ISR INTERNATIONAL SECURITISATION REPORT

Pressure to change Basel II capital rules

14 January 2009

Major UK banks are putting pressure on the UK Treasury to change pro-cyclicality rules under Basel II.

HSBC executive chairman, Stephen Green, sent a letter to in late-December 2008 (also signed by Abbey and Barclays) to Alistair Darling, the UK's Chancellor of the Exchequer, highlighting that the Basel II rules could be hindering efforts to re-ignite lending in the UK.

Under Basel II, banks are required to hold additional capital against existing loans. Its detractors argue that these requirements are pro-cyclical and are in fact making things worse.

The Treasury committee recently reaffirmed this theory, stating that Basel II promotes pro-cyclicality: i.e. where firms are forced to hold more capital back in bad times and less capital in good times.

Chris Marrison, CEO of **Risk Integrated**, states: "Pro-cyclicality is dangerous because in good times you are shedding the capital and in bad times you cannot get new capital which constrains new lending and makes the cycle even worse."

Simulation models are the best alternative--where the current state of the market is analyzed, but there is also analysis of what is likely to happen over the next few years.

He notes that it is not only Basel II itself that is pro-cyclical, but it is also the common choices that people make for the models to implement Basel II, as they are typically heavily pro-cyclical.

"To a large extent the pro-cyclicality is not the fault of Basel II regulations, but the way that they have been implemented," he says. "Most firms have built regression models which take historical data and create a relationship between a customer's financial ratios and their probability of default. This is the most common kind of risk model, and I would say that approximately 90% of the models used for Basel are built like that. However, these models are particularly sensitive to times of financial crisis."

This means that in good times firms may not see risk and shed their capital, meaning that they are unprepared for bad times. Marrison explains that an alternative model is one with **mean reversion**. For example, simulation models are the best alternative--where the current state of the market is analyzed, but there is also analysis of what is likely to happen over the next few years.

"However, even when using the mean reversion model there is still some pro-cyclicality in Basel II," he states, adding that this will be true of any regulation where capital is set as a constant multiple of the risk, because when you go into a bad economic situation the true risk is going to increase whatever models you use."

Marrison suggests that there does need to be an extra element in Basel which increases the required capital in good times and decreases it in bad times. "Currently the capital is fixed to be 8% of the risk-weighted-assets, that percentage could be increased as GDP growth increases and reduced when GDP growth falls. This would tend to stabilize the volume of lending," he says.

Analysts at the Royal Bank of Scotland state that changing the pro-cyclicality rules under Basel II would help to restore external confidence, but would most likely require international agreement.