Basel 3: Endgame for global consensus?

"But to my mind, though I am native here; And to the manner born, it is a custom; More honored in the breach than the observance."

Hamlet, Act 1, Scene 4

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It very much looks like the post-Endgame world will be one of material inconsistency

- Europe is already "materially noncompliant" and likely to be downgraded to "noncompliant" at the next review
  - Treatment of sovereign bonds and permanent partial use
  - CVA on corporate, pension fund and public sector counterparties
  - The "Danish Compromise" on insurance holdings
  - SME and infrastructure support factors
  - All these things were reiterated in the CRR3, and are basically here to stay – they are the "Specificities"
- The USA has always hidden behind its interpretation of "internationally active banks", but is increasingly becoming divergent itself
  - By aggressively interpreting the Basel criterion of "large internationally active banks" to mean "only GSIBs", the USA has managed to claim to have the toughest interpretation of global standards, while not actually applying them to most of its banking system
  - It might have been thought that the Silicon Valley Bank collapse marked the end of the road for this strategy
  - But it looks like the < US$100bn segment will escape everything under Endgame – even at $250bn there is only a proposal to deduct unrealised losses
  - Endgame also includes the first case I'm aware of in which the USA has materially weakened a Basel standard
    - Operational risk is meant to be measured on gross revenues – the Fed proposal intends to use net
    - This is basically because of the trust banks – the USA has "specificities" too!
  - There is probably not enough here to warrant being rated "materially noncompliant" by the RCAP … but it looks kind of noncompliant!

But … devil's advocate here … what do we really want from a global banking standard?

- Going back to 1987 and the original Basle* Accords
  - These had a clear purpose. Everyone was worried about huge, undercapitalised Japanese banks, funded by domestic deposits and so not subject to any meaningful market discipline, taking share in global financial centres.
  - A relatively simple, quick-and-dirty solution, with two big principles – "you can't just buy each other's preference shares" and "there have to be some limits on leverage"
  - There was never any real agreement that what was needed was a single global standard, nor would there have been
- Basel* II in 2004 was a very different beast
  - The work on B2 began after about 15 years of B1. People had built careers on the new regulation. Old fashioned onsite examinations and intrusion into management decisions were very much out of fashion (except in America!)
  - If you believe that bank regulation is about ratios, then B1 was inadequate. It didn't cover market risk (Barings!) and the ratios were pretty crude.
  - Regulatory arbitrage was a significant concern
- Basel III was the child of B2, not B1
  - In the immediate aftermath of 2008/9, it was realised that B2 had been the low point of the lobbying/regulatory cycle
  - So we needed to change the ratios. But (outside America!) the principle that "regulation is ratios" still drove the process
  - Lots of bitterness over this – particularly on securitisation and internal modelling, a strong sense of "European solutions to American problems"

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An imperfect world, but good enough

- The European departures should be seen as a reaction to the American two-tier system
- But it is the US which is actually more true to the original idea of the Basel Accords!
  - It is intrinsically difficult to agree a standard that's appropriate for the largest banks in America, but also for every bank in Europe.
  - So what happens is that we agree rules that Asia can live with, then Europe and America tailor them to their own needs
- This works! For one important reason – regulatory arbitrage doesn't really work
  - The European "support factors" are well known to be useless
  - The US banking sector **gained** from stricter regulation – it is surprising that Jamie Dimon is lobbying against the system that underpinned his "fortress balance sheet"
  - The only way that banking industries gain international competitiveness through more lax regulation is by pushing bailout risk onto their domestic sovereign
  - After a long and painful education process, most sovereigns understand that this isn't a good idea any more
- The purpose of Basel is to stop LTCBs, not SVBs
- Regulators can keep struggling for consistency, but the rest of us shouldn't worry

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