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Basel III and existing banking rules are inadequate to regulate derivatives, says economist

Oct 18 2013 Ajay Shamdasani, Compliance Complete

The Basel III capital accord and prevailing banking regulation fail to tackle the regulation of derivatives properly, with insufficient information available to global regulators and academics making it difficult to calculate risk. Vania Stavrakeva, an assistant professor of economics at the London Business School, told Compliance Complete that existing rules on such instruments failed in two critical ways.

"Current derivative regulation is very non-transparent and still very much work in progress," she said. "First, it does not take into account the correlation of bank positions across different classes of derivatives but also between derivatives and the rest of the balance sheet. Essentially, what regulators should worry about is how well capitalized banks will be in the case of systemic crisis. To ensure that they are well capitalised we need to make sure that the risks they take are not very correlated."

"Second, current derivative regulation treats buying and selling insurance equally [with the exception of the collateral requirements, for example]," Stavrakeva said. The sale of credit default swap contracts and speculation was more dangerous to banks' financial health than just buying such CDS contracts, were another crisis to arise.

"The current risk weights in Basel III penalize only counterparty risk and large notional value and they do not take those two issues into account," Stavrakeva said.

Even without counterparty risk — an effective Basel III weighting of zero — banks in countries with strong moral hazard would be tempted to pledge too high payments in a crisis by selling CDS contracts, for example. She said that while talks to introduce a financial transaction tax on derivatives would be a step in the right direction, it affected both beneficial and speculative uses of derivatives, discouraging both in the same way, which was sub-optimal.

"We need a much more comprehensive approach that takes into account the whole bank balance sheet plus the correlation of risk among institutions and also international spillover effects," she said.

Topping up existing bank rules

Stavrakeva said that in the aftermath of the financial crisis, banks were more likely to offset risk using derivative contracts, because Basel III has increased the minimum bank capital requirements. "Even if we contain the risk shifting of other asset classes using minimum bank capital requirements, banks can shift risk using derivative contracts such as CDS contracts," she said. "The need to regulate derivatives comes from the presence of moral hazard. I think their importance and the danger associated with them will increase in future."

Stavrakeva said moral hazard was higher in countries with deep pockets — such as the U.S. — because they could afford larger bank bailouts during crises. "Banks in those countries with deep pockets perceive taking risky positions as less costly as they know they will get bailed out in a systemic crisis since the government can afford the bailout," she said. "Another dimension that affects the strength of the moral hazard and the incentives to shift risk is the size of the banks."

Countries with large banks, she said, had stronger moral hazard, as banks in those countries were likely to internalize the impact of their positions on aggregate "fire sales" and hence, on the amount of their bailout in a potential crisis.

Compliance and risk management

Stavrakeva's said that based on her research, the best advice for compliance and risk management personnel was t take a full-scale, comprehensive approach. "Take a more macro approach and think about better 'sufficient regulatory statistics'," she said.

"Simple leverage and risk-weighted minimum bank capital requirement both have flaws. One of them is that in no way do they take into account derivatives in a meaningful way or any other exotic instruments that might emerge."

In a perfect world, she said, with full information on bank balance sheets, no shadow banks and very good ability to evaluate future risk, "sufficient statistics" would be the total capitalisation of the banking system in a systemic crisis event, weighted by the probability of such a crisis occurring. "As a regulator, that is the number I care about because that is when I provide bailouts, which triggers the moral hazard in the first place," she said.

How such a "sufficient statistic" would work is unclear, however. For example, by selling many CDS contracts that tend to be a larger liability when defaults are high during a recession, that regulatory metric would be lower and banks would have to adjust their balance sheets to either hedge or simply take fewer risks. Such a measure would also have to take into account how correlated risks are among banking and financial institutions, irrespective of national boundaries.

Stavrakeva said devising the optimal number for "sufficient statistics" would be difficult because it would require much information and complicated risk model valuations. "However, the benefit is that it targets precisely what regulators should be targeting and incorporates the danger stemming from the use of derivatives or whatever exotic contracts banks come up with in the future," she said.

Lessons for Asian financial hubs

The lessons for Asia were difficult because Hong Kong and Singapore were two of the largest players in the region's derivatives markets, but had small fiscal capacities. "Hence, at first look the need for derivative regulation does not appear so crucial relative to the U.S., for example," Stavrakeva said.

"However, the big banks [in Hong Kong and Singapore] are very interconnected with the U.S. and China and also the EU, and potentially will become more so post derivative regulations in the EU and U.S. Large derivative players might expect a bailout from the U.S., EU or China and take excessively large positions."

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