CHAPTER 14

From Basel 1 to Basel 3

INTRODUCTION

What is the future of banking regulation? What will be the next evolution of the fast-moving regulatory framework? Those questions are central for top management as more advanced banks will clearly have a key competitive advantage. With the progressive integration of risk-modeling best practices into the regulation framework, banks that have the best-performing risk management policies, and that can convince regulators that their internal models satisfy basic regulatory criteria, will be those that will be able to fully leverage their risk management capabilities as the double burden of economic and regulatory capital management progressively becomes a unified task.

HISTORY

The future is (hopefully) full of surprises; however looking at history is one of the most rational ways to build a first guess at how things may go. We shall not review banking regulation developments in detail as they were considered in Part 1, but we may reprise the three most significant steps:

■ The first major international regulation was the Basel 1 Accord. It focused on the credit risk which was the industry’s main risk at the time. Regulators proposed a simple rough weighting scheme that linked capital to the (supposed) risk level of the assets.
Some years later, with the boom in derivatives in the 1980s and the greater volatility of financial markets, the industry became conscious that market risk was also an issue. The 1996 Market Risk Amendment proposed a set of rules to link capital requirements with interest, currency, commodities, and equity risk.

The proposed Basel 2 framework was a reaction to the critics of the increasing inefficiency of the Basel 1 Accord and of the capital arbitrage opportunities that recent product developments had facilitated. Besides a refined credit risk measurement approach, it also recognized the need to set capital reserves to cover a new type of risk – operational risks.

From those three major steps in banking regulation, we can already draw four broad conclusions:

- First, there is a clear evolution towards more and more complexity, necessary to manage the sophistication of today’s financial products. Today, fulfilling regulatory requirements is a task reserved for highly skilled specialists and this trend is unlikely to reverse.

- Secondly, we can see that regulators tend to follow market best practices concerning risk management. They are obliged to do so if they want their requirements to have any credibility. The Basel 1 framework was very basic. The Market Risk Amendment was already much more sophisticated with the recognition of internal VAR models, a major catalyst to their widespread use today. The credit risk requirements in Basel 2 were also based, as we shall see in Chapter 15, on state-of-the-art techniques. No doubt future regulations will continue to integrate the latest developments in risk modeling.

- The scope of the risk types that are being integrated is becoming wider. The 1988 Accord focused on credit risk, then market risk was introduced, and in Basel 2 operational risk appeared. We can reasonably expect that future developments will keep on broadening the risk types covered as the industry becomes more and more conscious of them and devotes efforts to quantifying them (see chapter 17 for an overview).

- Recognition of VAR internal models, and our comments on Basel 2 also show that regulators have come to acknowledge that simplified “one-size-fits-all” models are not a solution for efficient oversight of the financial sector. No doubt future trends will involve working in partnership with banks to validate their internal models rather than to impose external regulations.