

## Basel II and Future Supervision

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1

## Objective

- Outline some of the criticisms of the Basel II approach being raised in academic and practitioner circles
  - Potential influences on the future development of banking regulation



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2

## Outline

- Risk Management Systems & VAR
- Basel II and Operational Risk
- Consolidation of Capital Requirements
- Market Based Risk Assessment
- Market Discipline v Regulation
- Accounting Standards and Disclosure
- Complexity and Risk Weights
- Governance



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3

## Risk Management Systems & VAR

- VAR is a simple risk metric
  - Underpins Basel II
- VAR has shortcomings
  - Recognised by emphasis on stress testing
- VAR fails to meet requirements of a “coherent” risk measure
  - Alternatives (e.g. expected shortfall) being developed and applied by finance theorists



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4

## Basel II and Operational Risk

- Reliance on internal models seems premature
  - Lack of a track record
  - Country differences may be important
- Operational risk definition excludes “business risk” and thus an important driver of economic capital
- Is Capital the appropriate method for managing Operational Risk?



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5

## Consolidation of Capital Requirements

- Banks, Securities Firms, Insurance Companies
  - Part of financial conglomerates
  - Create & manage different types of risk
  - Involve different social consequences from failure
  - Utilize different accounting
- Convergence & Consolidation of capital requirements problematic



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6

## Market Based Risk Assessment & Discipline

- Market prices incorporate information and can provide signals of risk and discipline inappropriate risk taking
- Subordinated debt is such an instrument
  - Mandatory requirements?
- Ensuring lower seniority in default enhances monitoring and risk sensitivity
  - Depositor preference legislation
  - Mandatory convertibility into equity



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7

## Market Discipline and Systemic Risk

- Market discipline can supplement regulation
- Some commentators suggest that capital regulation, founded on fear of systemic risk is unfounded
  - Correctly priced deposit insurance protects depositors, removes source of contagion, and has incentive effects
  - Real Time Gross Settlement prevents/limits spillovers from individual bank failure
- Can market discipline replace capital regulation?



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8

## Accounting Standards and Disclosure

- Capital is a balance sheet residual
- Capital requirements are only as good as the accounting used
  - Increased emphasis on market value accounting important
  - Provisioning for doubtful debts and recognition of losses are the Archille's heel of capital regulation



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9

## Complexity and Risk Weights

- US rejection of Basel II standardised approach creates uncertainty about widespread international adoption
- Risk weights arguably not appropriately calibrated
  - May distort funding patterns and use of techniques and instruments such as securitization, credit derivatives.



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10

## Governance

- Release of revised "Enhancing Corporate Governance for Banking Organisations" by Basel Committee, end July 2005.
  - Little reason to argue with suggested principles
  - As a practical matter, supervisory oversight of "fit and proper" requirements, emphasis on codes of conduct take attention away from an important question
- Why doesn't the corporate governance "market" work well in banking (via stakeholder "voice" or "exit"), and how can it be made to work better?



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11