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## Session 4, Part 1

International Responses to Current Financial Turbulence:  
Focus on Basel II

**Prof Michael Skully**

Chair of Banking, Monash University

The sub-prime crisis starting in the USA in mid 2007 has transformed itself into a wider liquidity crisis, then to a more general financial crisis, and no doubt, in due course, an economic crisis. The regulatory responses to date have been concentrated at national level problems initially in the UK and then more importantly in the USA. Any international responses are somewhat more complicated but are currently be driven by the Financial Stability Forum and the Basel Committee of Banking Supervision (BCBS). The discussion is directed at the latter's post 2007 efforts.

The BCBS was created back in 1975 to address similar contagion risks concerns following the failure of the Herstatt Bank. Its resulting Basel Capital Accord in 1988 was the first formal global attempt at coordinating bank regulation across countries and its capital adequacy provisions have driven bank behaviour ever since. Over time, regulators have modified these regulations to incorporate other risks such as market risk in 1998 and operational risk in 2006. The latter, known as Basel II, attempted to refine the coverage of credit and other risk treatments (Pillar One) as well as force more risk monitoring responsibilities on regulators (Pillar Two) and on markets (Pillar Three). Ironically, these measures did not directly address the key driver of the current crisis, liquidity risk.

Contrary to some press reports, the BCBS was not without liquidity policies: its "Sound Practices for Managing Liquidity Risk in Banking Organisations" was published back in 2000. Its revision process following a study of financial conglomerate liquidity management practices in 2006. A working group followed in December 2006 to review the existing liquidity supervision practices. This exercise proved well timed given the market liquidity problems in mid 2007 and the group reported in 2008 with two BCBS papers: Liquidity Risk: Management and Supervisory Challenges, in February 2008 and the "Principles for Sound Liquidity Risk Management and Supervision" in June 2008.

This most recent paper is a consultation draft rather than a final product but still provides some insights as to what the end response may be. It contains 17 principles. The first simply states that “a bank is responsible for the sound management of liquidity risk.” The remainder argues for a stronger role of governance in liquidity risk management, better measurement and management of liquidity risk, more public disclosure and a greater role for the supervisors. For the most part, these principles are statements to which most bankers would easily agree. Principle 5 on the measurement, monitoring and controlling risk is probably the most interesting as its paragraph 23 provides almost a direct description of the current market conditions. Bankers are warned to consider the “interactions between exposures to funding liquidity risk and market liquidity risk” and that under stress, investors may not only require more compensation and shorter periods but “refuse to extend financing at all.”

Some may argue that the regulatory changes that result from this consultation process should address most of the current problems (the last war). So bank regulators will live an easy life as a result. Indeed, Nout Wellink (Chair of BCBS) even suggested in October 2007 that had Basel II been fully implemented, the sub-prime crisis might not have occurred. Sadly, this claim seems doubtful at best. Even if Basel II was wonderful, it only applied to commercial banks. The investment banks at the heart of the current crisis were largely untouched as were the hedge funds.

One must wonder instead whether the recent crisis does not argue for a serious need for a Basel 3. The regulators have had a real world testing of their stress models and at least some tinkering, if not major changes, should be anticipated.

The immediate problems, as highlighted in the *Financial Times* (25 July 2008), suggest that Basel II neglected three key factors: the impact of vanishing liquidity; the high level of market inter-connectivity; and the occurrence of “black swan” events. The latter raises Basel II’s heavy dependence on value at risk quantitative models. Even the BCBS (PR 17/7/08) admits, other issues like the “capture of off-balance sheet exposures, securitisation activities, and other contingent liquidity risks .... were not well managed.” In retrospect, there is also an over reliance on credit rating agencies assessments and too much emphasis on credit origination at the expense of credit derivatives and other similarly styled products. If these problems weren’t sufficient, other concerns could include the pro-cycle impact of provisioning which could exacerbate recessions by restricting credit when it was needed most. Finally, there remains the issue of poor disclosure, a problem identified in Pillar 3 but not well addressed by the industry.

So while Basel II was certainly a useful international response to preclude future financial turbulence, it is just the first step in addressing the current crisis. There are still the matter of investment bank regulation, hedge funds and short selling to consider. What these recent events do show is that a modern financial crisis is just too big for one country alone to resolve; the danger of worldwide contagion is all too true.