Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Last week, the head of Britain's key financial-regulatory agency, Sam Woods, stunned his Basel colleagues by suggesting that the entire edifice of Basel I, II, II.5, III, and what is rightly called IV should be tossed out in favor of something far more elegant and considerably less procyclical than the thousands of pages of Basel minutiae. Mr. Woods calls the alternative the "Basel Bufferati" in honor of the concept-car approach to auto innovation and it's hard not to like something with such a cute name that might also achieve these essential goals. But, Mr. Woods's Bufferati drives on the power of regulatory discretion over key considerations such as when there's systemic risk and how susceptible to it each bank is likely to be. Been there, done that, it didn't work.

The key features of the Bufferati are a minimums standard that's a single number comprised only of common equity Tier 1 capital set by each supervisor's judgement and a buffer for good measure set by "macroeconomic cost-benefit analyses." The buffer could be released under stress and the minimum doesn't necessarily bind even if there isn't stress, making it unclear what either of these thresholds is other than ratios that might be useful cushions against undue risk-taking if supervisors guess right about both the bank and the financial system.

Could they? The idea of leaving minimum ratios to supervisory judgment actually harks back to the world before Basel I, when each nation's supervisors looked at each of its banks and set the ratio it liked the best, more often than not to gain global competitive edge than to ensure resilience under stress. Mr. Woods also assumes that regulators know systemic risk when they see it, but there's little evidence to substantiate this – see for example the Fed's sanguine forecasts of financial-stability risk ahead of the 2019 repo debacle and again before 2020's crash.

Mr. Woods also likes Basel's measure of systemic risk: asset growth. However, it is particularly ill-suited to financial markets, which are of course fraught with derivatives exposures, operational risk such as cybersecurity, and inter-connectedness that is demonstrably dangerous.

To be sure, this conceptual capital framework isn't all in the mind of each supervisory beholder. The Bufferati is supposed to be crash-tested via stress tests, tests the U.K. regulator says would be more meaningful than any seen anywhere outside the U.S. because they would bar capital distributions if stress-test scenarios uncovered vulnerability.

Here, I think the concept car has wheels. Mr. Woods also suggests that tests be simpler, more frequent, and go beyond the limited number of largely credit-based scenarios on which most are founded. A distribution of scenarios over more dynamic time periods is more burdensome than the current stress-test construct, but so much of this infrastructure is now so hard-wired that it seems both viable and desirable. Continuing the auto analogy, this approach to stress testing is akin to dashboard lights that go off when risk tolerances are transgressed.

But, for all my concerns with the Bufferati's durability, Mr. Woods is right: the current system is absurdly complex and pending Basel IV changes are only a marginal improvement. The number of surcharges for different types of banks under different conditions for different reasons is bewildering as is the interplay between the standardized and internal ratings-based approaches and that of the credit rules with those for market and operational risk and the over-arching interaction between all of these capital rules and the liquidity standards with which they all too often collide. The regulatory construct with all its complexity and contradictions also combusts with monetary policy, leading to still more unintended consequences – see our 2016 paper and then look to see how much of what we feared then came to pass.

A memo is even less suited to crafting a successor to Basel I, II, II.5, III, and IV than a speech, so I won't try here to outline what might well be better than a Basel V based on best guesses and good wishes. Where Mr. Woods's speech is totally correct is that the current capital construct is increasingly imploding under its own weight and – what he neglects to mention – also that the brute force of more and more critical financial infrastructure is beyond its reach.

The U.S. will soon issue proposals of hundreds of pages to implement the many changes to Basel III global regulators crafted in 2016. We've learned a lot the very hard way since then. Instead of just continuing to tinker with this bloated capital construct, why not use the opportunity of a rewrite to consider core questions such as whether all of the many ratios, surcharges, and scaling factors are really needed given the benefits of well-designed stress testing, the leverage ratio's continuing role, and meaningful risk-based capital floors backed, if supervisors can bring themselves to it, by the "prompt corrective action" U.S. law demands.