Risk Integrated

Mortgage Finance GAZETTE

Speaker's Corner

# Basel II and the subprime blow?

**Peter Andresén** looks at how Basel II could have softened the subprime crisis and how it may help in commercial real estate

October 2007

As financial institutions prepare for the Basel II regulations in Europe, the crisis in the US subprime mortgage sector and its knock-on effect on world markets have illustrated why it is so important to implement the principles of the new capital adequacy regulations across all financial institutions worldwide. Although Basel II came in too late to wholly prevent the crisis in the retail mortgage sector, the commercial real estate sector historically lags the wave of retail defaults by a year, so there may still be time for good risk measurement to soften the blow.

## Basel II

Basel II represents a major revision of the international standard on bank capital adequacy introduced in 1988. It lays out a comprehensive framework for setting regulatory capital and implementing advanced risk management. Three pillars form the foundation of the Basel II accord:

(i) Sets minimum capital requirements and how to calculate its increase as the risk of assets changes
(ii) A well-defined supervisory review process that provides for increased power to regulators
(iii) Market discipline requirements for greater transparency through increased disclosure requirements

The new and improved Basel II Accord defines three categories of risk that must be considered for calculating minimum capital requirements: credit risk, market risk, and operational risk.

Furthermore, the Accord provides an incentive to improve internal risk measurement practices. Financial institutions can qualify for three different tiers of Basel II compliance: standardized, foundation and advanced. Each successive tier requires more stringent risk management practices, with the most advanced approach rewarding the bank with the lowest capital requirements. Qualification for these tiers is dependent on the institution's dedication to risk measurement. For each portfolio of assets that it holds, each bank must choose the methodology that suits the asset class and calculate the capital it must hold to protect against market, credit, and operational risk.
The better an institution understands its risks, the less capital it will have to hold to cover the unknowns.

## Structured Debt

The subprime crisis has its roots in the relaxation of financial institutions' underwriting standards. This was particularly evident in the residential mortgage market where the relaxation was fueled by an appetite for continually increasing returns, and the emergence of new structured debt products and credit derivatives, such as collateralized debt obligations (CDOs). These structures allowed institutions to sell the assets, and thereby the risk, to investors in packaged securities.

The complex structure of these packaged securities allowed them to be rated as investment grade by the credit rating agencies, despite the fact that the underlying assets were predominantly subprime. When subprime default rates in the residential market experienced a slight increase, some investors were surprised to realize their investment-grade CDO tranches were affected, and a massive sell-off ensued. The over-optimistic rating of some of the facilities has led to strong criticism of the credit rating agencies and their alleged conflict of interest. Indirectly, Basel II has also been criticized because institutions under the standardized approach would have had to rely more heavily on the ratings by the agencies.

However, the more critical issue with respect to the Basel II regulations has been the suggestion by some critics in the US that the current CDO debacle is evidence that the regulation is not well-aligned with modern markets. It cannot satisfy the requirements of capital measurement for the highly complex structured products being offered today and should not be implemented.

The criticism is a bit premature as the regulation is not yet in operation for most banks. If anything, the preparation by some of the larger financial institutions may have cushioned the impact. Many have been moving towards more advanced risk management systems driven by the savings the Basel II Accord offers, in particular, lower capital requirements for those with good risk systems.

Had Basel II been in place during the current subprime crisis, many financial institutions in the US would potentially not have relied on the ratings provided by the credit agencies. Instead, they could have referred to proprietary models that would have better aligned the rating of the securities to the credit-worthiness of the underlying assets.

If the CDO debacle can teach us anything, it is that the risk assessment failed to be effective, through no fault of Basel II. The risk profile of these complex products was rarely assessed in enough detail, and on the occasion they were understood, the risk officer's voice was not loud enough when the underwriting took place.

## Sound Principles

The principles of the Basel II regulations are sound and address many of the issues exposed by the subprime crises. Whether the detailed rules meant to implement these principles are always sound is another question, but these are meant to be refined over time.

The irony is that had the Basel II been implemented at the institutions involved in making the subprime loans, they and the market would have better understood the risks they were running. Had it been in place at the institutions investing in CDOs, they would have been better capitalized and less vulnerable to default. Basel II and its principles of improving information about risk are a good step forward in improving the stability of the financial markets. The next test is whether the risk measurement methodologies developed for Basel II are sufficient to guide banks in restructuring their portfolios, before the effects catch up and are felt in commercial real estate.

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