The new Accord delayed

Implementation of Basel II has been delayed to 2005, and regulators are revising key elements of their proposals for a new Accord on bank capital. Christopher Jeffery reports.

The mammoth task of creating a new set of rules to govern the amount of capital banks around the world set aside for risk was never going to be easy. The Basel Committee on Banking Supervision’s first draft of its proposals for a new Accord on bank capital – dubbed Basel II – has provoked 270 responses from academics, banks and banking organisations, leading the committee to set back the implementation date a year to 2005. The Committee will now embark on another round of consultations and finalise the new Accord in 2002.

“In recognition of the Committee’s desire to continue working co-operatively with the industry to achieve the best possible proposals, the Committee has determined to modify the timetable for completion and implementation of the new Accord,” said the Committee in a statement.

In the same document, Basel virtually confirmed that risk calibration weightings for credit risk under the internal ratings-based (IRB) foundation approach and the operational risk 20% floor will have to be reduced, following a storm of industry protest that claimed the current proposals were “excessively conservative” and would overestimate the amount of risk on banks’ balance sheets.

“There is little incentive for banks to move from the standardised approach to IRB treatment,” said the International Swaps and Derivatives Association, which drafted its response in collusion with the European Banking Federation, the London Investment Banking Association and the British Bankers’ Association.

“Those who have tried to calculate [the credit risk capital] charges using the new Accord’s approach found they are, to a greater or lesser extent, larger than under the old Accord,” adds Nenad Marinovich, managing director and head of the risk analytics group at Merrill Lynch.

Concerns centred on the risk-weighting curve and the inclusion of an “arbitrary” 1.5 multiplier in the IRB function. Bankers are also worried about excessive charges for institutions using advanced IRB, with the rule that restricts the reduction of advanced IRB capital to no less than 90% of the amount under foundation IRB for the first two years under attack.

Such an increase in capital requirements is clearly in breach of Basel’s stated commitment to keep overall regulatory capital in line with the old Basel I rule and reward banks that use more sophisticated risk management techniques.

The earliest indication that Basel would be responsive to these concerns came from Darryll Hendricks, senior vice-president of the bank supervision group at the Federal Reserve Bank of New York, who works for Basel Committee chairman William McDonough. “The notion is that the overall amount of capital, particularly for foundation IRB approach, is too high,” said Hendricks, noting industry concern at Risk’s Risk 2001 USA conference in Boston last month. He added that addressing the issue was now “top of the priority” list for the Basel Committee.

His comments were later followed by the Basel Committee statement saying: “The Committee anticipates the need for reductions in the basic calibration of the foundation IRB approach, both for corporate and for retail portfolios.”

As a result, Basel has set up an impact survey on IRB, with early signs indicating that “the foundation IRB approach in particular may be calibrated to the point where it is not roughly flat with current capital requirements”, according to Hendricks. “It would be quite surprising if we had got the calibration right the first time, and we are looking at changing it. [By the end of July], the Committee will have a pretty good sense of how large an adjustment we think we need to make, and then we will have to spend some additional time working out the impact of the modifications. This will not be a trivial exercise,” he added.

Included in the impact survey will be a review to ensure appropriate treatment of credit exposures related to small and medium-sized enterprises (SMEs). “This is likely to lead to lower capital for SME lending compared with the proposals in the January 2001 consultative paper,” said the Committee.

The IRB foundation approach was developed as an intermediary step between the “standardised”, one-size-fits-all regulatory capital requirement and an “advanced”
IRB approach for banks with highly sophisticated risk management systems.

Basel’s proposals on operational risk were also widely lambasted, not only for the 20% regulatory capital charge floor set aside for operational risk being too high, but also for presenting banks with acute challenges in terms of measurement – especially given the lack of established operational risk modelling techniques and poor historical data.

“We believe it is too early to identify a specific methodology for measuring operational risk for regulatory capital purposes and we want to see much more work done in this area before one specific approach is endorsed. The fact is that work on the quantitative measurement of operational risk is still in its infancy,” says Jan Kalff, former chairman of ABN Amro, who heads the Institute of International Finance (IIF) steering committee on regulatory capital. The IIF’s Basel response was backed by Deutsche Bank, Morgan Stanley Dean Witter, Citigroup, Credit Suisse and UBS.

Merrill’s Marinovich added that Basel II’s approach for calculating the operational risk charges provides a false sense of sophistication, which is not merited by the current state of operational risk modelling technology or data availability. Morgan Guaranty Trust Company managing director Adam Gilbert added that Basel II failed to measure the extent risk mitigation techniques could be used to reduce operational risk, and how operational risk is used in correlation with credit and market risks.

“Clearly a lot of institutions have said that 20% of the total regulatory capital on average coming from operational risk is too high. I think the Committee is prepared to be responsive,” said Hendricks nearly a fortnight before Basel issued a statement on the matter, saying: “The Committee has concluded that the target proportion of regulatory capital related to operational risk (ie, 20%) will be reduced in line with the view that this reflects too large an allocation of regulatory capital to this risk as the Committee has defined it.”

Bankers also raised more general concerns, including the competitive effects from uneven regulatory treatment of bank and non-bank financial institutions. “There are important level playing field questions with regard to competition between banks and non-bank financial institutions. Firms not regulated as commercial banks will not be subject to the validation and transparency requirements proposed in the new capital framework,” says Kalff.

Institutions that derive income from trading rather than loan-making could also be disproportionately affected by Basel, claimed Merrill Lynch – although this will be more acute in the European Union, where the Basel II accord will be relevant not just to commercial banks, but also investment houses. “In our opinion, if left unchanged, the Accord could have a detrimental impact on markets and on investment firms. In certain cases these impacts may be so serious as to call into question the viability and/or geographic locations of these organisations,” said Merrill Lynch in its formal response.

‘Increased charges’ fears

The US investment bank believes the existence of “collateral haircuts”, the loss of the 50% risk-weighting cap on over-the-counter derivatives, and the application of the credit risk mitigation proposals to the treatment of repurchase agreements (repos) and similar products, would produce a “significant increase in charges”. Merrill Lynch has urged Basel not to apply its credit risk mitigation proposals outside the banking book.

The Bond Market Association (BMA), the US trade association for fixed-income securities dealers and underwriters, agreed that the new proposals could impair liq-

How the new Accord is changing prime broking

Prime brokers are worried that Basel II will hurt their business. One thing they can do is change the way they deal with hedge funds. By Carola Schenk

It’s boom time for hedge funds. There are more than 3,000 of them, with total assets of around $400 billion. This means plenty of business for prime brokerage desks, which provide financing services to hedge funds – stock lending, capital introduction and so on. The same desks also help the funds with their accounting and risk management.

But prime brokers are worried that the international banking regulators may adopt a new Basel Accord on bank capital that will raise their cost of capital. This, they say, will hurt them and their clients. And it will reduce liquidity in markets across the board.

The key concern is that Basel II, as the Basel Committee on Banking Supervision’s proposals for a new Accord are known, contains standards for credit risk mitigation for the banking book that may also apply to the trading book.

This will make prime brokerage far more credit-sensitive, and brokers will incur Basel’s proposed 15% ‘w’ charge on credit derivatives. They would also have to charge larger haircuts for leveraged finance, and assess their credit exposure to individual counterparties on a transaction-by-transaction, rather than a portfolio, basis.

The way prime brokerage business is conducted is already changing because of these concerns. Large dealers are channelling more of their trades with hedge funds through prime broker accounts, rather than using the transaction-based documentation produced by the International Swaps and Derivatives Association. That way, they get a better overview of a hedge fund client’s risk, and can apply cross-collateralisation and netting to the portfolio.

“For us, it’s a matter of better risk control and better understanding the client,” says Stuart Bohart, risk manager for Morgan Stanley Prime Brokerage in New York, one of the brokers that has adopted this portfolio approach.

“For the client, it’s a matter of getting full credit for all risk-reducing activity, in line with our approach to collateralised lending.”

Dealers are also encouraging hedge funds to improve their risk management. They typically require funds such as convertible arbitrage funds to hedge some of their credit exposure, if they fear the fund is too highly leveraged. The burgeoning credit derivatives market makes this easier. Some firms are also developing risk management tools specifically designed for hedge funds. Morgan Stanley Prime Brokerage, for example, has just launched a risk management application called AlgoLink, designed to handle the complex portfolios of equity hedge funds. Developed jointly with software vendor Algorithmics, it provides details on risk exposures, value-at-risk reports and stress testing.

But not all lenders to hedge funds and prime brokers apply such stringent risk management, and the Basel Committee on Banking Supervision, in its latest report on highly leveraged institutions, published in March, voiced concerns that “more progress remains to be made towards the development of whole portfolio modelling and stress testing of collateral and liquidity”. The Committee also said that dealers need to deepen “their stress-testing capabilities for assessing the combined impact of large market moves, counterparty credit exposures and collateral value”.

As for Basel II, the Committee’s approach to
15% risk-based capital reserve required from the proposed ‘narrow class of funding transactions’ exempted from the proposals. The BMA believes the w factor is not sensitive to any specific risk and may penalize other funding transactions that employ equally robust credit risk management practices and liquid securities collateral, such as equities.

“The w factor will apply regardless of the quality of the collateral obtained, the frequency with which such collateral is revalued and the additional margin provided. The w factor does not encourage these or other risk mitigation practices and may encourage parties to be more lax in applying these practices,” said the BMA.

Isda also pushed for the w charge to be withdrawn, in particular with regard to credit derivatives. “The Committee seems to be lending a premium to the less standardised, less transparent side of the unfunded credit risk protection market, for reasons that have not been satisfactorily spelt out,” said Isda. The association added that this could lead to protection buyers restructuring credit default swaps as guarantees, which could in turn fragment the market and push up the cost of credit protection. Bank loans are not hit by the w charge, unlike credit derivatives.

But it is unclear if Basel is prepared to climb down on the w charge, which was said to be the brainchild of the UK’s Financial Services Authority. Hendricks gave little encouragement that the w charge would be scrapped, saying no consensus had been reached on the matter, but senior risk managers at several large international banks said they were “hopeful” of persuading Basel to climb down on the issue.

Capital treatment does not differentiate between the type of counterparty a transaction is executed with. Rather, it focuses on the risk characteristics of a particular transaction.

But some bankers believe the Basel Committee is deliberately trying to cut the level of leverage of hedge funds in the context of the new Basel capital Accord. “Ever since Long-Term Capital Management, supervisors have wanted to constrain what they see as the systemic risk posed by hedge funds,” says a senior banker closely involved in discussions with the Basel Committee. “But equally, there is no political will to regulate hedge funds directly,” he adds. Prime brokers are major providers of leveraged finance to hedge funds. By raising their cost of capital, regulators may indirectly be able to reduce leverage within the hedge fund industry. “Basel II is a deliberate attempt by supervisors to make that financing activity for highly leveraged institutions notably more expensive,” says the banker. Basel II, unless it is changed, will achieve this goal, he adds.

The Committee will not comment officially on its current thinking on the potential application of credit risk mitigation rules to the trading book. It will only say that all issues and concerns raised by the industry are being looked into and discussions are continuing.

Bankers say they are confident the supervisors will amend their current credit risk mitigation proposals for the banking book, should they apply to trading book activities as well.

One reason for such tailoring is that the trading book focuses on market risk, whereas the key concern with the banking book is credit risk.

And firms are willing to co-operate with the supervisors. “The industry would be prepared to accept some change in the capital treatment of these instruments. But the current proposals go way over the top,” says a senior banker at a global securities firm. One way forward, he says, would be the adoption of a portfolio approach to the exposure to any single counterparty and using this as a basis for determining the appropriate haircut. “You could imagine getting to a situation that is reasonably close to the way that sophisticated firms do their own credit risk modelling today. And that would not be too bad.”

Whatever the capital rules turn out to be, the impact on prime brokers and securities firms will largely depend on how individual firms approach the collateral question. Credit-based providers of lending, which take no or little collateral, will be hurt most. The largest prime brokers, such as Morgan Stanley and Goldman Sachs, may not need to amend their approach much.

Morgan Stanley Prime Brokerage says its policy is to be “fully collateralised”, and this means taking sufficient collateral to be able to survive extreme events like those of 1998. The key, says the firm, is to differentiate between credit risk and fully collateralised risk, and to know when the latter becomes exposure – in other words, the risk that collateral might prove inadequate.

If the cost of providing prime brokerage services increases, firms may be able to pass on part of such cost to the hedge fund industry by raising fees. But prime brokerage fees have come under growing pressure as new players enter the market, offering services at a discount. For example, take the fee for a full equity finance package, including start-up consultancy, capital raising and stock lending services, for a convertible arbitrage fund. Currently, this fee is around 100 basis points on the fund’s net assets, down from the 200bp to 400bp that was charged two years ago.

Darryll Hendricks, Federal Reserve Bank of New York: “I think the Committee is prepared to be responsive.”