

Critiques of Basel II and the problem of procyclicality

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Criticised from the outset, Basel II attracted a critique that grew in intensity as the framework neared implementation. The first objection concerned complexity. The 2004 text and its comprehensive version ran to several hundred pages. The number of parameters that a large bank had to estimate and validate under the IRB approaches reached into the thousands. Critics pointed out that complexity favoured the large banks with the resources to build and maintain models, which could reduce their capital requirements relative to smaller banks using the standardised approach.¹

The second objection concerned the reliance on external ratings in the standardised approach. Rating agencies were paid by the issuers whose securities they rated. Despite that conflict of interest, the standardised approach gave their judgments direct regulatory force. The crisis of 2007 revealed how badly the agencies had misjudged the risks of structured products, especially of collateralised debt obligations backed by subprime mortgages. Their AAA ratings had allowed banks to hold such instruments with very low capital charges.²

The third and most fundamental objection concerned procyclicality. In a risk-sensitive framework, the measured probability of default of borrowers falls during an economic upswing and rises during a downturn. Capital requirements therefore decline in good times, when banks expand lending, and increase in bad times, when banks need to absorb losses and when credit is scarce. Several economists warned, before the framework was finalised, that Basel II would amplify the business cycle. Among them were the authors of a well-known paper submitted to the Committee by a group of academics associated with the London School of Economics in 2001, which argued that the proposals were likely to make the financial system less stable.³

The Committee tried to meet these concerns by requiring banks to use long-run averages of default probabilities and downturn estimates of loss given default, and by asking supervisors to consider cyclical effects under the second pillar. The adjustments did not remove the underlying dynamic. A further weakness lay in the treatment of the trading book, where the value-at-risk models introduced in 1996 continued to determine capital for large and growing portfolios of complex credit products. Since those models relied on short historical periods of calm markets, they produced very low capital charges for instruments whose prices could collapse.⁴ When the crisis came, the leading banks of the world held capital that was adequate by the standards of Basel II and wholly inadequate by the standards of the markets.

1 Notes

1. See, for example, Tarullo (2008), chapters 5 and 6, on the competitive effects of the IRB approaches and on the complexity of the framework. To be verified. ↩
2. On the role of credit rating agencies in the crisis and the subsequent efforts to reduce mechanistic reliance on ratings, see Financial Stability Board, Principles for Reducing Reliance on CRA Ratings (October 2010). To be verified. ↩
3. Danielsson, Embrechts, Goodhart, Keating, Muennich, Renault and Shin, An Academic Response to Basel II (LSE Financial Markets Group, Special Paper No. 130, May 2001). To be verified. ↩
4. On the attempts to mitigate procyclicality within Basel II, see Basel Committee (2004), paragraphs 415, 434–435 and 468 (downturn LGD). Paragraph references to be verified. ↩

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