A Review of the Review

BY HOWARD DAVIES

In 1997 a process started to review the 1988 Basel I Accord, which ultimately led to the Basel II Accord of June 2004. In this paper Sir Howard Davies, Director of the London School of Economics and Former Chairman of the Financial Services Authority, provides an analysis of this review process. Several issues related to the complexity and implementability of the Accord are discussed. Although the author thinks that Basel II has many appealing aspects (such as the three-pillar framework), he argues that the outcome is very complicated, it took a very long time, and needs to be adapted in ways not originally envisaged. He calls for a "Review of the Review" to see what lessons can be learnt from the review process which might be helpful for the future.

I. INTRODUCTION

This is a good moment to bring together regulators, practitioners and academics. There are plenty of issues to discuss as the Basel II implementation process begins. There may not have been enough academic engagement in the process in the early phases, but many academics are now taking a close interest in the Basel II Accord and its potential impact. Much commentary at present is focusing on potentially perverse consequences. For example, will the Accord incorporate a procyclical bias, so that bank lending to small firms, or to emerging market countries will be cut back too sharply in an economic downturn?

Regulators argue that there is enough flexibility built into the three-pillar framework to avoid damaging consequences. We shall learn who is right over the next few years. Among practitioners, some are very nervous about the new Accord. Others are more positive, perhaps because they are true believers, or perhaps, because they follow the advice of a Chinese proverb: "If a thing is inevitable, welcome it."

My focus is not so much on the potential consequences, but on the process of reaching a new accord. Why has Basel II been so much longer in gestation and has emerged an so much more complicated than Basel I? What can we learn from an assessment of the process which might be useful for the future?

II. THE BASEL II ACCORD

The contrast between the two accords is indeed marked. I was not directly involved in 1988. But I am told it was essentially an Anglo-American deal at the heart of the committee, then chaired by Peter Cooke.

The process was, largely as a result, relatively rapid. The output was brief. Peter Cooke likes to boast that the essence could be written on a postcard. The committee cannot be accused of that brevity this time around. The new review began in 1997 and is more or less complete now, but only after some heroic efforts by Jaime Caruana in the last 18 months. The output runs to around 800 pages, if you ignore the footnotes and annexes.

The Committee handling the review is essentially composed as it was in the late 1980s. It is a self appointed group of supervisors and central banks from industrialized countries, with heavy domination from Europe, at least numerically. Indeed the number of Europeans around the table has gone up, with the addition of the European Commission, the ECB (albeit a central bank without any supervisory responsibilities) and, the new addition, Spain. That brought one huge benefit in the form of Jaime Caruana but otherwise might be thought an odd move given that the committee includes only the U.S., Canada, Japan and 10 Europeans.

How is this representation justified? The Basel Accord supposedly formally applies to only internationally active banks. But there are other countries with such banks, such as Australia. And, more importantly, we have to accept that the world has changed, and the impact of the Accord is now broader. It used to be essentially voluntary; now it barely is. The IMF FSAP process assesses every financial system against the principles in the Basel Accord. So emerging countries are reasonably complaining that they are being assessed against principles and detailed rules when they have had no role in determining them. There is a sharp contrast with the more democratic structures of IOSCO and IAIS, in which all member countries have a voice. The Basel committee has responded with some outreach activity through the core principle liaison group and elsewhere. But I believe it is time for a rethink on the membership of the committee and indeed on the international organization of banking supervision generally. Banking supervisors meet only every two years for a rather vaguely structured conference. There is no international organization like IOSCO, which is odd.

The accountability of the Committee is also unusual and anachronistic. It reports formally to the G10 governors. But some of them, including the UK, Canada, Germany, Sweden and now Belgium do not oversee banking supervision domestically. And, indeed, the Fed is only one of a number of banking supervisors in the U.S. The differences between the Fed and the OCC at certain points on the Basel Accord have been well publicized, in Congress and elsewhere. Maybe a part of that problem lies in the accountability of the committee itself.

This has highlighted another awkward issue—which is the interface between Basel rules and domestic legislation. In principle, in Basel countries reach agreement and then go home and implement that agreement on a best endeavors basis. Some jurisdictions are now questioning this, notably in the U.S. Congress, but also in Europe. Should it not be subject to normal domestic procedures of legislative review? What is the basis of the legitimacy of a Basel Accord? There is a draft bill in Congress which suggests that U.S. representations should seek a kind of negotiating authority before each meeting. If implementation turns out to be different from place to place, that throws into question the process of agreeing the accord in the first place.

Eddie George as Chairman of the G10 governors attempted a partial resolution of this accountability problem, with support from Andrew Crockett. He established a group of Governors and heads of supervision which meets annually. The process needs to be more regular and needs to be formalized. This is not just special pleading by a former non–central bank supervisor. It is very important for the heads of agencies or central banks to be engaged, whoever they are. In Basel, there is typically one Governor as Chairman (always a central banker so far) supported by more technical staff from elsewhere. In the case of IOSCO, or CESR in Europe, regulatory Chairmen remain close to the process of rule making. There is a risk that if the heads are not engaged then we might end up with something very detailed, very complex, over engineered and heavily influenced by background deals between technicians. Thank goodness that did not happen this time, but in theory it could have done!

Of course, more seriously, complexity is a big issue. If you leave technicians in a back room to reach agreements, they will tend to produce even more elaborate solutions, in which everyone's favored bell or whistle finds a place. The architects of the Accord themselves have recognized that the outcome is very complex and have tried to design simpler versions. But is that a sound approach? Surely it would be preferable to begin with an Accord which matches the needs of all the countries who will be affected at the start, rather than to produce cut down versions later on.

So emerging market countries need to be involved in the process at an earlier stage. As things stand, there is a serious risk that many countries will begin to adopt the advanced IRB approach, because they think this is the global standard to which they must aspire, when it may not be appropriate for their banks at their current stage of development.

There is also the rather simple and fundamental criticism that the Committee has spent a huge amount of time trying to resolve a problem—determining the capital of major banks like Citibank and HSBC—which is hardly one of the biggest issues faced by the world financial system. The bigger problems, such as the capital adequacy of banks in the emerging markets, and risk transfers between different types of financial institution, have become secondary.

Another problem, which is partly process and partly substance, concerns the relationship between the review and the rating agencies. This is a complex area. Basel II incorporates somewhat greater reliance on the work of rating agencies, while the question of how ratings agencies should be regulated, if at all, is under discussion elsewhere. The SEC, CESR and the European Commission are all thinking hard about it. Yet there has so far been little meaningful interaction between those who advocate an increased the emphasis on rating agencies in Basel, and those engaged in discussions about an appropriate regulatory regime for them generally.

It also seems likely that for some retail banks, in particular, Basel II will deliver a significantly lower capital charge than the rating agencies themselves are looking for, and the banks will almost certainly be more influenced by the latter than the former. Indeed even the regulators may be. So I believe it is important to try to get to grips with this issue, which involves bringing other, non-banking supervisors into the picture.

That links to another point, which is the interaction between the review and the capital requirements for securities and investment firms. In the EU the Accord is transposed into a Capital Requirements Directive (CRD), which applies to many types of financial firms. As the SEC moves into the consolidated supervision business, driven by the financial groups directive, that will happen in the U.S. too. Yet the Basel Committee, which is a banking supervision only body, does not consider those issues until late in the day. In the future, that will have to change. I have argued in the past that one useful step would be to co-locate the secretariats of the three global bodies in one place. Currently, both the banking and insurance secretariats are in Basel, while IOSCO is in Madrid.

Finally, there is a need for greater consideration, as the new Capital Accord is developed, of the impact on practical supervision. In other words how implementable is the Accord? Do supervisors have the skills and the people to make sense of it?

In my experience heads of regulators do not particularly enjoy discussing the strengths and weaknesses of their own organizations, in international fora. That is understandable. But in this case it is very relevant. In some places the Capital Accord will be extremely hard to implement, and will require a massive re-engineering of the regulating body and huge increases of staff. That is less so in the case of the FSA where a regime of variable capital ratios has involved supervisors in making judgments for some years. In other places such judgments have not been routinely been made and even in some cases have been explicitly excluded by the legislation. There, the Capital Accord will involve a major cultural shift in regulation.

An Accord Implementation Group under Nick Le Pan of Canada has been looking at these issues—but it started rather late in the day. It needs to be given strong support.

III. CONCLUSION

I may appear rather disenchanted, for someone who was responsible for a major participant in the review for eight years. I cannot conceal that. I argued strongly for a simplification process, as we reached the end of the design phase, but did not carry the day.

But I do believe that the efforts of the last eight years have produced many useful results. The basic three-pillar framework remains intellectually appealing. The notion of a basic capital charge which aligns regulatory and economic capital more closely is attractive. The idea that the charge can then be varied in the light of regulators judgment on a bank's business mix and its risk management expertise is also sensible. It is appropriate that it should be illuminated by enhanced disclosure. In fact the three-pillar approach has been influential elsewhere, too. The FSA now uses it in the insurance market, where the need for improvement in the methods of determining capital is more pressing than in the banking system.

The Committee has also done a lot of good work on understanding the dynamics of default and on operational risk, though the latter process was quite painful at times. The work has, similarly, strengthened risk management in banks across the world. It has considerably strengthened the job market for risk managers, too.

However, we have to accept that there have been flaws. The outcome is very complicated; it took a very long time, and needs to be adapted in ways not originally envisaged. I do not look forward with enthusiasm to a Basel III, or even II.1, devised in the same way.

I therefore think there should now be a "Review of the Review" to see what lessons can be learned from the process which might be helpful in the future. That should cover the important questions of representation, accountability and the interface between banking supervision rules and regulatory regimes in other parts of the sector which I have outlined. It should be carried out involving at least some independent outsiders, and should be published. The Financial Stability Forum could act as its parent and sponsor.

In due course it will also be necessary to look at whether the revised capital charges make sense, and how they relate to the rating agencies' assessments. That is for the longer term, however.

IV. NOTES ON CONTRIBUTOR

Howard Davies is Director of the London School of Economics (LSE), a post he took up in September 2003. From 1997–2003 he was Chairman of the Financial Services Authority, the single regulator for the UK financial sector, which was created under his leadership from nine separate regulatory agencies. From 1995–1997 he was Deputy Governor of the Bank of England. Before that, from 1992–1995 he was Director-General of the Confederation of British Industry and,

from 1987–1992, Controller of the Audit Commission. He was also, for six years, a director of GKN plc and a member of the International Advisory Board of Natwest. In his earlier career he worked in the Foreign and Commonwealth Office and H M Treasury, both as an official and as special adviser to the Chancellor of the Exchequer. And for five years he worked as a management consultant for McKinsey and Co. Inc. Howard Davies was educated at Manchester Grammar School and Merton College, where he took an MA in History and French. In 1979 he was awarded a Harkness Fellowship and in 1980 gained an MSc in Management Science at Stanford Graduate School of Business. Throughout his career he has written widely for publication, reviewing fiction for the *Literary Review* and *The Times*, historical and economics books for the *Economist*, *The Times*, the *TLS* and the *Times Higher*, among other publications. He has lectured extensively at home and overseas and is a regular participant in the World Economic Forum in Davos. In 1993 he was Deputy Chairman of the Rowntree Committee Enquiry into the distribution of income and wealth, working with John Hills of the LSE. He is a member of the governing body of the Royal Academy of Music; Patron of Working Families; and in 2004 was elected to an Honorary Fellowship at Merton College. In 2004 he joined the board of Morgan Stanley as a non-executive director. He was featured as "A man of our times" in Nicholas Henderson's *Old Friends and Modern Instances*. Aged 54, he is married to Prue Keely, a Commissioning Editor on BBC Radio 4. They have two sons and live in London and Dorset.