Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Risk Wait[*]

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The international capital framework that is based upon the risk of a bank's assets has been in effect for 25 years. One of the goals of this framework has been to establish consistency in capital standards for internationally active banks. Yet, a "consistency" analysis conducted by the Basel Committee has found significant variations in the risk weights assigned to trading assets by banks in different countries. While the Basel capital process has always accepted some variations in the capital framework implemented in different countries, significant variations in the risk weights suggest that the process of harmonizing international capital standards remains a work in progress.

In April 2012, the Basel Committee announced a Regulatory Assessment Program, which is intended to ensure consistent implementation of the Basel framework, to maintain market confidence in regulatory ratios, and to provide a level playing field for banks operating internationally. As part of that program the Basel Committee conducted an exercise in which 15 internationally active banks were given a hypothetical trading portfolio and asked to determine the risk weights of the positions in the portfolio. That exercise found a substantial difference between the bank reporting the lowest risk weights and the bank reporting the highest risk weights.[1]

Two factors explain this difference. A sizable portion of the variation was found to result from supervisory policies in individual countries. For example, a country may restrict the range of options a bank can use in its risk models. The other source of the variation was found to be in the

[*] The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] That analysis may be found ***here***. The Basel Committee also conducted a similar analysis of the banking book and the results of that analysis should be released sometime later this year.

modeling choices made by individual banks. In other words, different models used by different banks produced different risk weights.

The Basel framework has long recognized the need to accommodate some differences in the application of the framework in different jurisdictions. However, as the Basel Committee has noted "excessive variation in risk measurement is undesirable." In response to this exercise, the Committee has suggested that it may consider one or more policy responses, including (1) improving public disclosure and regulatory data collection to aid the understanding of risk weights; (2) narrowing the modeling choices for banks; and (3) a further harmonization of supervisory practices with regard to model approvals. And so, after 25 years, we continue to wait for these international capital standards to achieve the goal of consistency and harmony across different jurisdictions.

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