Basel 2, 3, 4...?

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The Basel II agreement, adopted in 2004, introduced greater sensitivity to risk in banks' capital requirements, which developed their own models in which capital is raised or lowered according to the risk of the assets involved. In 2010, Basel III reinforced the amount and quality of capital, introduced new leverage and liquidity ratios, developed a specific regulation for systemic financial institutions, as well as a new bank resolution framework, reformed the treatment of derivatives and undertook other changes in areas such as rating agencies or so-called banking system.

Now the Basel regulators are considering tweaking banking regulations which the industry has dubbed Basel IV, although the regulators emphatically deny that this is another full-fledged reform. The new wave of reforms aims to correct the excesses found in the use of internal models, whose complexity has been taken advantage of, in the opinion of many regulators, to artificially reduce capital consumption. The degree of permissiveness in the use of these models has been very disparate, depending on the supervisor, which has created competition problems between banks. To correct this, they propose establishing limits on capital savings derived from using internal models, bolster the standard models (the ones used when no internal models are available) and set floors for capital consumption in certain portfolios.

Regulators assure that the objective of this tweaked Basel III is not to increase capital requirements, but rather correct excess. But if that is the goal, it seems that the proposal is not well calibrated, according to the calculations from the private sector, which show significant increases in capital requirements. Furthermore, some of the measures being proposed seem redundant compared to the reforms already adopted and pending implementation, such as the leverage ratio and the new Total Loss Absorption Capacity. In particular, all the regulation related to bank resolution will considerably increase the resilience of the banking system, which raises doubts about whether capital regulations should be made even stricter before seeing the effects of these new measures.

Apparently, some regulators feel that they weren't strict enough in the reform of Basel III. To correct it, many supervisors have raised the capital requirements above the minimum, through so-called pillar 2, a relatively discretional increase by the supervisors based on the valuation of each bank and heterogeneous according to the supervisor who sets it. However, if the pillar 2 surcharges partly stemmed from a lack of trust concerning the internal model, which could be leading to a capital requirement that is too low, then the reforms to make internal models more reliable should produce a lower pillar 2 surcharge.

Basel works according to a coordination based on minimums, in which national regulators are free to set higher requirements. This mechanism works when there is a "race to the bottom" in regulation (as was the case during the period of deregulation that ran from the decade of the 70s to the recent crisis), but not when there's a "race to the top" as we are currently seeing.

Another problem is the predomination of developed countries, where most of the global banks have their headquarters and the scant sensitivity to the problems faced by emerging countries. Often the parent company's consolidated regulation has strong extraterritorial effects, which could thwart the financial inclusion processes emerging economies are currently undertaking.

A bureaucracy of regulators and supervisors has been created whose main task is to permanently reform the regulatory framework. Regulatory uncertainty has hindered the bank decision-making process in an environment already made difficult by low interest rates. And the implementation of reforms is increasingly uneven among countries, which is creating a dangerous fragmentation of the international financial system.

It seems that the time has come to stabilize the regulatory framework and observe the effect of the numerous reforms adopted before proposing further changes.

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