	100 bps	1.77 years	156.8 percent	International Specialization	Citigroup Inc.
Wachovia Bank, National Association	BBB	12 bps	5.80 years	69.2 percent	All Other > $1 Billion	Wachovia Corporation
Wells Fargo Bank, National Association	BBB	20 bps	2.27 years	42.4 percent	All Other > $1 Billion	Wells Fargo & Company
Washington Mutual Bank, FA	A	4 bps	0.00 years	30.4 percent	Mortgage Lending Specialization	N/A
Bank One, National Association	BBB	26 bps	1.55 years	51.2 percent	All Other > $1 Billion	Bank One Corporation
Fleet National Bank	BBB	27 bps	6.51 years	123.5 percent	All Other > $1 Billion	Bank of America Corporation
U.S. Bank National Association	BBB	46 bps	3.84 years	74.8 percent	Commercial Lending Specialization	U.S. Bancorp
SunTrust Bank	BBB	17 bps	3.95 years	68.8 percent	Commercial Lending Specialization	Suntrust Banks, Inc.

Sample Basel II Benchmarks, June 2004

Source: Institutional Risk Analytics, *IRA Bank Monitor* (http://67.100.194.122/demo/basel_sample.asp), using data from the Federal Deposit Insurance Corporation.

cromanage the risk management programs at U.S. banks, with the unintended consequence of stifling further development. This overriding concern forms the backdrop for many of our general comments."

Second, Basel II is built around a suite of risk analysis tools that are, at best, a reflection of market sentiment rather than an accurate opinion on a company's financial statement. In May 2004, the Bank for International Settlements issued a statement indicating that the Basel Committee had reached a consensus on the new risk framework for financial institutions. The statement said in part: "Basel II represents a major revision of the international standard on bank capital adequacy that was introduced in 1988. It aligns the capital measurement framework with sound contemporary practices in banking, promotes improvements in risk management, and is intended to enhance financial stability."

Translated into simple language, the New Basel Accord proposes to use precisely those measures of risk and credit quality that caused such fiascos as Enron, WorldCom, and Parmalat, to name the most familiar names. The largest banks will employ risk models that are based on derivative indicators and academic assumptions about the statistical distribution of such events (defaults and restatements, for example) that do not accurately describe the real world.

Third and most important, the Fed is pushing the Basel II framework as a panacea for the growing market risk created by the Fed's profligate monetary policies. Throughout the post-bubble deflation, the Fed has flooded the market with fiat paper dollars, fueling the growth of derivatives activity and market volatility in general. The federal budget deficit and the Fed's efforts to accommodate it are the two biggest sources of instability in the U.S. economy today.

The OCC reports that holdings of derivatives by U.S. commercial banks rose to $76.5 trillion at the end of the first quarter of 2004, and this represents a 21.2 percent increase from $63.1 trillion for the first quarter of 2003. The outstanding amount of swaps grew by 33.8 percent over the year ending with the first quarter of 2004 to $47.8 trillion, and that compares to a 20.0 percent growth in options (including both exchange-traded and over-the-counter traded options). By far the fastest growing derivative product was the credit derivative, which grew by 69.3 percent over the same twelve months to reach $1.2 trillion by the end of March 2004.

From the perspective of the Fed, the growth in derivatives activity is evidence that banks are becoming more adept at managing their risk, a central goal of Basel II. But risk managers, bank examiners, and others who operate with both feet on the ground know that derivatives are merely a tool for shifting, even concentrating, financial and market risk in fewer and fewer hands, providing short-term advantages to the superior players but ultimately increasing the instability of the financial system as a whole. Unfortunately, since few employees of the Fed have ever actually taken risk, they fail to appreciate this basic market reality.

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The Fed's support of Basel II suggests they believe that merely measuring various types of risk will make banks safer in a market where the aggregate level of risk is increasing rapidly. Critics, on the other hand, point out that no amount of risk management will protect the largest financial institutions from periodic "hits" when they rely upon principal trading activities for more and more of their operating profits. Even smaller community banks are growing increasingly dependent on fee income and trading gains, less on core interest earnings on loans and deposits.

Basel II may, at the end of the day, help banks better measure risk, but nothing in the proposal can shield the global financial system from the multiplying risks within the derivative economy encouraged and fostered by the Fed. Basel II, when all is said and done, is a bureaucratic response to a macroeconomic problem that neither the Fed's economists nor the Congress have even begun to recognize. Stay tuned. ◆