

Recent market conditions

What does it mean for Basel II?

Well, edition 13 of BaselBriefing is being written and released at a pivotal point in the evolution of the new Basel Accord. The Foundation Internal Ratings Based (FIRB) approach has been available during 2007, but with few firms having satisfied their respective regulators that they meet the minimum standards, it is 2008 that will see the big switch on of capital treatments under FIRB and the Advanced IRB approach.

Having said that, 2007 was very much a year of two halves – it started with record profits being reported by all the major banks, and the good news seemed to continue during the first six months. However, there were signs of the trouble to come, and rising levels of sub-prime defaults in the US pre-saged the crisis that was

to unfold in the second half of the year leading to the collapse of two German banks and the first run on a UK bank for nearly 150 years. By the end of the year almost all the major banks had reported massive write-downs on mortgage and structured product assets, some were reporting losses and several chief executives were looking for alternative employment (see figure 1).

As commentators trawl through the wreckage asking “how did this happen?”, we consider what lessons can be drawn for risk management and, in particular, for the impact that Basel II has had and will continue to have over the coming months.

Innovate or die?

Over the past few years the banking industry, and in particular the investment banking industry, has been fabulously creative. The growth in securitisation structures and credit derivatives over the past decade has been phenomenal. The lexicon is now filled with a string of three letter acronyms such as ABS, MBS, CDO and CDO squared.

What was originally conceived as a way of spreading the risk out across the industry is now being attacked by some commentators concerned that firms are unaware of the underlying risks that they hold and that they blindly invested in, on the basis of some external rating agency gradings.

Disintermediation, it is said, has also led to a lack of responsible lending, as originators were incentivised to lend without regard to the consequences of the lending, providing the core base material for the investment banking packaging.

The counterfactual (which is difficult to prove) is that without the spread of securitisation and risk transfer mechanisms, firms would have been even more badly hit by the impact of the sub-prime mortgage losses in the US.

As discussed further in our securitisation article, Basel has introduced more requirements including more risk sensitive requirements for securitisation structures, and in particular for the liquidity facilities provided to some of the structured products. The revised Basel Securitisation framework has seen more changes over the development period than possibly any other area in Basel, and it will be interesting to see how it survives in practice.

Blurring between credit and market risk

Another consequence of the recent events has been the demonstration of the significant linkage between credit and market risk, between the trading and banking books. Whilst trading book exposures get preferential regulatory capital treatments, firms have tried to squeeze more and more

Figure 1 Estimated write-downs of structured products

Firm	Amount (US\$bn)
Citigroup	13.7
UBS	13.7
Merrill Lynch	8.4
Morgan Stanley	4.6
Deutsche Bank	3.1
Credit Suisse	1.9
JP Morgan	1.6
Goldman Sachs	1.5
Wachovia Bank	1.1
Bear Stearns	0.7
Lehman Bros.	0.7
Total:	55.0

Source: KPMG International analysis of press coverage

exposures into them. The Basel Trading Book Review¹ introduced enhanced guidance to try to provide clarity around the eligibility of instruments for the trading book, with a renewed focus on the liquidity of the underlying positions and the ability to price them effectively and efficiently. In some respects this principles based guidance was highly prescient with the troubles of the last few months demonstrating how difficult it is to put prices on what have now become highly illiquid assets. As the packaging and re-packaging has gone on and on, it has sometimes become difficult to see where the boundary has been drawn – when has counterparty and underlying credit risk been effectively transformed into market risk, and does it matter?

Further work still has to be done during 2008 to complete the work on the incremental default risk surcharge for the trading book within the Basel

framework; further work on a tricky area that aims to compensate for some of the difficulties outlined earlier.

Role of rating agencies

Unregulated and seemingly with a licence to print money through their bond and entity rating activities, the rating agencies are not currently top of anyone's Christmas card lists.

They have played a key role in the events leading up to the liquidity crisis. They are a key participant in the development and origination of structured products, and whilst this is not the place to undertake a full examination of their rights and wrongs, it is inevitable that they will see a much greater level of scrutiny during 2008. With a significant part of the new Basel Accord dependent on the ratings provided by approved External Credit Assessment Institutions, including the controversial structured credit product area,

questions are already being asked around the implications of this for the new regulatory capital requirements. If nothing else, then market participants and the rating agencies need to reach a greater level of mutual understanding of what each brings to the table.

Firms responses to the crisis

As the crisis has unfolded, organisations have been cutting back on front office staff, taking the sword to the highly remunerated ranks of young salespeople and structurers who were responsible for putting together the sophisticated structured credit products.

At the same time, many are finding that they don't have sufficient experience in the risk control departments; they don't have those individuals with the ability to price, value and carry out stress testing on the products that have been created – it is a boom time for these areas.



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Another key area is firms spending time reviewing the whole balance sheet to understand what is on it – a fundamental root and branch review of the portfolio to understand the quality, nature and latent risks in the assets.

Implicit support

One of the most interesting areas arising from the growth of securitisation and its subsequent problems has been around implicit support – significant regulatory capital benefits were obtained by originators by demonstrating the appropriateness of their risk transfer mechanisms to third parties. The recent inability to finance these off-balance sheet obligations has led to many firms being forced for various reasons to take these assets back on their balance sheets, whether they were standard securitisations or some of the more in vogue ‘conduit’ vehicles. This has sent shockwaves through regulators who have had long held concerns about the degree with which risk had truly been transferred. Basel II has increased the attention of the industry on the formality and appropriateness of the risk transfer that has taken place. However, some would argue that their fears had been realised, when, under the first significant stress, the moral hazard and reputational damage arising from just walking away from these assets

has been a deterrent from firms sticking to their contractual protection.

Disclosure

One of the contributing factors in the crisis has been the uncertainty around valuation, around ‘how bad actually was it’ – recent accounting developments have led to a much greater focus on ‘fair value’. For many of the more complex instruments fair value is much harder to establish and firms rely on complex mathematical models loaded with assumptions and reliant on analysis that at times can be considered fairly dubious.

During 2008 and into 2009 two developments in this area may provide greater clarity. The accounting standard IFRS 7 becomes extant for accounting periods beginning on or after 1 January 2007 and therefore most banks will be making IFRS 7 disclosures during the reporting season in early 2008. Whilst no one should argue that disclosure is the panacea for all ills, enhanced disclosure is usually considered to be a good thing, and it certainly focuses the minds of senior management who are having to sign-off on ‘what they do’ and ‘what do we currently have on the books’.

From a Basel perspective, the Pillar 3 disclosures will begin to kick in, with most firms likely to make the

qualitative disclosures during 2008 aligning with IFRS 7 and then the quantitative disclosures in 2009. With regulators hoping that market forces drive improvements in risk management it remains to be seen whether this works.

Pricing for risk

One of the oft quoted phrases during the recent turmoil has been that pricing had become dislocated from the risk (and in particular the credit risk) associated with lending. If there is one thing that has been stressed about Basel II, it is the objective of developing more risk sensitive capital requirements, linking risk assessment methods with business and operational use. It can be hoped that by encouraging robust use test frameworks, strong governance and oversight and the leveraging of Basel infrastructure for business and operational purposes that a re-establishment of the link between price and risk can start to be seen.

Challenges into 2008

With Basel II in full swing in 2008, and the US belatedly embracing the Accord in full, albeit with a one year delay, the challenge now is to restore credibility and reputation to an industry that came under significant public, regulatory and governmental pressure during 2007.

In the minds of many regulators, Basel II is a good thing as it provides a more robust risk sensitive approach for the assessment of banking organisations; it requires an examination of off-balance sheet instruments, such as liquidity facilities, and the effectiveness of risk transfer mechanisms, and the Pillar 2 framework provides scope for a thorough firm-wide review of risk management, especially liquidity risk and a robust regime of severe stress and scenario tests.

Many in the industry are hoping that there are no knee-jerk regulatory or legal responses to the difficulties experienced during the market crisis. With the bad news coming out of the woodwork, the market is now in a better position to assess the underlying issues and gauge the future problems.

What is certain is that attention will now turn to the 'forgotten risk' up to this point: that of liquidity risk. Whilst regulators can point to Pillar 2, and the need for firms to have had a joined up capital management, risk management and financial management strategy, there is no denying that liquidity risk has not been given the exposure or study that it deserved. The events of the last six months have strengthened the arms of regulators, provided impetus and a much needed wake up call for firms and senior management.

Indeed, senior management are likely to face greater pressure during 2008 from regulators, from shareholders and from the general public. They need to understand their businesses like never before and the mantra of appropriate governance and oversight will echo strongly.

For those who thought Basel II was completed and that Basel III was on the horizon, think again. There remains significant work to be done down a robust regime of capital requirements, capital, financial and strategic management, and disclosure that is consistent with the risks facing organisations in the current climate.

Contact

Steven Hall
Senior Manager
KPMG in the UK
Tel: +44 20 7311 5883
e-Mail: steven.hall5@kpmg.co.uk

¹ The Application of Basel 2 to Trading Activities and the Treatment of Double Default Effects, BIS (consultation paper, April 2005; and final rules, July 2005)