# Political Economy and Basel Process

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# Political Economy and Basel Process

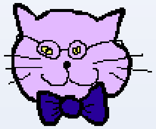
Corruption is our protection. Corruption keeps us safe and warm. Corruption is why you and I are prancing (living in luxury) around in here instead of fighting over scraps of meat out in the streets. Corruption is why we win. We have laws against it precisely, so we can get away with it.

Corruption is government intrusion into market efficiencies in the form of **regulations***.
That's Milton Friedman. He got a goddamn Nobel Prize.

*Frequently misattributed to Milton Friedman based on a monologue from the 2005 movie Syriana

What is Political Economy?

## Political Economy is the <u>investigative</u> branch of history which analyses the evolution of mankind along the pathways of its long journey from a primordial tribe to a sophisticated civilization in terms of <u>political science, economics</u> and <u>philosophy</u>.



*The explanations are based on the views of a veteran PhD candidate Ali TARHAN who is a *real* political economist.

# Political Economy and Basel Process

***By description, political economists are very rare.**

**So are the real Basel experts!**

***If there is any they must feel themselves very lonely.**

**So are the real Basel experts!**



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# Political Economy and Basel Process

*The complicated and demanding nature of political economy is very discouraging that the majority of social scientists neither can easily grip, nor want to be entrapped in this tough field.

*The complicated nature of Basel 2/3 is so discouraging that majority of people thinks it as a ratio of capital to something calculated in some way!



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## Political Economy and Basel Process



*We cannot expect to see a person having both capacities of a historian and a philosopher in our business world, streets, friend circles, even at our academies.

*We always hope to meet somebody who really knows what the Basel Regulatory Process is! If we find (by chance) we ask for a training or a few short questions at least!



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What is Political Economy?

# Political Economy and Basel Process

***We can finally accomplish to squeeze all crucial concepts of political economy in just three words:**

-History in investigation

-Civilization in evolution and

-Philosophy in sophistication

Namely,

-Bankers, traders, regulators and supervisors <u>under investigation</u>

-B-2/3 training and education <u>in evaluation</u>

-Models and calculation <u>in sophistication</u>



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**It is no longer the *old* geography with competing nation states as the key spatial (3-D) units of interest,**

**but**

**a *new* geography is emerging, where *globally dispersed* creditors and debtors are the main actors.**

Based on the views of Bieri, D.S., 2009



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**ATTENTION !**

**Individual governments *(central banks, regulators and supervisory institutions)* continue to influence international financial markets …through monetary and fiscal policy by influencing the *regulatory architecture* of the global financial system (i.e.TARP, QE etc.).**



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Albeit (at the expense of) co-ordinating their efforts at the level of international financial institutions !

This situation should be monitored carefully!

Because:

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**Instead of bringing about a more uniform distribution of risk in financial space, globalized capital markets have encouraged the build-up of significant, regionally concentrated imbalances.**

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Rather than reducing it, *financial globalization* has actually increased overall *systemic risk*. True & False?



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# Political Economy and Basel Process

## Refresh our memories:

Bankhaus Herstatt (1974)

BCCI (1991)

Barings (1995)

LTCM (1998)

AIB (2002)

Society Générale –Kerviel (2008)

Northern Rock, Bear Sterns, Lehman Brothers, Wa-Mu , AIG (global financial crisis, 2007-.....)

## **Did Basel Committee take any precautionary measures?**

- Establishing internal control systems
- Home-host country responsibility
- Corporate governance
- Market & credit risk
- Operational risk
- Model based calculations ….



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## Political Economy and Basel Process

# **Basel Process:**

The *Basel Process* helped us in some different ways:

1. Initiation of a dialogue between supervisors and supervised institutions
2. Incorporating new techniques into the current financial system
3. Increased international dialogue between both supervisors and bankers
4. And so on….



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# Basel Process:

The recent sub-prime crisis has subjected the *Basel Process* to intense internal and external scrutiny.



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## Political Economy and Basel Process

### Basel Process:

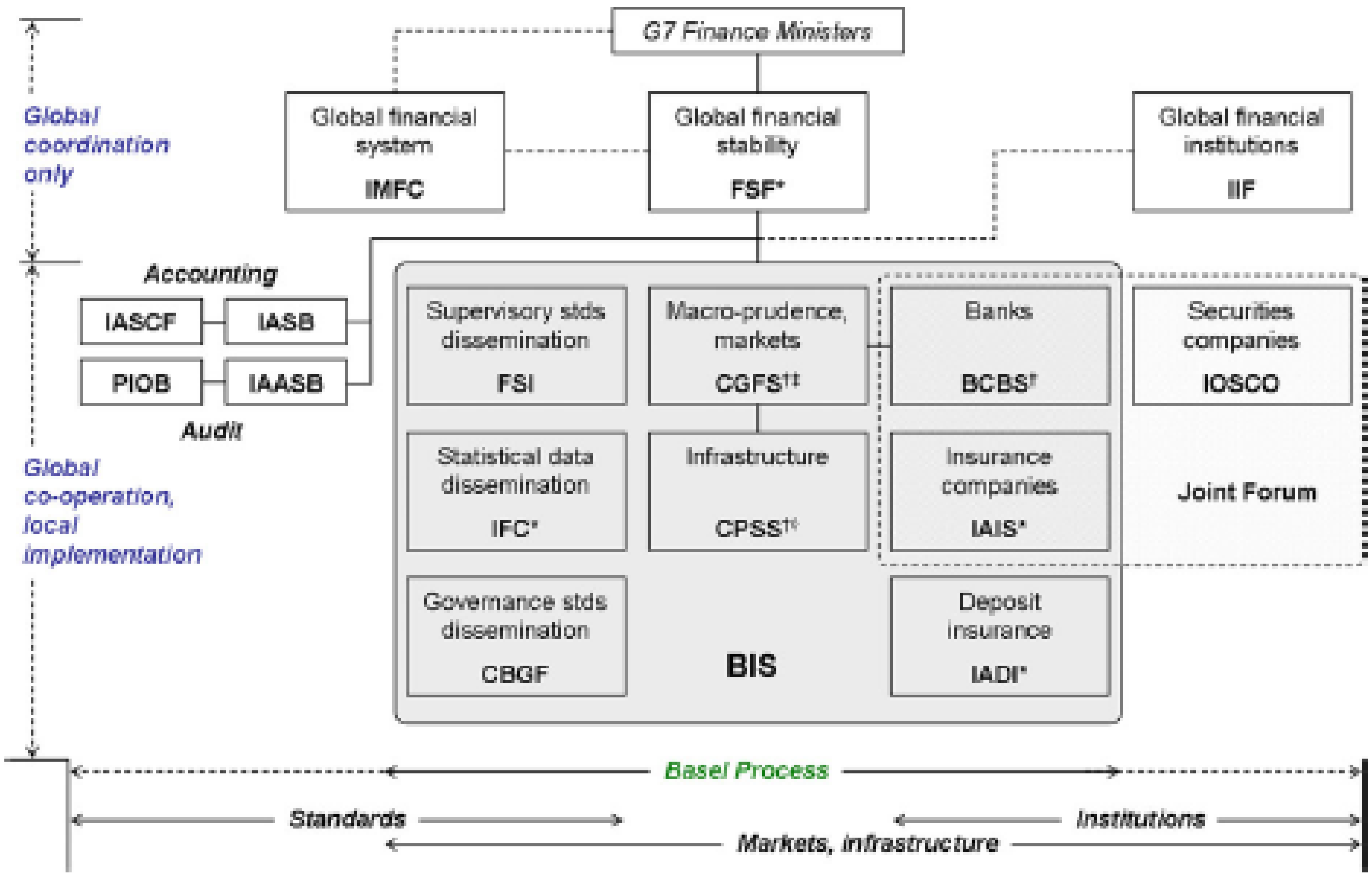
However, *Basel Process* seems uniquely positioned to provide policy makers with an institutional arrangement that straddles the gap between the old and the new geographies of financial markets.

# Political Economy and Basel Process

The chart in the next slide highlights that although the global financial system is increasingly interlinked, much of the international regulatory system still operates on a sectoral level.

While this dichotomy is ever more problematic, the *Basel Process* provides a unique institutional framework for future regulatory and supervisory co-coordination.

# Global Regulatory System and the Basel Process



# Political Economy and Basel Process

## Unique characteristics of the Basel Process

***Comprehensiveness:***

Continuous adaptation of changing circumstances of the global financial system

***Regional inclusiveness:***

Despite its global focus, the Basel Process is able to incorporate regional elements without necessitating separate regional channels for co-operation [see Yoshikuni (2002)].

# Political Economy and Basel Process

## Unique characteristics of the Basel Process (cont'd)

***Flexibility and scalability:***
Responding to global financial challenges in a timely manner, regular meetings (nearly all related parties), cooperation with the EU…

# Political Economy and Basel Process

## Unique characteristics of the Basel Process (cont’d)

***Network elements of the Basel Process:***
the Basel Process plays a little-discussed, but vital role in the formation of *regulatory human capital* by representing a vast network of contacts across institutions and markets within the global financial system[see Agrawal et.al., (2008) and Volker and Ferguson (2008)].

# Political Economy and Basel Process

And finally (in my view) the most important one is the ***QIS***s… Namely a hands on practice measuring the impact of regulatory arrangements….

In line with the Basel Process' overall philosophy as an ongoing progression of policy cooperation, the QIS did not end after the release of the Basel II Framework.

## SOME LATIN MIGHT HELP US TO BETTER UNDERSTAND BASEL 2/3

*Ignotum per ignotius*

The unknown by the more unknown

*Ignoramus et ignorabimus*

We don’t know and will not know

*Ignotum per æque ignotum*

The unknown by the equally unknown



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## Why Basel regulations severely criticized?

It's time to kill the culprit-Basel-

Basel regulations are emanated from a *highly politicized* committee process, and were the product of innumerable *arbitrary decisions*, *irrational compromises*, and *political horse-trades* not to mention to the *personalities* and *prejudices* of the main participants involved.

*(Dowd and Hutchinson, Alchemists of Loss, 2010)*

## Why Basel regulations severely criticized?

Rebonato (2005) quotes an unnamed "very senior official of one of the international regulatory bodies" who, in "looking over the hundreds of pages of the brand new, highly quantitative, bank regulatory regime (Basel II) … sighed: "It does read a bit as if it has been written without *adult supervision*"…

# Why Basel regulations severely criticized?

## Main anti-Basel arguments:

1. Use of discredited VaR measure as a base for capital adequacy requirements,
2. Pressuring banks to follow similar risk measures
3. Encouraging banks to Regulatory arbitrage through standardized and/or model based approaches
4. Pro-cyclicality/Complexity
5. Heavy reliance on –notorious-rating agencies' ratings
6. Difficult to implement but more difficult to supervise
7. If it has worked properly, we would not face a global financial crisis!

*(Dowd and Hutchinson, Alchemists of Loss, 2010)*



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## What is Basel really missing?

It is ***political risk***!

Yet *political risk* is not explicitly covered under Basel 2/3, and is not likely to be in the future. What this means is that there is *no requirement* for most corporations to consistently monitor and report on the political risks they face. As we saw with the example of *British construction firms operating abroad*, this can lead to an *ad hoc* approach to gathering and reporting data on political risk. (Bremmer, I. And Keat, P., *The Fat Tail, 2009)*

*Does history repeat itself?*

Think the situation in Libya and the Turkish construction companies and their lending counterparties once again!



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# Is 2019 deadline realistic?

**Annex 2: Phase-in arrangements (shading indicates transition periods)**
**(all dates are as of 1 January)**

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | As of 1 January 2019 |
|---|---|---|---|---|---|---|---|---|---|
| Leverage Ratio | Supervisory monitoring | | Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015 | | | | | Migration to Pillar 1 | |
| Minimum Common Equity Capital Ratio | | | 3.5% | 4.0% | 4.5% | 4.5% | 4.5% | 4.5% | 4.5% |
| Capital Conservation Buffer | | | | | | 0.625% | 1.25% | 1.875% | 2.50% |
| Minimum common equity plus capital conservation buffer | | | 3.5% | 4.0% | 4.5% | 5.125% | 5.75% | 6.375% | 7.0% |
| Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials ) | | | | 20% | 40% | 60% | 80% | 100% | 100% |
| Minimum Tier 1 Capital | | | 4.5% | 5.5% | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| Minimum Total Capital | | | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| Minimum Total Capital plus conservation buffer | | | 8.0% | 8.0% | 8.0% | 8.625% | 9.125% | 9.875% | 10.5% |
| Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital | | | Phased out over 10 year horizon beginning 2013 | | | | | | |
| | | | | | | | | | |
| Liquidity coverage ratio | Observation period begins | | | | Introduce minimum standard | | | | |
| Net stable funding ratio | | Observation period begins | | | | | | Introduce minimum standard | |



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## Is 2019 deadline realistic?

The *consultative process* usually adopted by regulators to design and implement new language and implement decisions is ridiculously *unsynchronized* with the *pace of financial markets*.

It took *10 years* to discuss and refine the mere guidelines of Basel-2 while *5 years* the CDS outstanding notional grew to equate to the GDP of the planet.

*(Carrel, P., The Handbook of Risk Management, 2010)*

# Is 2019 deadline realistic?

**Long way to go**
**2011….2015…2019…**




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# Question of the Presentation

As eloquently put by investment firm Coxe Advisors: “In terms of balance-sheet caution and coverage, Basel II was to Basel I what a **bikini** was to a **burkha**”.

Wall Street Journal Europe, 28/12/2009,
**Time for Banks to End Their Addiction**

If above statement is true; what can we say about Basel III to Basel II?

a) G-string
b) B-string*
c) Warren-Buffet style (swimming naked)
d) Impossible

*B does not stand for Basel



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Thanks

Your questions most welcome ☺

**BUT**

answer is not guaranteed ☹

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Thanks