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Basle 2:

**Privatisation of bank supervision brings more financial instability
and polarisation**

World Social Forum, Porto Alegre, 22-28 January 2003

Seminar on Financial Regulation

1. The Basle Committee on Bank Supervision has elaborated a new set of rules for minimum capital requirements for banks, i.e. for the minimum amount of equity or other capital which banks must hold to compensate for defaults on their loans. This set (Basle 2) shall come into force in 2006 and replace the existing regime (Basle1) of 1988. The main official aim is a more precise assessment of loan risks. The existing regime requires an 8% capital provision, but divides all loans in four classes (roughly loans to states, banks and corporations) and assigns every class a specific risk-weight (0,0 for states, 0,2 for banks and 1,0 for corporations and others), regardless of the individual status of the debtor. It is obvious that this regime establishes hidden cross-subsidies in favour of weaker units in each group and also between groups. The envisaged reform consists of three pillars:

- new rules for capital requirements, aiming at a more precise assessment of individual credit risks, which should be established by external ratings or internal risk models of the banks who hand out loans,
- bank supervision over the internal risk assessment models and procedures,
- more market discipline through enhanced transparency and public information.

The declared intention of this reform is to bring more stability to the financial system through more precise and accurate risk assessment and provision and thus guarantee a safe and comprehensive credit provision..

2. This intention will not be met by the Basle 2 package. Instead it will **increase financial instability and have a strong polarising effect in favour of large banks**, which will be harmful for comprehensive credit provision There are three reasons for this:

First: individual risk assessment and capital provision according individual risks of borrowers will have clear **pro-cyclical** effects. During recessions individual risks will rise, which will lead to higher capital requirements. These will be passed on to the borrower either through higher interests or less loans, both of which will deepen the recession. In a boom the effect is boom enhancing. The reason for this pro-cyclical dynamics is that individual risks are time sensitive, i.e. they change with the economic situation. In comparison the old (and current) system works as a kind of automatic stabilizer: the risk-weight remains stable over time: in recessions it makes loans cheaper than they would be under individual risk assessment conditions, in booms loans would be more expensive.

Second, individual risk assessment will have **structural effects towards stronger polarisation** between larger and smaller banks and loan conditions. The reason for this is that for smaller banks the cost of installing sophisticated risk assessment tools are relatively higher than for larger banks. This will deteriorate the already relatively precarious position of the smaller banks, regardless whether they pass these higher costs on to their customers or not. In the first case corporate financing becomes more expensive for the customers of these banks, who may chose to change their bank in favour of a large institution. This will also affect the credit provision in remote regions and small villages and towns. In this respect the old regime is a stabilising factor because it establishes equal rules for all institutions.

Third, the delegation of risk assessment to internal bank models is a **particularly delicate case of privatisation of bank supervision**: The banks, who are to be supervised establish the standards and models for their own supervision. The second pillar, the public supervision over the solidity of the private models, is largely illusionary: Establishing such risk models is a highly complicated matter for well trained experts. The public authorities are not in a position to employ a sufficient amount of experts and pay them accordingly, while large financial institutions will be easily in a position to do so. Public authorities are simply not in the position to exert efficiently the task assigned to them.

3. The reform package follows the logic of individual coast and risk minimisation which is not identical with minimisation of systemic risks or maximisation of financial stability as a whole. Structural cross-subsidies and cycle-resistant standards for capital requirements constitute a stabilising element for the financial system as a whole, although they are in clear contradiction to the microeconomic logic of every single financial institution. Public rules for financial markets should aim at financial stability as a whole and not scarify systemic stability to the benefit of the strongest financial institutions.

4. The alternative to this misguided reform project could be the **preservation and improvement of the existing system without giving up its stabilising properties**. The most important improvement would be to make special groups of loans more expensive, in the first place all loans which are not linked to real investment or consumption purposes, i.e. purely financial loans the proceeds of which are used for speculative purposes; the risk weight of such loans should be raised to 200% or more, whereas long-term finance should be covered by lower ratios. Loans to offshore institutions and hedge funds should be made very expensive or they should be quantitatively restricted or outrightly forbidden.