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# BASEL III: THE BANKING BAND-AID?

## INTRODUCTION

In 2010, the Basel Committee on Banking Supervision (the Basel Committee), for the third time, attempted to alter the failures of Basel II that were exposed during the 2007–2009 financial crisis in order to prevent future economic downturns.<sup>1</sup> Although their efforts will assist in curbing risks, previously realized under weaker bank capital requirements, the new measures are insufficient. Rather than fixing the flawed method of risk valuation, the Basel Committee simply made adjustments to its existing rules framework. In other words, the Basel Committee has merely reached into its past, strengthened the Basel II capital requirements, and relabeled the regulations.

The global banking community is currently undertaking an attempt to overhaul international banking regulations.<sup>2</sup> The new round of regulations, known as Basel III, continues the efforts of Basel II, focusing on improving the health of the global banking industry and fostering greater consistency across the world.<sup>3</sup>

Basel is a set of banking regulations created by the Bank for International Settlements (BIS), a group of representatives from the G20 countries. To date, there have been three adaptations of the Basel regulations, referred to as Basel I, Basel II, and Basel III. Basel I responded to “the increasingly more common cross-border capital flows and the resulting integration of financial markets that had been going on for some time, requir[ing] a new global regulatory framework which would help ensure the stability of the international financial system.”<sup>4</sup> Each set of Basel regulations has focused on increasing bank capital in proportion to credit risk, through the use of risk weights<sup>5</sup>—a tool that analyzes the capital adequacy of a bank.<sup>6</sup> The capital requirements imposed on banks by Basel I, however, were rather relaxed. This relaxed approach led to more risk

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1. WALTER W. EUBANKS, CONG. RESEARCH SERV., R41467, THE STATUS OF THE BASEL III CAPITAL ADEQUACY ACCORD I (2010).

2. See Nick Louth, *Will Basel III Change the Banks?*, MSN MONEY (Sept. 15, 2010, 4:41 PM), <http://money.uk.msn.com/investing/articles.aspx?cp-documentid=154680405>.

3. See *Progress Report on Basel III Implementation*, BANK FOR INT’L SETTLEMENTS, 1 (Oct. 2011), <http://www.bis.org/bcbs203.pdf>; see generally *History of the Basel Committee and Its Membership*, BANK FOR INT’L SETTLEMENTS, <http://www.bis.org/bcbs/history.htm> (last visited Apr. 9, 2012) [hereinafter *BIS Memorandum*].

4. Juliusz Jablecki, *The Impact of Basel I Capital Requirements on Bank Behavior and the Efficacy of Monetary Policy*, 2 INT’L J. OF ECON SCI. & APPLIED RES. 16, 16 n.1 (2009).

5. *Risk-Weighted Asset Definition*, INVESTORWORDS, [http://www.investorwords.com/6653/risk\\_weighted\\_asset.html](http://www.investorwords.com/6653/risk_weighted_asset.html) (last visited Jan. 31, 2012). A risk-weighted asset is “[a] bank’s assets weighted according to credit risk. Some assets, such as debentures, are assigned a higher risk than others, such as cash. This sort of asset calculation is used in determining the capital requirement for a financial institution, and is regulated by the Federal Reserve Board.” *Id.*; see also *Risk-Weighted Assets Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/r/riskweightedassets.asp> (last visited Apr. 9, 2012) [hereinafter *Risk-Weighted Assets Definition*].

6. Jablecki, *supra* note 4, at 18.

arbitrage<sup>7</sup> and increased the instability of banking institutions around the globe.<sup>8</sup>

In response, Basel II overhauled many of the loopholes in Basel I, taking a more careful approach to risk weights. Basel II “expand[ed] the scope, technicality, and depth of the original Basel Accord.”<sup>9</sup> Basel II created stronger capital requirements through the implementation of a standardized approach to evaluating credit risk.<sup>10</sup> This approach involves credit rating agencies (CRA) in the risk analysis process.<sup>11</sup> Basel II also introduced the Advanced Internal Rating Based (AIRB) approach, which is conducted by the banks themselves.<sup>12</sup> The standardized approach, in conjunction with the AIRB approach, served to increase the supervision lacking in Basel I. This framework was supposed to make the system safer across the globe but largely failed.<sup>13</sup>

Basel III is aimed at remedying this failure and preventing another financial crisis. Although it purports to remedy the flaws of Basel I and II, it does not go far enough to avert a future crisis. This is particularly true with respect to the continued practice of assigning risk weights through the standardized and AIRB approach.<sup>14</sup> The new capital requirements devote a larger portion of bank capital to common equity<sup>15</sup> and Tier 1 capital,<sup>16</sup>

7. “[A]ttempting to profit by exploiting price differences of identical or similar financial instruments, on different markets or in different forms.” *Arbitrage Definition*, INVESTORWORDS, <http://www.investorwords.com/245/arbitrage.html> (last visited Jan. 23, 2012).

8. Jablecki, *supra* note 4, at 16.

9. See Bryan J. Balin, *Basel I, Basel II, and Emerging Markets: A Nontechnical Analysis 6* (John Hopkins Univ. Sch. of Advanced Int’l Studies (SAIS), Working Paper, May 2008).

10. See W. Ronald Gard, *George Bailey in the Twenty-First Century: Are We Moving to the Postmodern Era in International Financial Regulation with Basel II?*, 8 *TRANSACTIONS: TENN. J. OF BUS. L.* 161, 164 (2006).

11. Balin, *supra* note 9, at 7.

12. *Id.* at 6–7.

13. See L. Jacabo Rodriguez, *Banking Stability and the Basel Capital Standards*, 23 *CATO J.* 115, 119 (2003) (“The original Basel Accord (Basel I) was the wrong response to a real problem—the conflict between deposit insurance systems and the national regulation of capital standards—and, most likely, has made the global financial system less, not more, stable.”).

14. Simon Johnson, *Top Finance Experts To G20: The Basel III Process is a Disaster*, THE BASEL SCENARIO (Nov. 11, 2010), <http://baselinescenario.com/2010/11/11/top-finance-experts-to-g20-the-basel-iii-process-is-a-disaster/>. Johnson discusses an article by Anat Admati, Professor at Stanford University, which finds that Basel risk weights are not working:

[T]he Basel process uses dysfunctional methods to adjust capital requirements to reflect the risk of various kinds of assets.

“The Basel accords determine required equity levels through a system of risk weights, . . . This system encourages ‘innovations’ to economize on equity, which undermine capital regulation and often add to systemic risk. The proliferation of synthetic AAA securities [around U.S. housing loans] before the crisis is an example.”

*Id.* (quoting Professor Anat Admati) (alteration in the original).

15. Press Release, Bank for Int’l Settlements, Basel Comm. on Banking Supervision (Sept. 12, 2010) [hereinafter BIS Press Release], *available at* <http://www.bis.org/press/p100912.pdf>.

which forces the bank to hold more capital on its balance sheet.<sup>17</sup> Common equity is defined as “[a] measure of equity which only takes into account the common stockholders, and disregards the preferred stockholders. It is equal to shareholders’ equity minus preferred equity.”<sup>18</sup> Tier 1 capital under the new system is “[a] term used to describe the capital adequacy of a bank. Tier I capital is core capital.”<sup>19</sup>

The risk-weighted asset (RWA)<sup>20</sup> framework of Basel III conditions the amount of common equity and Tier 1 capital a bank must hold on the risks associated with particular assets.<sup>21</sup> For example, “loans that are secured by a letter of credit would be weighted riskier than a mortgage loan that is secured with collateral”<sup>22</sup> and thus the loan secured by letter of credit would require a bank to hold more capital. The increase in capital requirements will alter the types of assets held and activities undertaken (such as issuing more common stock to raise capital) by banks.<sup>23</sup>

The use of RWA in capital measurements set forth in Basel II is, for the most part, maintained under Basel III.<sup>24</sup> Furthermore, banks, using internal

16. *Tier 1 Capital Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/tier1capital.asp> (last visited Oct. 29, 2010).

17. Basel Committee on Banking Supervision, *Capital Requirements and Bank Behaviour: The Impact of the Basle Accord 15* (Bank for Int’l Settlements, Working Paper No. 1, 1999) [hereinafter *Capital Requirements and Bank Behavior*] (“[D]epending on the ratio concerned (leverage ratio, Tier 1 to Risk-weighted Assets (RWA) or total capital to RWA), the numerator may be changed by retaining earnings, issuing equity or issuing other quasi-equity securities such as subordinated debt. Similarly, the denominator may be adjusted by cutting back loans or, in the case of ratios to RWA, by shifting into assets that bear a relatively low risk weight such as residential mortgages, short-term interbank exposures or government securities.”).

18. *Common Equity Definition*, INVESTORWORDS, [http://www.investorwords.com/6762/common\\_equity.html](http://www.investorwords.com/6762/common_equity.html) (last visited Apr. 9, 2012).

19. *Tier 1 Capital Definition*, *supra* note 16; see Balin, *supra* note 9, at 3.

20. *Risk-Weighted Assets Definition*, *supra* note 5. Risk-weighted assets are defined “[i]n terms of the minimum amount of capital that is required within banks and other institutions, based on a percentage of the assets, weighted by risk.” *Id.*

21. *Risk-Weighted Assets Definition*, *supra* note 5.

22. *Id.*

23. See Katharina Bart, *Swiss Banks Confident on Basel Reforms*, MARKETWATCH (Sept. 13, 2010, 1:08 AM), [http://online.wsj.com/article\\_email/SB10001424052748704483004575523141112159212-1MyQjAxMTAwMDIwNzEyNDcyWj.html](http://online.wsj.com/article_email/SB10001424052748704483004575523141112159212-1MyQjAxMTAwMDIwNzEyNDcyWj.html); Elena Logutenkova & Klaus Wille, *UBS, Credit Suisse May Need to Boost Capital to 19%*, BUSINESSWEEK (Oct. 4, 2010, 11:44AM), <http://www.businessweek.com/news/2010-10-04/ubs-credit-suisse-may-need-to-boost-capital-to-19-.html>. Both articles discuss the crossroads many banks are finding themselves at: how to raise enough capital to meet Basel III requirements, or, how to remove enough of the riskier capital the bank holds to meet the Basel III requirements. In either scenario, the bank activities (lending, asset purchases, etc.) will need to be reevaluated to ensure the capital ratios are followed.

24. Douglas J. Elliott, *Basel III, the Banks, and the Economy*, THE BROOKINGS INSTITUTE, 8 (July 23, 2010), [http://www.brookings.edu/papers/2010/0726\\_basel\\_elliott.aspx](http://www.brookings.edu/papers/2010/0726_basel_elliott.aspx) (stating that changes to Basel III will include higher capital ratios, which will be made more difficult for a bank to achieve, with higher risk weight values assigned to various asset classes, and countercyclical capital requirement of 2.5 percent that will be added on top of the 8 percent minimum total capital requirement).

risk based models,<sup>25</sup> create their own risk weights, which further complicates these measurements with regard to how the values are decided.<sup>26</sup> Much of the uncertainty concerning RWA measurements stems from the relative risk assigned to a particular asset class.<sup>27</sup> With credit rating agencies<sup>28</sup> valuing asset class risk levels (as they had under Basel II), the system runs into valuation issues. For example, during the financial crisis, many of the assets rated AAA,<sup>29</sup> such as mortgage backed securities,<sup>30</sup> were

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25. *Id.* (explaining that internal risk models are retained in the Basel III framework and how they are intertwined with the RWA approach). Banks can therefore assign risk levels to their assets that affect capital ratios and benefit the bank's leverage capabilities if the risk assigned were to be undervalued. See Jablecki, *supra* note 4, at 31 ("Most importantly, Basel II imposes a much more sensitive set of risk weights which are meant not only to eliminate capital arbitrage techniques, such as securitization, prevalent most notably in the U.S., but also ensure that riskier banks hold more equity. One interesting novelty is that under the new framework, banks' capital requirements are based on their internal estimates of the probabilities of default (PDs) and losses given default (LGDs) of their loans. Clearly, PDs and LGDs are highly pro-cyclical, i.e. the creditworthiness of borrowers moves with the economic cycle, and thus more capital will have to be set aside during a depression and less during an economic boom. In other words, when interest rates increase due to a monetary policy tightening, PDs and LGDs are likely to rise as well, and hence lead to higher capital requirements, which in turn, on both accounts mentioned before, might reduce bank lending. Thus, the tentative conclusion regarding Basel II is that it strengthens the bank lending channel.").

26. Elliot, *supra* note 24, at 8.

27. See *FDIC Law, Regulations, Related Acts*, 12 C.F.R. § 325, App'x A (2011) (discussing the FDIC model for assigning risk weights).

28. *Credit Rating Agencies Definition*, THE FREE DICTIONARY, <http://financial-dictionary.thefreedictionary.com/Credit+Rating+Agencies> (last visited Oct. 29, 2010). A credit rating agency is defined as

[a] company that provides investors with assessments of an investment's risk. The issuers of investments, especially debt securities, pay credit rating agencies to provide them with ratings. A high rating indicates low risk and may therefore encourage investors to buy a security. Additionally, banks may only invest in securities with a high rating from two or more credit rating agencies. The SEC recognizes 10 firms as credit rating agencies; Fitch, S&P, and Moody's are the three most prominent. However, the methods of credit ratings agencies have been subject to criticism. For example, most agencies gave high-risk mortgage-backed securities top ratings until they defaulted at the collapse of the housing bubble.

*Id.* See also Richard Smith, *Basel III vs. Dodd-Frank on Ratings Agencies and Risk Weights*, NAKED CAPITALISM (Sept. 23, 2010, 3:00 AM), <http://www.nakedcapitalism.com/2010/09/basel-iii-vs-dodd-frank-on-ratings-agencies-and-risk-weights.html> (discussing the negative impact that credit rating agencies had during the financial meltdown and their problematic and continued role in the Basel III framework). The Dodd-Frank Act has still not come to a conclusion as to what role credit rating agencies will play under the new financial regulations. *Id.*

29. AAA Rating Scale, *Bond and Long Term Debt Rating Scale*, CREDIT GURU, <http://www.creditguru.com/bondRating.htm> (last visited Oct. 29, 2010) ("Bonds rated AAA are of the highest credit quality, with exceptionally strong protection for the timely repayment of principal and interest. Earnings are considered stable, the structure of the industry in which the entity operates is strong, and the outlook for future profitability is favourable.").

30. *Mortgage-Backed Securities*, SEC, <http://www.sec.gov/answers/mortgagesecurities.htm> (last updated July 23, 2010) [hereinafter *Mortgage-backed Securities*] ("Mortgage-backed securities (MBS) are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a

not in fact low-risk to no-risk assets. Basel III leaves this framework in place and thus does not sufficiently curb risk.

To effectively curb risk, risk weights attached to assets such as sovereign debt, which is currently considered to present 0 percent risk, should be increased by a disinterested party with the authority to advise (similar to the BIS, which has no binding authority on member nations), with no asset class receiving a 0 percent risk weight. This will improve the stability of banking institutions as they strive to increase profits for their shareholders and those who use their banks as savings and loan institutions.<sup>31</sup> In addition to this safeguard, BIS should implement a more dynamic approach to risk evaluation. This note will propose a different standardized approach. This approach will embrace the valuation of risk by a neutral body and attempt to deemphasize the reliance on the AIRB approach.

Part I of this note discusses the provisions of Basel II and Basel III and the primary differences between Basel II and Basel III. Part II describes the anticipated effects of Basel III's RWA provisions. Part III argues that RWAs are at the core of Basel III's failure to curb risk and the new regulations do not depart enough from the Basel II framework because banks will use the AIRB approach to decide their own RWAs going forward. Part IV offers an alternative to assigning risk weights that will prevent the under-estimation of risk that caused the recent financial crisis.

## **I. THE BASEL CONFERENCE: A BANKER'S BALL IN SWITZERLAND**

Four times a year, a committee of international bankers gathers to deliberate over the status of the international banking community.<sup>32</sup> The committee is comprised of representatives from the G20 countries. Since its inception, the group has expanded to include twenty-seven members.<sup>33</sup> With its headquarters in the small Swiss town of Basel,<sup>34</sup> the Basel Committee

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governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.”).

31. See Felix Salmon, *The Biggest Weakness of Basel III*, REUTERS (Sept. 14, 2010), <http://blogs.reuters.com/felix-salmon/2010/09/15/the-biggest-weakness-of-basel-iii/>.

32. *BIS Memorandum*, *supra* note 3, at 1.

33. *Id.* (including: Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States).

34. *Id.* (noting two other offices exist in the Hong Kong Special Administrative Region of the People's Republic of China and in Mexico City).

was established in the mid-1970s in response to problems with currency deficiencies and banking markets.<sup>35</sup>

Most recently, on September 12, 2010, the group issued statements that Basel III would increase capital requirements.<sup>36</sup> This solution appears to be a logical response to the global financial crises and the resultant U.S. government bailout<sup>37</sup> of failing banks.<sup>38</sup> By requiring higher quality capital reserves to appear on bank balance sheets,<sup>39</sup> future economic downturns will not ruin the banking sector.<sup>40</sup> Although these new capital requirements better address risk management by banks, Basel III fails to address the methodology of risk valuation.<sup>41</sup> It permits banks to continue using the AIRB approach in the valuation of assets and risk weights.<sup>42</sup> This allows the largest banks to internally control the RWA framework and encourages banks to maintain the rules to remain profitable. Such an outcome is in conflict with the goals of the Basel Committee.

The goal of the Basel Committee is to “provide[] a forum for regular cooperation between its member countries on banking supervisory matters.”<sup>43</sup> The original intention behind the Basel Conference was to

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35. *Id.* (explaining the original international currency crisis involved Germany and their banking sectors currency control problems, which were jointly addressed by the original ten nations that belonged to the Basel committee).

36. Natsuko Waki & Catherine Bosley, *Global Regulators Agree on Tougher Basel III Bank Rules*, REUTERS (Sept. 12, 2010, 7:36 PM), <http://www.reuters.com/article/idUSTRE68B16L20100912> (discussing Europe’s reaction to the new rules imposed by Basel III). European arguments for and against Basel III are important to consider when analyzing the framework’s impact in the United States. *Id.*

37. See *History of U.S. Government Bailouts*, PRO PUBLICA, <http://www.propublica.org/special/government-bailouts> (Apr. 15, 2009, 12:02 PM) (discussing a history of government bailouts dating back to Penn Central’s bankruptcy filing and the subsequent bailout of the banking sector). “In October 2008, Congress passed the Emergency Economic Stabilization Act, which authorized the Treasury Department to spend \$700 billion to combat the financial crisis. Treasury has been doling out the money via an alphabet soup of different programs.” *Id.*

38. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT’L SETTLEMENTS, CONSULTATIVE DOCUMENT: STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR 2 (Dec. 2009) [hereinafter BIS CONSULTATIVE DOCUMENT] (on file with author) (explaining that a safer banking structure with more predictability in times of crisis will lead to a less harsh result for the broader economy).

39. BIS Press Release, *supra* note 15 (stating that high quality capital reserves are known as Tier 1 capital, and are considered the safest and most essential to a banks daily practices such as lending and trading activities).

40. BIS CONSULTATIVE DOCUMENT, *supra* note 38, at 1–2 (explaining that most recently, banks did not have enough core capital to respond to the economic downturn that was created by the home mortgage markets, so government bailouts infused capital to save the banks).

41. Felix Salmon, *The Good and the Bad of Basel III*, SEEKING ALPHA (July 27, 2010), <http://seekingalpha.com/article/212051-the-good-and-the-bad-of-basel-iii>.

42. Elliot, *supra* note 24, at 4–8.

43. *BIS Memorandum*, *supra* note 3, at 1. The Basel Conferences involve all member nations, and different nations have different representatives present at the Conferences. For example, the United States sends the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. *Id.*

streamline the supervisory process in the international banking community.<sup>44</sup> Basel supervises the banking industry “by exchanging information on national supervisory arrangements; by improving the effectiveness of techniques for supervising international banking business; and by setting minimum supervisory standards in areas where they are considered desirable.”<sup>45</sup>

The standards promulgated by Basel are not binding on member nations.<sup>46</sup> Rather, the member nations may adopt the suggested and agreed upon requirements that are negotiated throughout the Basel Conferences.<sup>47</sup> For example, in the United States, only the ten largest banks were subject to adhere to Basel II, while all other smaller banks were governed by Basel I and other U.S. banking regulations.<sup>48</sup>

Major focal points of the committee are capital requirements and the supervisory roles that governing bodies play in the enforcement of capital requirements.<sup>49</sup> Due to the globalization of the banking sector,<sup>50</sup> the Basel Committee has aimed its reforms at a globalized effort for the accounting of various risks that banks take on their balance sheets.<sup>51</sup> The Financial Risk Institute<sup>52</sup> explains the importance of the RWA schema: “(i) it provides a

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44. *Id.*

45. *Id.*

46. *Id.* (noting that a major debate over the most recent Basel requirements involved the time frame for implementation, which will be fully in effect by 2019, with some other changes being required for compliance with the Basel regime as early as 2013).

47. EUBANKS, *supra* note 5, at 1 (discussing the weight that Basel has on member nations by noting that twenty-seven of the largest world economies all influence the banking rules, which members are expected to adopt domestically).

48. *Id.* (providing an example of how the regulations stemming from Basel II are not binding without further domestic rulemaking).

49. *BIS Memorandum, supra* note 3, at 3.

50. See generally BOSTON CONSULTING GRP., GLOBAL CORPORATE BANKING 2010: CRISIS AS OPPORTUNITY (2010), available at <http://www.bcg.com/documents/file50789.pdf> (discussing the trend known as “Globalization 2.0”). The report explains how crisis in the banking industry will lead to the creation of “blue chip” bank opportunities, encouraging banks to go into emerging markets and find opportunities to expand business and find new clients abroad; due to “megatrends” in the global banking industry, such as tech development, globalization will most likely continue to emerge as a source of competitive advantage. *Id.*

51. See BANK FOR INT’L SETTLEMENTS, *International Regulatory Framework for Banks (Basel III)*, <http://www.bis.org/bcbs/basel3.htm> (last visited Jan. 25, 2012) [hereinafter *International Regulatory Framework*] (“The reforms target: . . . macroprudential, system wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time.”). The accepted idea is international cooperation in the banking sector will lead to safe investments in all markets. *Id.* See generally BASEL COMM. ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (2010 rev. Jun. 2011) [hereinafter BASEL COMMITTEE REPORT].

52. *About the Institute*, THE FIN. RISK INST., <http://riskinstitute.ch/about.htm> (last visited Apr. 9, 2012) (“IFCI Foundation – International Financial Risk Institute was established as a not-for-profit foundation under the supervision of the Swiss Federal Authorities in 1984. . . . The new objective of the Financial Risk Institute is to promote a ‘learning environment’ on issues relevant to financial risk management.” (emphasis omitted)).



fairer basis for making international comparisons between banking systems whose structures may differ; (ii) it allows off-balance-sheet exposures to be incorporated more easily into the measure; and (iii) it does not deter banks from holding liquid or other assets which carry low risk.”<sup>53</sup>

#### A. THE REVISED SYSTEM: HOW BASEL III WILL ADDRESS THE SHORTCOMINGS OF BASEL II

In light of the economic crisis, the Basel Committee realized that changes were necessary to help restore confidence in the global banking system.<sup>54</sup> Three key components of the Basel III framework are: (1) capital requirements, (2) RWA calculations, and (3) the continued use of AIRB modeling as a primary source of measuring a bank’s exposure to risk.<sup>55</sup> These three areas are intertwined, with a major area of concern involving risk weights and how they remain an area of uncertainty due to the continued support of the advanced internal risk modeling under the Basel III framework, which allows banks to determine the relative risk weights for their own assets.<sup>56</sup> Uncertainty still exists due to the current degree of bank discretion that exists without clear guidelines to supervise the AIRB calculations.<sup>57</sup>

##### 1. Capital Requirements

There are two notable changes to the Basel III capital requirements: an increase in the percentage of common equity a bank must retain in relation to its RWA, and an increase in the Tier 1 capital ratios. First, capital requirements<sup>58</sup> will increase from the 2-percent common equity<sup>59</sup>

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53. *International Convergence on Capital Measurement and Capital Standards: Part II: The Risk Weights*, COMM. AT THE BANK FOR INT’L SETTLEMENT (Apr. 1988), <http://www.riskinstitute.ch/CapAcCapital.htm>.

54. *Basel III: What the Experts Say*, GUARDIAN.UK.COM, <http://www.guardian.co.uk/business/2010/sep/13/basel-iii-what-the-experts-say> (last visited Nov. 20, 2010) (discussing how Basel III influenced markets across the globe to increase capital, and many banks view the rules as not as strict as many had expected).

55. See *International Regulatory Framework*, *supra* note 51; BASEL COMMITTEE REPORT, *supra* note 51, at 39; *Capital Requirements and Bank Behavior*, *supra* note 17, at 6, 15–16.

56. See DOUGLAS J. ELLIOT, THE BROOKINGS INSTITUTE, A PRIMER ON BANK CAPITAL 9 (2010), available at <http://www.brookings.edu/papers/2010/~media/A84D1C57A7CE4539BCD0FE6F66D1FB63.pdf> [hereinafter A PRIMER ON BANK CAPITAL] (discussing why RWAs are an important aspect of the global banking streamlining process).

57. Vanessa Le Leslé & Sofiya Avramova, *Revisiting Risk-Weighted Assets: “Why Do RWAs Differ Across Countries and What Can Be Done About It?”* 21 (Int’l Monetary Fund, Working Paper, 2012), available at <http://www.imf.org/external/pubs/ft/wp/2012/wp1290.pdf> (describing the four major components within the internal ratings based formula, including: probability of default (PD), Loss Given Default (LGD), Maturity (M), and risk-weight (RW)).

58. Douglas B. Elliot defines capital requirements as “the portion of a bank’s assets which have no associated contractual commitment for repayment. It is, therefore, available as a cushion in case the value of the bank’s assets declines or its liabilities rise.” A PRIMER ON BANK CAPITAL, *supra* note 56, at 1.

requirement under Basel II to 3.5 percent retained in common equity.<sup>60</sup> Common equity is important to a bank because, “as we understand it, [it] is the first line of capital to take losses.”<sup>61</sup> In hindsight, many in the banking sector agree that the former capital requirements were set too low to respond to a global financial meltdown.<sup>62</sup> Thus, the new common equity level puts banks on alert that more money must remain available to respond to financial stress in case loan and asset values decline.<sup>63</sup> The Tier 1 capital requirement will also be increased from 4 to 6 percent by January 1, 2015.<sup>64</sup> These changes were a direct response to a “run on the banks” issue experienced during the economic downturn.<sup>65</sup> The anticipated effects of increasing capital requirements will be to force banks to raise more capital through equity offerings,<sup>66</sup> decrease their participation in riskier, higher

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59. Tracy Alloway, *Tangled Tangibles*, FIN. TIMES (Nov. 21, 2008, 14:42 PM), <http://ftalphaville.ft.com/blog/2008/11/21/18538/tangled-tangibles/>. Common equity is defined as

‘tangible common equity,’ which is common equity minus the value of ‘intangible assets.’ Common equity is the total accounting (“book”) value of assets minus the value of liabilities (everything that the company owes) minus the value of any form of equity other than common stock, usually consisting only of preferred stock. That is, it represents the value of the assets minus everything that someone else has a claim on.

DOUGLAS B. ELLIOT, THE BROOKINGS INSTITUTE, *BANK CAPITAL AND THE STRESS TESTS* 9 (2009), available at [http://www.brookings.edu/~media/Files/rc/papers/2009/0303\\_bank\\_capital\\_elliott/0303\\_bank\\_capital\\_elliott.pdf](http://www.brookings.edu/~media/Files/rc/papers/2009/0303_bank_capital_elliott/0303_bank_capital_elliott.pdf).

60. See BASEL COMMITTEE REPORT, *supra* note 51, at 69 (stating that the capital ratio of 4.5 percent is calculated by taking common equity divided by risk-weighted assets).

61. Alloway, *supra* note 59.

62. Kerry Curry, *Higher Capital Requirements Needed on ABS, Federal Reserve Governor Says*, HOUSING WIRE (Nov. 24, 2010, 10:29 AM), <http://www.housingwire.com/2010/11/12/higher-capital-requirements-needed-on-abs-federal-reserve-governor-says-2> (“It was also apparent that at least some of the instruments that qualified as Tier 1 capital for regulatory purposes were not reliable buffers against losses, at least not on a going-concern basis . . . .” (quoting Federal Reserve Governor Daniel Tarullo)).

63. See YCHARTS PRO INVESTOR SERVICE, *Bank Capital: Tangible Common Equity vs. Wishful Thinking Ratios*, FORBES (Apr. 26, 2012, 9:35 AM), <http://www.forbes.com/sites/ycharts/2012/03/10/bank-capital-tangible-common-equity-vs-wishful-thinking-ratios/print/>.

64. BIS Press Release, *supra* note 15, at Annex 1. See also Elliot, *supra* note 24, at 3. BIS explains the rationale for the increase, stating that “[i]f bank balance sheets were always accurate and banks always made profits, there would be no need for capital. Unfortunately, we do not live in that utopia, so a cushion of capital is necessary.” *Id.*

65. BASEL COMMITTEE REPORT, *supra* note 51, at 1–2.

66. Radio Interview by Renee Montagne with David Wessel, Economics Editor, Wall St. J., (May 8, 2009), available at <http://www.npr.org/templates/story/story.php?storyId=103926731>. David Wessel, Economics Editor of the Wall Street Journal, discussed the need, during the financial crisis, for banks to raise capital, and provided several examples:

Bank of America, like any bank, has a couple of choices now. If they can, they’ll go out and raise equity by selling shares. Wells Fargo and Morgan Stanley said yesterday they’re going to do that. They can sell off businesses, and then they take the money and put that into their capital cushion. They can do this conversion of preferred stock, either preferred held by private investors or by the government already, and convert that.

*Id.*

yielding investments,<sup>67</sup> or merge with other banks.<sup>68</sup> Holding more capital aside takes money away from bank operations aimed at increasing profits,<sup>69</sup> an issue many global banks have recently spoke out about in the European banking community.<sup>70</sup> This could decrease profits and decrease the number of banks in the sector.<sup>71</sup> None of these drastic results will occur in the near future,<sup>72</sup> however, because these rules will not be fully in effect until 2019.<sup>73</sup>

Under Basel II, the remainder of capital requirements could be made up of Tier 2 capital.<sup>74</sup> This meant a bank could keep less liquid<sup>75</sup> and riskier

67. Bart, *supra* note 23 (discussing how UBS will have to alter their capital ratios in order to comply with the Basel ratio and maintain their ability to pay out dividends to shareholders); Logutenkova & Wille, *supra* note 23 (discussing how the Swiss government will almost double the capital requirements of Basel III by 2019, severely altering the asset holdings of both UBS and Credit Suisse).

68. Joe Ortiz, *Blue Skies For Banks? M&A Could Follow*, WALL ST. J. (Sept. 1, 2010, 10:41 AM), <http://blogs.wsj.com/source/2010/09/01/blue-skies-smiling-at-banks-ma-could-follow/> (discussing how banks that are well capitalized may look for opportunities to buy smaller banks in order to better position themselves for the future Basel III framework).

69. Simon Johnson & James Kwak, *Capital Requirements Are Not Enough*, THE BASELINE SCENARIO (Apr. 1, 2010), <http://baselinescenario.com/2010/04/01/capital-requirements-are-not-enough/> (“The more capital, however, the lower the institution’s leverage, and hence the lower its profits per dollar of capital invested—which is why banks always want lower capital requirements.”).

70. Bart, *supra* note 23; Logutenkova & Wille, *supra* note 23.

71. Ortiz, *supra* note 68. Ortiz describes the initial fears that Basel III would freeze lending and harm profits in the sector:

Consequently, the scare stories of earlier this year from people such as the Institute of International Finance that claimed the new regulations would hurt bank profits and their ability to help the economic recovery seem to have been consigned to the garbage. The banks won. Under “blue-sky,” Credit Suisse now sees bank returns reaching 17% by end-2012 compared with its current 14% forecast.

*Id.*

72. Suzanne McGee, *Wall Street’s Still on the Road to Risk*, PORTFOLIO.COM (Sept. 17, 2010), <http://www.portfolio.com/industry-news/banking-finance/2010/09/17/wall-street-is-bound-to-repeat-mistakes-even-after-dodd-frank-financial-reform> (discussing how Dodd-Frank and Basel III have increased the banking sector’s stability). Risk taking, as it existed prior to the financial crisis, will still be prevalent across the system as banks fight to squeeze out profits while dealing with increased capital restraints. *Id.*

73. BIS Press Release, *supra* note 15, at 7.

74. *Id.*, at 3 (“The difference between the total capital requirement of 8.0% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital.”); *Tier 2 capital*, MONEY TERMS, <http://moneyterms.co.uk/tier-2/> (last visited Jan. 14, 2012) (“Tier 2 capital is used to calculate the tier 2 capital adequacy ratio, a broader measure than the tier 1 ratio. Tier 2 capital is tier 1 capital plus subordinated debt and some less certain assets such as revaluation reserves. The tier 2 ratio is much the same as the tier 1 ratio: tier 2 capital ÷ risk weighted assets. Tier 2 capital is divided into lower and upper tiers. The upper tier consists of undated subordinated debt on which the bank can defer interest payments, essentially identical to cumulative prefs which would also fall into this tier. The upper tier also includes revaluation reserves. General provisions would also fall into this category, but as IFRS only allow specific provisions this is no longer relevant. Other subordinated debt is classified as lower tier 2 capital [sic] The tier 2 capital ratio is the most relevant measure for depositors, counter-parties and other holders of banks’ debt other than the subordinated debt. It

assets on their balance sheets as part of their core capital calculations.<sup>76</sup> Added to the Basel III requirements will be a new aspect of bank capital deemed the “capital conservation buffer”<sup>77</sup> of 2.5 percent in addition to the 4.5 percent initial common equity requirement, bringing the total common equity requirement to 7 percent. The total capital requirement of 8 percent remains unchanged.<sup>78</sup> What has changed is the increased percentage of Tier 1 capital required by the new rules.<sup>79</sup> As a result, 6 percent must be Tier 1 capital by January 1, 2015,<sup>80</sup> while Tier 2 or other forms of low risk capital can fill in the additional 2 percent.<sup>81</sup>

Finally, a countercyclical buffer<sup>82</sup> in the common equity calculation of 0 to 2.5 percent will be factored into a bank’s capital calculations, the BIS explains:

The purpose of the countercyclical buffer is to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth. For any given country, this buffer will only be in effect when there is excess credit growth that is resulting in a system wide build up of risk. The countercyclical buffer, when in effect, would be introduced as an extension of the conservation buffer range.<sup>83</sup>

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tells us what proportion of the bank’s assets could be lost with the loss entirely absorbed by holders of equity, hybrid and subordinated debt.”).

75. *Liquidity Definition*, MONEY TERMS, <http://moneyterms.co.uk/liquidity/> (last visited Feb. 13, 2012) (“Liquidity is the extent to which a security is easily tradeable. If a security is constantly trading in large quantities it is liquid. A liquid security can be sold easily and quickly, so investors have the assurance that if they wish to sell a holding they will be able to find a buyer at a reasonable price without problems. Other things being equal, the price of a liquid security is less volatile because, with a constant stream of purchase and sales being offered, each investor has less influence on the price.”).

76. *See Tier 1 Capital Definition*, *supra* note 16 (noting that tier 1 capital and core capital are often used interchangeably to describe the equity capital derived from shareholders and other disclosed reserve). Banks are expected to maintain a “safe” level of core capital to be able to absorb shocks to the financial system. *Id.*

77. *Basel Committee on Banking Supervision Reforms – Basel III*, BASEL COMMITTEE ON BANKING SUPERVISION, <http://www.bis.org/bcbs/basel3/b3summarytable.pdf> (last visited Apr. 9, 2012). The buffer zone represents an additional layer of Tier 1 capital on top of the 4.5 percent requirement, which is another provision to aid in response to an economic downturn. *Id.*

78. BASEL COMMITTEE REPORT, *supra* note 51, at 28.

79. *See id.*

80. *Id.*

81. *Id.* (“Tier 2’ adds in certain types of preferred stock that are less like common stock and more like debt, as well as certain subordinated debt securities. In addition, Tier 2 includes some accounting reserves that provide a protective function similar to other forms of capital.” (footnote omitted)); Elliot, *supra* note 24, at 5.

82. *Basel Committee on Banking Supervision Reforms – Basel III*, BASEL COMMITTEE ON BANKING SUPERVISION, <http://www.bis.org/bcbs/basel3/b3summarytable.pdf> (last visited Apr. 9, 2012). A Countercyclical buffer is “[i]mposed within a range of 0–2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.” *Id.*

83. BIS Press Release, *supra* note 15, at 2.

The new capital requirement provisions reflect a more dynamic system, able to fluctuate in times of economic growth as well as recession.<sup>84</sup> Therefore, under the new requirements, banks will be holding anywhere from the minimum common equity expectation of 4.5 percent, with an additional 2.5 percent countercyclical buffer, and an increase in Tier 1 capital, bringing the possible total up to 10.5 percent.<sup>85</sup>

## 2. RWAs

The topic of Tier 1 and Tier 2 capital leads into a discussion of how that capital is measured using RWAs<sup>86</sup> and how RWAs factor into calculating capital ratios. RWAs were part of Basel II<sup>87</sup> in an effort to curb systemic risk in the banking sector through a more dynamic approach to risk evaluation.<sup>88</sup> By assigning a percentage that reflects the relative risk of an asset, multiplying that percentage by the asset's value, and adding the number across all assets, you arrive at a risk-weighted asset value. The range in risk percentage goes from 0 to 100 percent (in certain cases, assets are assigned percentages above 100 percent), from lowest risk to highest risk assets as defined by the committee.<sup>89</sup> David J. Elliot provides an example of risk weighting is in his paper for the Brookings Institute on bank capital, entitled *A Primer on Bank Capital*:

[R]esidential mortgage loans often have a 50% risk-weighting, so that a \$1 million mortgage would generate a risk-weighted asset of \$500,000. If a bank were trying to hold capital equal to 10% of its RWA, then it would need \$50,000 of capital to cover this mortgage. If instead of making a loan immediately, the bank made a commitment to lend in the future should the homeowner wish, then the \$1 million commitment might be treated as equivalent to, say, a \$750,000 loan. After applying the 50% risk-weighting, this would produce an RWA of \$375,000 and a need for capital of \$37,500.<sup>90</sup>

Under Basel II, the above example would provide the amount of money a bank was required to hold, based on the particular asset and in accordance with the assigned level of risk associated with that asset. Under Basel III, these RWA calculations are applied to a Tier 1 capital ratio, with the amount of Tier 1 capital placed in the numerator and the RWA calculation

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84. *See id.*

85. *See id.* at 6.

86. A PRIMER ON BANK CAPITAL, *supra* note 56, at 9–14.

87. Rodriguez, *supra* note 13, at 119 (discussing risk-weighted assets' importance to the capital valuation scheme under Basel II).

88. *See Risk-Weighted Asset Definition*, *supra* note 5 (explaining the flexibility of risk-weight assets).

89. A PRIMER ON BANK CAPITAL, *supra* note 56, at 9–10 (noting that there has been much discussion over what assets receive what percentage and whether or not any assets should receive a 0 percent risk weight).

90. *Id.* at 10.

in the denominator, arriving at a percentage number that is assigned one of five ratings relating to the capitalization of a bank.<sup>91</sup> The five different ratings that may be given to Tier 1 capital ratios are: well-capitalized, adequately-capitalized, undercapitalized, significantly-undercapitalized, and critically-undercapitalized.<sup>92</sup> Under the standardized approach, CRAs<sup>93</sup> (such as Moody's, Standard & Poor's, etc.) assign risk percentages for various assets the banks hold;<sup>94</sup> however, under the AIRB approach banks evaluate the risk attached to their own assets.<sup>95</sup>

### 3. AIRB Modeling and the Standardized Approach to Capital Ratios Under Basel III

Lastly, it is important to note that the Tier 1 and Tier 2 capital measurements and the risk-weight assessments used by banks to ensure their capital structure is in line with Basel III are also created by the banks.<sup>96</sup> Two accepted practices used in Basel II are known as the "standardized approach"<sup>97</sup> and the AIRB.<sup>98</sup> The AIRB approach continues to be the favored method of valuing the risks of assets.<sup>99</sup> This level of trust in the banking sector's ability to accurately calculate capital asset values,<sup>100</sup> and in turn the risks banks were undertaking, is incongruous with a bank's goal of increasing profits.<sup>101</sup> It is this constant conflict that will eventually play out as Basel III is slowly phased in<sup>102</sup> across member nations.

Under Basel II, the theory was that global banks could create more sophisticated risk models<sup>103</sup> for measuring their own risk, which would be

91. *Tier 1 Capital Ratio Definition*, INVESTOPEDIA, [www.investopedia.com/terms/t/tier-1-capital-ratio.asp](http://www.investopedia.com/terms/t/tier-1-capital-ratio.asp) (last visited Feb. 11, 2012).

92. *Id.*

93. Smith, *supra* note 28.

94. BIS CONSULTATIVE DOCUMENT, *supra* note 38, at 6.

95. *Id.*

96. Elliot, *supra* note 24, at 5.

97. *Id.* (discussing an area of non-change between Basel II and Basel III, where banks will still internally manage their risk and assign valuations to their balance sheets).

98. Leslé & Avramova, *supra* note 57, at 5.

99. BIS Press Release, *supra* note 15 (discussing the Tier 1 capital requirement, which includes common equity and other approved financial instruments).

100. See Leslé & Avramova, *supra* note 57, at 14 ("[T]he majority of systemically important jurisdictions report under Basel II, with the Advanced IRB approach . . . ." (footnote omitted) (emphasis omitted)).

101. *Id.* at 8; see also Elliot, *supra* note 24, at 1 (explaining that compliance with banking regulation is expensive). Increases in Tier 1 capital means less bank leverage through holding riskier assets, which will put a strain bank profitability. Although banks claim the effects of Basel III will seriously harm the profitability of the banking sector, most people involved in the discussion agree that increasing capital is a cautious step in the right direction. Jamie Grant, *De-Leveraging Means Tight Credit Will Continue Through Year-End 2009*, MIRUS CAPITAL ADVISORS, <http://www.merger.com/admin/research/uploads/MCA%2009%2035Viewpoint-528a.pdf> (last visited Apr. 19, 2012).

102. BIS Press Release, *supra* note 15, at 69.

103. Elliot, *supra* note 24, at 5; Leslé & Avramova, *supra* note 57, at 21 ("By design, the AIRB formula is complex and leaves ample room for interpretation." (emphasis omitted)).

far more complex and accurate than risk analysis imposed by a third party in the standardized approach.<sup>104</sup> Many in the banking community argue that although private institutions can expend far more resources in achieving complex risk analysis and that self-interest will steer banks in the right direction, the system remains flawed.<sup>105</sup> As Basel III develops, however, opposition to the internal risk modeling theory increases, with some stating that the risk modeling must be modified.<sup>106</sup>

Basel III maintains the capital ratios of Basel II and is therefore subject to the same criticisms.<sup>107</sup> One major critique of Basel is that its internal risk models were ineffective in the detection of exposure to the mortgage crisis, which involved complex securitizations of mortgages to form towers of collateralized debt.<sup>108</sup> For example, at the height of their popularity, mortgage-backed securities held ratings from CRAs, with which banks agreed, of AAA at a level of 93 percent.<sup>109</sup> The system made a clear miscalculation in its risk analysis, and the public paid for this mistake.<sup>110</sup>

In response to the economic crisis, Basel III has elected to keep the internal risk metrics approach within the allowed calculation of risk.<sup>111</sup> The 2009 BIS Consultative Document, entitled *Strengthening the Resilience of the Banking Sector*, proposed a method of dealing with measuring exposure to credit risk:

*Credit risk:* Banks should have methodologies that enable them to assess the credit risk involved in exposures to individual borrowers or counterparties as well as at the portfolio level. *Banks should also assess*

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104. Leslé & Avramova, *supra* note 61, at 33–34 (discussing Basel II and the Advanced Internal Ratings Based Approach that was implemented to allow larger, more sophisticated financial institutions to rate their risk based on internal metrics).

105. Elliot, *supra* note 24, at 8.

106. *Id.* See also Penny Crossman, *Top 7 Ways Basel III Affects U.S. Banks and Their IT Departments*, BANK SYS. & TECH. (Sept. 15, 2010), <http://www.banktech.com/regulation/compliance/showArticle.jhtml?articleID=227400445> (explaining that the banks will need to alter their internal risk modeling). Altering the internal risk modeling could increase complexity to the calculation of risk because of additional provisions in Basel III that call for more sophisticated models, including heightened scrutiny in areas involved in the financial crisis, such as securitized products. *Id.*; Leslé & Avramova, *supra* note 57, at 31 (describing how enhanced supervision and more robust disclosure requirements as to how RWAs are decided would help investors have a better picture of the banks they invest in).

107. *Banking Day Background: Basel III*, BANKING DAY, [http://www.bankingday.com/nl06\\_news\\_selected.php?act=2&selkey=10477&stream=4](http://www.bankingday.com/nl06_news_selected.php?act=2&selkey=10477&stream=4) (last visited Nov. 22, 2010) [hereinafter *Banking Day Background*] (giving an overview of Basel III along with positives and negatives of the new requirements).

108. Elliot, *supra* note 24, at 8; see also PROVITI INC., *Ten Common Risk Management Failures and How to Avoid Them*, 3 THE BULLETIN, no. 6, at 1–5 (2008) (discussing various risk management issues and how to avoid common risk management mistakes); Crossman, *supra* note 106.

109. Peter Cohan, *Misplaced Incentives Were the Rot at the Core of the Financial Crisis*, BANKING DAY (Sept. 27, 2010), <http://www.dailyfinance.com/story/investing/financial-crisis-incentives-mortgage-backed-securities/19649593/>.

110. See *id.*

111. See *Banking Day Background*, *supra* note 107.

*exposures, regardless of whether they are rated or unrated, and determine whether the risk weights applied to such exposures, under the Standardised Approach, are appropriate for their inherent risk. In those instances where a bank determines that the inherent risk of such an exposure, particularly if it is unrated, is significantly higher than that implied by the risk weight to which it is assigned, the bank should consider the higher degree of credit risk in the evaluation of its overall capital adequacy.* For more sophisticated banks, the credit review assessment of capital adequacy, at a minimum, should cover four areas: risk rating systems, portfolio analysis/aggregation, securitisation/complex credit derivatives, and large exposures and risk concentrations.<sup>112</sup>

The standardized approach to credit risk “increases the risk sensitivity of the capital framework by recognizing that different counterparties within the same loan category present far different risks to the financial institution lender.”<sup>113</sup> This means that CRAs assign risk weights not only to asset types but also to types of borrowers.<sup>114</sup> Therefore, multiple levels of ratings must be considered when modeling risk: asset classes, CRAs, internal bank models, and risk assessments of borrowers.<sup>115</sup>

In a recent paper published by the International Monetary Fund, the authors debate the benefits and detriments of the calculation of RWAs in each framework. Among the advantages of the AIRB approach is the efficiency of banking institutions.<sup>116</sup> Although the listed disadvantages of returning to the Standardized Approach as described under Basel II (the sophistication of banks, reliance on credit rating agencies, and cost) outweigh the advantages (simplicity and transparency), it may be worth revisiting the disadvantages in an effort to modify the system.<sup>117</sup> This note advocates the creation of a modified standardized approach. This approach would address concerns such as the removal of the CRAs from the process. It would empower a disinterested organization to conduct a quarterly review of banks’ assets, assessing their relative value and risk weights in order to ensure asset bubbles are not being unduly influenced by the Basel regime.

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112. BIS CONSULTATIVE DOCUMENT, *supra* note 38, at 57 (emphasis in original) (boldface omitted) (stating the proposed revision for paragraph 733 of Basel II framework).

113. Raymond Natter, *The Basel II Standardized Approach*, AM. BAR ASS’N 1, <http://www.apps.americanbar.org/buslaw/committees/CL130000pub/newsletter/200609/natter.pdf> (last visited Oct. 30, 2010).

114. *Id.* (explaining that ratings are done on multiple levels). Still, under Basel II and continuing under Basel III, banks have their own internal ratings for their own risk management purposes, which will ultimately be used in their capital calculations. *Id.*

115. See generally Amanda J. Bahena, *What Role Did Credit Rating Agencies Play in the Credit Crisis?*, UNI. OF IOWA CTR. FOR INT’L FIN. & DEV. 5 (Mar. 2010), <http://blogs.law.uiowa.edu/ebook/uicifd-ebook/part-5-iii-what-role-did-credit-rating-agencies-play-credit-crisis> (discussing the differences between “standardized approach” and the Internal Ratings Based Approach (IRB) that remain a part of the Basel III regulation).

116. Leslé & Avramova, *supra* note 57, at 34–35.

117. *Id.*



## II. DOES BASEL III CHANGE THE FAILED SYSTEM . . . OR HAS TOO MUCH BEEN KEPT OF THE FORMER BASEL?

When looking at how the chosen RWA value is incorporated into the risk management scheme, it is important to take note of who is doing the risk ratings and how they are implemented. One question to consider is who is most qualified to assign risk weights: ratings agencies, banks, a government entity, or a combination of all three?

The problem of assigning RWAs is complicated because of the favored method of deciding risk weight, the AIRB approach, which allows for a bank to assess their capital adequacy with a view dominated by profit and self-interest.<sup>118</sup> This has led to a deviation from the standardized approach. Changes in capital requirements that influence RWAs will have implications across the banking world in terms of where the next “asset bubble”<sup>119</sup> is forming. RWAs are a major consideration in a bank’s own risk management decisions because many institutions decide to use the AIRB and are encouraged to lower RWAs to meet domestic regulations and “look attractive under their regulatory regime.”<sup>120</sup>

Under Basel III, the Basel Committee is currently conducting a voluntary test for the implementation of the new capital adequacy regulations.<sup>121</sup> As part of the examinations, this note urges the Basel Committee to attempt to revise the standardized approach to RWAs through a modified standardized approach.

### A. THE BALANCING ACT BETWEEN RWA AND CAPITAL

Basel III relies heavily on increasing the capital a bank must hold on its balance sheet in order to ensure that banks can cover their losses in times of financial emergency.<sup>122</sup> The amount of capital needed by a particular bank

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118. *Id.* at 14 (“Banks have a strong regulatory incentive to select assets that look attractive under their regulatory regime.”).

119. Kimberly Amadeo, *Asset Bubble*, ABOUT.COM, [http://useconomy.about.com/od/glossary/g/asset\\_bubble.htm](http://useconomy.about.com/od/glossary/g/asset_bubble.htm) (last visited Oct. 31, 2010) (“An asset bubble is formed when the prices of assets are over-inflated due to excess demand. It usually occurs when investors all flock to a particular asset class, such as real estate or commodities such as oil. This happened in 2005–2006 with real estate, and in the summer of 2008 with oil prices. It is a form of inflation that is not always accurately captured in the Consumer Price Index (CPI). For that reason, asset bubbles can be aggravated by low interest rates.”). See also Claudia Assis, *Emerging-Markets Bonds Raid Bubble Concern*, MARKETWATCH (Oct. 15, 2010, 6:40 PM), <http://www.marketwatch.com/story/emerging-markets-bonds-raise-bubble-concerns-2010-10-15>.

120. Leslé & Avramova, *supra* note 57, at 14–15 (describing how the influence of the Basel I or Basel II reporting scheme within a country’s domestic regulations will influence the assets that a bank carries); McGee, *supra* note 72 (mentioning how banks lobby to remain trusted to use the AIRB approach despite shortfalls of internal risk management and bank business models failing to take precautions to avoid the financial crisis).

121. BASEL COMM. ON BANKING SUPERVISION, PROGRESS REPORT ON BASEL III IMPLEMENTATION 1 (2011), available at <http://www.bis.org/bcbs/qis/biiiimplmoninstr.pdf>.

122. BIS Press Release, *supra* note 15, at 1.

will depend on its capital ratio,<sup>123</sup> calculated by dividing Tier 1 capital by risk-weighted assets.<sup>124</sup> This is one way of measuring the “health”<sup>125</sup> of a bank. Basel III attempts to use both the RWA capital ratio approach and a new leverage liquidity ratio<sup>126</sup> in order to provide a more accurate view of risk.

On Wall Street, banks are starting to comment on their current status related to capital adequacy and the new risk-weight ratio requirements that have been released under Basel III. Recently, UBS and Credit Suisse issued estimates of the costs attributable to compliance with the Basel III ratio requirements.<sup>127</sup> This will lead to less exposure to risk for banks, and will cause changes in banks’ business models with regard to how they reduce

123. *Id.* See also *Basel III – Heightened Requirements May Create New Capital Pressures*, ARNOLD & PORTER ADVISORY, 4 (Sept. 2010), [http://www.arnoldporter.com/resources/documents/Advisory-BaselIII\\_Heightened\\_Requirements\\_May\\_Create\\_New\\_Capital\\_Pressures\\_092410.pdf](http://www.arnoldporter.com/resources/documents/Advisory-BaselIII_Heightened_Requirements_May_Create_New_Capital_Pressures_092410.pdf) (discussing how many U.S. banks already satisfy the capital ratios prescribed under Basel III). Dodd-Frank may actually impose more strict requirements domestically for U.S. banks.

124. *San Francisco Region Director’s College Computer-Based Training Capital, Director’s Corner: Key Financial Ratios*, FED DEPOSIT INS. CORP., [www.fdic.gov/regulations/resources/directors\\_college/sfcb/capital.pdf](http://www.fdic.gov/regulations/resources/directors_college/sfcb/capital.pdf) (last updated Aug. 3, 2005) (discussing the meaning of capital in evaluating the risk level of a particular bank).

125. See, e.g., *Banking Health in the Ninth District*, FED. RES. BANK OF MINN., [http://www.minneapolisfed.org/publications\\_papers/bankingresearch/bankinghealth/index.cfm#earningscapital](http://www.minneapolisfed.org/publications_papers/bankingresearch/bankinghealth/index.cfm#earningscapital) (last updated Aug. 3, 2005) (discussing the various tools used to evaluate a bank’s health, including asset quality and concentration, earnings and capital, liquidity, and overall condition).

126. *Id.*

One of the underlying features of the crisis was the build up of excessive on- and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while still showing strong risk based capital ratios. During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses, declines in bank capital, and contraction in credit availability.

The Committee announced in 2009 its intention to introduce a leverage ratio as a supplemental measure to the risk-based ratio of Basel II. . . .

The leverage ratio is intended to achieve the following objectives:

- constrain the build-up of leverage in the banking sector, helping avoid destabilising deleveraging processes which can damage the broader financial system and the economy; and
- reinforce the risk-based requirements with a simple, non-risk-based “backstop” measure based on gross exposure.

BIS CONSULTATIVE DOCUMENT, *supra* note 38, at 60.

127. Jeff Horwitz, *Risk Lies in the Risk-Based Capital Approach of Basel III*, ASSET SECURITIZATION REP. (July 14, 2010), <http://www.structuredfinancenews.com/news/-208477-1.html> (“UBS analysts have estimated the plan would require global banks to raise \$375 billion in new capital.”); Bart, *supra* note 23 (noting that UBS has said their strategy will be to keep more profits and avoid raising new capital so that the bank will not be issuing dividends or making new asset purchases in the near future).

their risk-weight asset numbers.<sup>128</sup> In addition, adding risk to the balance sheets will be even more difficult due to proposed Swiss rules that will hold banks headquartered in Switzerland (e.g., UBS and Credit Suisse) to even higher capital standards than the new Basel III requirements.<sup>129</sup> As mentioned above, because the Basel Accords are influential but not binding, their adoption depends on domestic integration of the rules into each country's financial system.

In the United States, the Dodd-Frank Wall Street Reform Act<sup>130</sup> may hold banks to a capital adequacy standard above the minimum required by Basel III.<sup>131</sup> One major area of concern involving risk weights involves § 939A of the Dodd-Frank Act.<sup>132</sup> Section 939A was created to reevaluate the manner in which risk weights will be assigned by reviewing CRAs to determine alternatives to CRAs.<sup>133</sup> CRAs have been the primary player in the standardized approach to assigning RWA values.<sup>134</sup> Because the AIRB approach is only implemented by the largest banks, the standardized

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128. See Logutenkova & Wille, *supra* note 23 (discussing the ways in which banks in Switzerland will be selling contingent convertible bonds in order to raise upwards of 70 billion Swiss francs in order to meet the new relevant capital ratios).

129. See Bart, *supra* note 23 (describing how the Swiss banks fear profits are predicted to fall based on the rumors of heightened capital requirements above and beyond Basel III). Furthermore, Swiss banks are grappling with the government over a proposed total capital requirement of 19 percent. Banks are lobbying to set the requirement at 13 percent. Elena Logutenkova, *UBS Says Swiss Capital Rules Should Be Aligned Globally*, BLOOMBERG (Mar. 23, 2012), <http://www.bloomberg.com/news/2011-03-23/ubs-says-swiss-capital-rules-should-be-aligned-internationally.html>.

130. Peter J. Rivas, *Dodd-Frank Capital Requirements for Financial Institutions*, JONES WALKER (Oct. 14, 2010), available at <http://www.joneswalker.com/news-publications-659.html> ("The centerpiece of the Act's new regulatory capital requirements is Section 171, the Collins Amendment, which is intended to ensure that 'financial institutions hold sufficient capital to absorb losses during future periods of financial distress.' Section 171 directs federal banking agencies to establish minimum leverage and risk-based capital requirements on a consolidated basis for insured depository institutions, their holding companies and nonbank financial companies that have been determined to be systemically significant by the Financial Stability Oversight Council (FSOC).") (quoting Sheila Bair to Sen. Collins) (footnote omitted).

131. Ross Kerber, *US Bank Rules to be Stricter Than Basel-FDIC's Bair*, REUTERS (Oct. 20, 2010), <http://www.reuters.com/article/idUSN2024825320101021>. In her speech at Harvard University, Sheila Blair, head of the Federal Deposit Insurance Corporation, said, "she expects large U.S. banks will have to meet stricter capital requirements than specified in the new international rules known as Basel III." *Id.* (quoting Sheila Blair).

132. See Barry Hester, *Regulators Respond to Dodd-Frank*, BRYAN CAVE (Sept. 2, 2010), <http://www.bankbryancave.com/regulators-respond-to-dodd-frank/> ("These rules are to be promulgated pursuant to Section 939A of Dodd-Frank, a section which essentially eliminates regulatory reliance on the 'big three' rating agencies in developing capital standards.").

133. Lisa Pollack, *Read My Lips: No More Credit Ratings*, ALPHAVILLE (Sept. 22, 2010), <http://ftalphaville.ft.com/blog/2010/09/22/349406/read-my-lips-no-more-ratings/> ("The two major potential approaches that the agencies are seeking comment on from the industry are an exposure category approach, which applies broad risk weights by the categories that an exposure falls into, and an exposure specific approach where more granular metrics, such as credit spreads, can be used.").

134. Leslé & Avramova, *supra* note 57, at 34, 37.

approach remains relevant and should be a major focus for regulators to revisit both in the United States and around the globe.

Although the United States has not fully embraced Basel III, it appears that the United States has adopted or will agree to adopt many of the ideals of the Basel Accord (such as increased capital requirements); however, the legislature's response to RWA may be different.<sup>135</sup> Already, many top banks in the United States are predicted to fall short of the capital requirements, with estimates ranging from \$100 billion to \$150 billion.<sup>136</sup> Formerly, the United States opted to only subject the largest domestic banks to Basel II<sup>137</sup> and allowed all other institutions to remain compliant with Basel I.<sup>138</sup>

As more capital is required, the efforts to either raise that capital or shed assets that are assigned greater RWA values are necessary to increase the numerator of the ratio (capital) to comply with Basel III.<sup>139</sup> Under the new rules, risk weights across asset classes remain relatively unchanged,<sup>140</sup> while tighter constraints<sup>141</sup> as to what constitutes capital that can be used in the Tier 1 capital ratio equation<sup>142</sup> creates a stress on banks to alter what asset classes<sup>143</sup> they hold that will be risk weighted. According to Noah Millman, Basel III is simply a repeat of the RWA problems experienced in Basel II, albeit with a higher capital number required in the ratio

135. *U.S. Implementation of Basel III: Current Developments*, MORRISON & FOERSTER, 4 (Mar. 12, 2012) <http://www.mofo.com/files/Uploads/Images/120312-US-Implementation-of-Basel-III-Current-Developments.pdf>.

136. Brooke Masters & Justin Baer, *U.S. Banks Face \$100 Billion Capital Shortfall*, FIN. TIMES (Nov. 22, 2010), <http://www.cnn.com/id/40309961> ("The top 35 US banks will be short of between \$100 billion and \$150 billion in equity capital after the new Basel III global bank regulations are imposed, with 90 percent of the shortfall concentrated in the biggest six banks, according to Barclays Capital. The BarCap study assumes the banks will need to hold top quality capital equal to 8 percent of their total assets, adjusted for risk.")

137. William R. Emmons, Vahe Lskavyan & Timothy J. Yeager, *Basel II Will Trickle Down to Community Bankers, Consumers*, THE REGIONAL ECON., Apr. 2005, at 12, available at <http://www.stlouisfed.org/publications/re/articles/?id=363> ("The New Basel Capital Accord, or Basel II, is scheduled for full implementation in 2008, and it will apply initially to only about 20 of the largest U.S. banking organizations.")

138. *Id.*

139. Leslé & Avramova, *supra* note 57, at 5–6 (depicting the capital ratio and the focus on RWAs).

140. N.M., *Basel III: Third Time's the Charm?*, ECON. FREE EXCH. (Sept. 13, 2010, 5:57 PM), [http://www.economist.com/blogs/freeexchange/2010/09/basel\\_iii](http://www.economist.com/blogs/freeexchange/2010/09/basel_iii) [hereinafter *Third Time's the Charm*] (discussing that RWA, which remains in Basel III, is a major Basel II flaw).

141. BIS CONSULTATIVE DOCUMENT, *supra* note 38, at 18–21; BIS Press Release, *supra* note 15, at 2–3.

142. BIS CONSULTATIVE DOCUMENT, *supra* note 38, at 2. (discussing how Tier 1 capital increases will be helpful during times of financial crisis).

143. Huw Jones, *ANALYSIS – Implementation Key to Basel III Success*, REUTERS (Sept. 13, 2010), <http://blogs.reuters.com/financial-regulatory-forum/2010/09/13/analysis-implementation-key-to-basel-iii-success> (discussing how different asset classes are subject to various pressures to form bubbles in the market, which should be managed by using a case by case analysis based on the type of asset, the institution involved, and the country of operation).

numerator.<sup>144</sup> Keeping risk weights in play through the AIRB approach can lead to problems when future risk is evaluated to see where a particular asset falls in the RWA scheme in comparison to how a bank decided to weight the asset.

The tricky question to answer is: does the system create future asset bubbles that could lead to massive disruption across financial markets? This concern arises because of the competitive nature of the banking industry to remain profitable despite new regulations that are expensive and burdensome.<sup>145</sup> Due to the globalization of the banking sector, asset bubbles are a growing cause for concern<sup>146</sup> because of the competition across the banking sector to remain profitable and the vast array of financial products that are available to investors.

The financial crisis was caused in part by an asset bubble in the marketplace that stemmed from an investment vehicle known as the mortgage backed security (MBS), which led to large profits for banks coupled with a shift in risk.<sup>147</sup> The MBS crisis arose from the securitization<sup>148</sup> of large pools of debt into collateralized investment

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144. *Third Time's the Charm*, *supra* note 140 (keeping the RWA framework with the same risk weights is creating a similar scenario where banks will search for assets with less risk weight so that they do not have to put as much money aside if an asset underperforms).

145. Emmons et al., *supra* note 137, at 12.

146. See *Third Time's the Charm*, *supra* note 140 (“Since it did not change this risk-weighting, Basel III effectively doubles down on Basel II. Banks will need to hold more common equity than ever against [sic] their risk-weighted assets. That massively increases the incentive to find low-risk-weight assets with some return, since these assets can be leveraged much more highly than risky assets.”).

147. *Mortgages/Mortgage-Backed Securities Definition*, ENCYCLOPEDIA FOR BUS., <http://www.referenceforbusiness.com/encyclopedia/Mor-Off/Mortgages-Mortgage-Backed-Securities.html> (last visited Nov. 23, 2010) (“MBSs shift risks related to changes in interest rates, prepayment and refinancing of mortgages, and default or nonpayment, and thus trends in these same areas affect the market for mortgage securities.”).

148.

Securitization is the process of taking an illiquid asset, or group of assets, and through financial engineering, transforming them into a security.

A typical example of securitization is a mortgage-backed security (MBS), which is a type of asset-backed security that is secured by a collection of mortgages. The process works as follows:

First, a regulated and authorized financial institution originates numerous mortgages, which are secured by claims against the various properties the mortgagors purchase. Then, all of the individual mortgages are bundled together into a mortgage pool, which is held in trust as the collateral for an MBS. The MBS can be issued by a third-party financial company, such a large investment banking firm, or by the same bank that originated the mortgages in the first place. Mortgage-backed securities are also issued by aggregators such as Fannie Mae or Freddie Mac.

Regardless, the result is the same: a new security is created, backed up by the claims against the mortgagors' assets. This security can be sold to participants in the secondary mortgage market. This market is extremely large, providing a significant amount of

vehicles that CRAs improperly gave a AAA. Thus, when assets are not properly risk weighted, dangerous bubbles in the market form because of the incentive to invest in the particular “riskless” asset.<sup>149</sup> These assets will most likely have attractive yields to boost bank profitability.<sup>150</sup>

One area of increased concern raised by Millman and others across the banking community is the nature of 0 percent risk-weight assets in particular sovereign debt.<sup>151</sup> For example, “[b]onds issued by developing countries have outpaced U.S. equities, corporate debt and even many commodities in 2010 as investors looked for ways to tap into markets enjoying fast growth.”<sup>152</sup> Under the current system, sovereign debt is part of the low risk liquidity requirements,<sup>153</sup> with little money, if any, being set aside in case the underlying assets become worth less than evaluated. Thus, the choice of how to value assets becomes an exercise in how to find a way to put aside the least money and use the RWA scheme that works best for an institution.<sup>154</sup>

This creates an incentive for banks to invest in this type of debt for several reasons. First, holding highly-rated assets without having to hold capital to cover losses suffered by the potential loss of these assets saves the bank money, allowing it to remain profitable.<sup>155</sup> Second, banks looking for higher yields will be able to find them within emerging<sup>156</sup> markets where debt is sold at a high rate with a low accompanying interest rate.<sup>157</sup> Third, by shedding high risk investments, banks lower their RWA numbers and

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liquidity to the group of mortgages, which otherwise would have been quite illiquid on their own.

*What is Securitization?*, INVESTOPEDIA, <http://www.investopedia.com/ask/answers/07/securitization.asp#axzz1140YboVS.html> (last visited Feb. 1, 2011).

149. Smith, *supra* note 28, at 3 (discussing how credit ratings agencies and internal risk modeling both missed the unforeseen risk in their ratings of assets); Cohan, *supra* note 109 (describing how this occurred most recently with MBSs, where AAA ratings were given to over 93 percent of MBS’s, which proved to be grossly incorrect).

150. Assis, *supra* note 119 (discussing the growing concern in high yield foreign debt offerings, which could be responsible for producing a bubble).

151. *The Third Time’s the Charm*, *supra* note 140.

152. Assis, *supra* note 119 (providing examples in China and Brazil).

153. *Sovereign Debt and the Basle Rules – Clearing up the Confusion*, SOBER LOOK, <http://soberlook.com/2011/12/sovereign-debt-and-basle-rules-clearing.html> (last visited Dec. 7, 2011).

154. Leslé & Avramova, *supra* note 57, at 8 (“[B]anks converge toward the regulatory capital ratio that is the most favorable to them.”).

155. See *The Third Time’s the Charm*, *supra* note 140.

156. *Emerging Market Definition*, INVESTOR GLOSSARY, <http://www.investorglossary.com/emerging-market.htm> (last visited Feb. 11, 2012) (“Emerging market, or emerging economy, is market with a relatively short and uncertain history of open market relations and foreign investment. . . . Depending on its nature and commitment to becoming a free-market economy, one emerging market may be different from another. Thus for example, after the collapse of a communist regime, Russia became a notable emerging market. . . . The stock markets of any given emerging market tend to be more volatile than more established markets.”).

157. See Assis, *supra* note 119.

consequently do not need to raise additional capital.<sup>158</sup> Thus, the framework is doomed to fail due to the inverse relationship between the capital and RWA aspect of the capital ratios and will continue to encourage arbitrage<sup>159</sup> that undermines the goal of the requirements.

### III. IS BASEL III BLOWING THE BIGGEST BUBBLE YET?

The Basel capital framework will be implemented slowly over the next seven years.<sup>160</sup> Unfortunately, the higher capital ratio standards imposed by the new requirements will not remedy an inherent flaw in the system—mainly, that the capital ratios will increase competitiveness among banks and lead to increased risk taking in uncharted assets to maintain record profits.<sup>161</sup> Another concern revolves around the global sovereign debt crisis<sup>162</sup> and the global bailout<sup>163</sup> of banks over the past few years.<sup>164</sup>

In order to understand the impact of the sovereign debt crisis, one must look only as far as news clippings from the start of the Eurozone debt crisis. In 2010, news outlets reported that Greece had debt equal to 115 percent of its GDP.<sup>165</sup> This situation was further complicated by the Greek government's lack of cooperation with the European Union<sup>166</sup> in resolving their debt crisis.<sup>167</sup> Although faced with economic turmoil, Greece issued government debt with 20 percent yields.<sup>168</sup> Almost simultaneously, major concerns arose in Portugal and Spain surrounding their ability to meet debt obligations,<sup>169</sup> while Italy became increasingly aware of its questionable economic health due to a nearly failed debt auction.<sup>170</sup>

Next came the European Union bailouts. The Wall Street Journal reported that “[t]he European Union agreed on an audacious €750 billion (\$956 billion) bailout plan in an effort to stanch a burgeoning sovereign

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158. Bart, *supra* note 23; Interview by Renee Montagne, *supra* note 66.

159. See *supra* text accompanying note 7.

160. *Banking Day Backgrounder*, *supra* note 107.

161. *Id.*

162. Vincent Fernando, *Europe's Giant Bailout Fund Ignores The Root of the Debt Problem And Actually Makes Things Far Worse*, BUS. INSIDER (May 10, 2010), <http://www.businessinsider.com/europes-bailout-fund-ignores-moral-hazard-2010-5>.

163. Stephen Glover, *Would it be so Bad if the Euro Failed?*, ONLINE MAIL (Nov. 23, 2010), <http://www.dailymail.co.uk/debate/article-1332216/IRELAND-BAILOUT-Would-bad-euro-failed.html>.

164. *Id.*

165. *Europe's Sovereign Debt Crisis: Acropolis Now*, THE ECONOMIST, Apr. 29, 2010, available at <http://www.economist.com/node/16009099> [hereinafter *Acropolis Now*].

166. *Id.* (“[Greece] cannot grow out of trouble because of fiscal retrenchment and its lack of export prowess. It cannot devalue, because it is in the euro zone. And yet its people seem unwilling to endure the cuts in wages and services needed to make the economy competitive. In short, Greece looks bust.”).

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.*

debt crisis that began in Greece but now threaten[ed] the stability of financial markets world-wide.”<sup>171</sup> Investors celebrated the news, and the Dow Jones Industrial Average<sup>172</sup> soared over 400 points.<sup>173</sup> Although the EU was commended for its cooperative efforts to save the Euro,<sup>174</sup> and for rescuing member nations with sovereign debt troubles,<sup>175</sup> the long-term effect of the bailouts may encourage continued risky behavior around the world.<sup>176</sup> For example, in November 2010, Ireland agreed to a government debt bailout of £70 billion,<sup>177</sup> which was the first of probable government bailouts across Europe.<sup>178</sup>

What do government bailouts and the Basel III risk-weight asset framework have in common? The overall theme of international cooperation across the banking sector encompassed in Basel III may be at the heart of the problem due to the political nature of the Basel negotiations,<sup>179</sup> a thought discussed in Felix Salmon’s article, entitled *Grading Basel III*<sup>180</sup>:

Basel III has been put in place by a group of 27 national governments. All of those governments have to borrow money. They want to ensure that their borrowing costs are as low as possible. And one very effective way of doing that is to ensure that government debt has a very low risk weighting, and that banks don’t need to hold much if any capital against it.<sup>181</sup>

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171. Stephen Fidler & Charles Forelle, *World Races to Avert Crisis in Europe*, WALL ST. J. (May 10, 2010, 5:50PM), <http://online.wsj.com/article/SB10001424052748703880304575235632618569478.html>.

172. Joshua Kennon, *What is the Dow Jones Industrial Average*, ABOUT.COM, <http://beginnersinvest.about.com/cs/newinvestors/f/whatisdowjones.htm> (last visited Feb. 13, 2012) (“The Dow Jones Industrial Average (DJIA) is an index of thirty, blue chip stocks that are traded in the United States. It is believed that by looking at the companies on the list, a person can get a general picture of how the market as a whole is performing.”).

173. *Stocks Bounce Back Big-time After EU Euro Plan*, MSNBC.COM (May 10, 2010, 5:29 PM), [http://www.msnbc.msn.com/id/37059741/ns/business-stocks\\_and\\_economy/](http://www.msnbc.msn.com/id/37059741/ns/business-stocks_and_economy/).

174. *See id.*

175. *See id.*; *see generally Acropolis Now*, *supra* note 165 (discussing the sovereign debt troubles faced by Greece, Portugal, Spain, and Italy).

176. McGee, *supra* note 72 (discussing how Wall Street continues to make mistakes).

177. Glover, *supra* note 163.

178. *Id.* In 2011, Portugal received a \$110 billion bailout from the European Union. *Portugal’s 78bn Euro Bail-Out is Formally Approved*, BBC NEWS (May 16, 2011, 7:07 PM), <http://www.bbc.co.uk/news/business-13408497>. In 2012, Greece received a \$170 billion bailout from the European Union. Gabrielle Steinhauser & Sarah Dil Orenzo, *Greek Debt Crisis: European Union to Give \$170 Billion Bailout to Greece*, HUFFINGTON POST (Feb. 20, 2012, 11:06 PM), [http://www.huffingtonpost.com/2012/02/20/greek-debt-crisis\\_n\\_1289242.html?view=print&comm\\_ref=false](http://www.huffingtonpost.com/2012/02/20/greek-debt-crisis_n_1289242.html?view=print&comm_ref=false).

179. Felix Salmon, *Grading Basel III*, REUTERS (Oct. 1, 2010), <http://blogs.reuters.com/felix-salmon/2010/10/01/grading-basel-iii/>.

180. *Id.* (discussing the shortcomings of Basel II that Basel III needed to address in order to be successful).

181. *Id.*



What is dangerous about an asset bubble forming in the asset category of sovereign debt? According to Millman, the topic of the risk-weight framework and the search to decrease the money that banks must hold against their assets was offered as a warning to the Basel III interaction with sovereign debt.<sup>182</sup> Millman explains:

Since it did not change this risk-weighting, Basel III effectively doubles down on Basel II. Banks will need to hold more common equity than ever—against their risk-weighted assets. That massively increases the incentive to find low-risk-weight assets with some return, since these assets can be leveraged much more highly than risky assets. Unless I've missed something, lending to AA-rated sovereigns still carries a risk-weight of zero. So one result of Basel III could be to encourage banks to increase their lending to sovereigns at the margins of zero-risk-weight status. If that happens, anyone want to guess where the next crisis will crop up?<sup>183</sup>

Thus, the self-interested governments that created this framework may have tilted the rules governing RWAs in their favor to allow banks to continue lending to troubled nations.<sup>184</sup> In return, banks can put more of their money to work while the world is seemingly a safer place because of the bailout culture that has developed over the past ten years.<sup>185</sup> Taxpayers are left to foot the bill as a result of poor investment decisions by various financial institutions.<sup>186</sup> Changes to the framework are necessary to deter banks from prioritizing profits over shareholder and institutional safety.

#### **IV. THE SOLUTION: INCREASE RISK WEIGHTS FOR SOVEREIGN DEBT AND REVISIT THE STANDARDIZED APPROACH—THERE IS NO SUCH THING AS ZERO-RISK**

Basel III would be more effective if risk weights assigned to sovereign debt were significantly increased by a disinterested self-regulatory organization. To ensure that banks do not have any reason to avoid the intended effects of the capital requirements, one might avoid the standardized and AIRB approaches for assigning risk weights altogether and instead opt for an outside, independent regulatory body to be constructed by the global community to monitor risk weight, and, in particular, assess the stability of government debt on a case-by-case basis. This self-regulatory organization should be charged with quarterly analysis of risk weights to facilitate a dynamic approach to managing risk. The board could respond to asset bubbles by reviewing bank capital to achieve a

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182. *The Third Time's the Charm*, *supra* note 140.

183. *Id.*

184. *Id.*

185. David Weldner, *The Bailout Culture Turns 10*, MARKETWATCH, [http://articles.marketwatch.com/2008-09-11/news/30745643\\_1\\_bailout-ltcm-john-meriwether](http://articles.marketwatch.com/2008-09-11/news/30745643_1_bailout-ltcm-john-meriwether) (Sept. 11, 2008).

186. *Id.*

dynamic approach to heightening risk weights. If, for example, risk weights increase enough for the sovereign debt asset class, banks will have less incentive to squeeze out profits by overinvesting in zero-risk assets that could overexpose the global community to an asset bubble.<sup>187</sup> The efforts on the part of the regulators should be to identify asset classes that have become or may become bubbles that could damage the global economy. It is important that within this regime, there be both intelligent investments in government debt as well as protection against shortcuts to meet capital requirements. In hindsight, both the CRAs and the banks themselves were involved in gross miscalculations that led to a world financial crisis.<sup>188</sup> In the spirit of global cooperation, why not remove the credit ratings and the AIRB approach from such a central role in the process, and instead, create a neutral supervisory board that will take account of credit ratings and internal bank ratings while completing an independent assessment of the accuracy of these ratings?

There are benefits and detriments to improving the standardized approach and to maintaining the AIRB approach. This note argues that because of the complexity and lack of transparency of the AIRB approach,<sup>189</sup> revisiting the standardized approach will be an easier and more efficient method of addressing issues of credibility that are currently hampering Basel III from being a true tool for change.

The modified standardized approach could influence banks in the Basel framework. If the AIRB approach is going to be effective moving forward, greater transparency is needed to ensure that there are not gross deviations from the RWA percentages assigned under the modified standardized approach. It is unlikely that a bank would agree to share their methodology for RWA measurements, as this is an aspect of the competitive advantage over other institutions. Instead, penalties should be levied against banks to deter them from skewing RWA calculations in such a way that leads to losses.

The modified standardized approach could potentially influence banks in a jurisdiction that still uses the AIRB approach. A bank that deviates from the modified standardized approach by an agreed upon value would not have the same access to bailout money that was previously afforded with generosity across the banking sector in the United States and Europe. Under this new framework, member nations would have to agree to the fundamental principle that no asset could receive a rating close to a 0 percent risk weight, placing an emphasis on intelligent asset purchases over money-saving shortcuts.

Furthermore, member nations to Basel would have to decide on a self-regulatory organization to provide the RWA percentages. Interested parties,

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187. *See id.*

188. *Id.*

189. Leslé & Avramova, *supra* note 57, at 34–35.

such as CRAs, must be removed from the process to allow for this modified standardized approach to gain a foothold in the banking industry. As we just saw in the United States, a AAA country came close to default because of a political dispute. The default would have had nothing to do with the near-term financial health of the United States, but is just one example of a need to periodically revise the risk associated with varying assets by a disinterested third party. The advisory board would protect investors and limit the likelihood of failed banking institutions. Banks and CRAs could still be involved in the process through comment and review of revised capital proposals.

Lastly, to address the concern that AIRB method is better for the banking community, the regulators need to recruit talent to assess risk weights on an asset-by-asset basis. Building up a modified standardized approach to influence banks who continue to use the AIRB approach will be aided by establishing credibility that CRAs lost in the financial crisis. This concept will address the idea that the modified standardized approach is “throwing the baby out with the bath water”—it will increase efforts to have a dynamic review process of the value and relative risk of assets, and it will improve the assessment of banks and their risks to the financial system as a result of their asset positions.

## CONCLUSION

Is Basel III the alternate reality that we would travel back in time to create? The rules were released by the BIS on December 17, 2010, and have been met with concern around the globe. Increased capital requirements are a logical step in the right direction, but the world should stay alert to the choices that banking leaders make today that will most certainly alter tomorrow. The next asset bubble could be forming right now due to the Basel III capital/RWA ratio framework.

In the end, Basel III appears to be more of a Basel II with a few extra ingredients added in, and will make banks hold more capital while allowing leeway in their calculations of RWAs to avoid the intended effects of making the system safer. Although the AIRB approach was kept in Basel III and CRAs are still being reevaluated, the Basel Committee plans on revisiting the prescribed risk multiples assigned to asset classes. This means the RWA structure will be altered by assigning new percentages to various asset classes in order to instruct the banks on how much money they must hold in order to ensure their assets are backed by an appropriate amount of money relative to the risk assigned to that asset. The significance of the changes made to RWAs in the sovereign debt asset class is yet to be seen. If Basel III hopes to be effective, significant increases in RWAs will be needed to avoid asset bubbles. A greater degree of independence among those who decide on how the system operates is also an area that Basel III should embrace through the use of a modified standardized approach to

assigning RWAs. The analysis will involve the interplay of Dodd-Frank Wall Street Reform Act and Basel III in an effort to create a safer banking sector.

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