Basel III and Credit Risk Measurement: Variations Among G20 Countries

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Basel III and Credit Risk Measurement:
Variations Among G20 Countries

MATT SCHLICKENMAIER*

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I. INTRODUCTION

Most countries require banks to hold extra capital to protect against unforeseen financial calamities; banks with riskier loans must hold more capital than those with safer loans. Basel II, a set of international banking standards, allows banks to measure a loan’s risk in different ways: some banks make their own judgments; others use outside agencies. The recent mortgage crisis prompted banks to reevaluate these methods, in part due to banks having failed to perceive the high level of risk inherent in securitized mortgages. The international community’s response was Basel III, an updated version of its previous standards. This Comment will look at how Basel III’s implementation will change the way banks measure the credit risk of their loans.

Part I of this comment will examine how credit risk measurement fits into the overall Basel scheme; Part II will analyze Basel II’s options for estimating credit risk; Part III will illustrate how inaccurate credit risk estimations contributed to the mortgage crisis; Part IV will explain the new Basel III rules; and Parts IV and V will examine problems with the Basel III rules and propose some solutions.

II. THE IMPORTANCE OF CREDIT RISK MEASUREMENTS

One important component of the financial crisis of 2008 was poor information. Banks and investors falsely believed that they held low-risk assets; regulators incorrectly believed that banks had enough capital to weather tough times; and both banks and regulators mistakenly believed that they had fully accounted for all possible risks. Although no single

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3. Id. at 2–3.
4. Id. at 3.
factor caused the financial crisis, reliance on bad information played a significant role.

Prior to the financial crises, specific rules designed to prevent banks from failing had been in place. Regulations derived from the Basel II accord, an international agreement that set baseline capital requirements for banks, were in force in many countries. The basic idea behind the original Basel rules, Basel I, was that banks were required to counterbalance risky investments with a sufficient cushion of backup capital. Because some loans are riskier than others, Basel I “weighed” each one. Depending upon the kinds of loans the bank made, the bank would have to hold more, or less, extra capital. Essentially, the Basel rules classified each loan under a different category of riskiness. Under Basel I, generally only one method of categorizing an asset’s level of risk existed. Later, Basel II attempted to give banks more flexibility by offering the banks more choices: banks could use credit rating agencies (“CRAs”) or their own risk models.

The Basel II rules presumed that both the CRAs and the bank’s internal models were accurate. If either model misjudged the riskiness of particular assets, the rules would require the bank to hold too much, or too little, capital. Unfortunately, neither the internal models nor the

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6. The origin of the Basel rules was a response to the failure of an internationally connected German bank in 1974. The event prompted the Basel Committee to publish the first Basel accord in 1988. Id. at 10.
7. King & Tarbert, supra note 2, at 1.
8. One Basel Leads to Another, supra note 5, at 10. For example, a loan to a rich Western country would have a risk weight of 20%, but a loan to a company would have a risk weight of 100%. Id. Thus, the borrowing party determined how risky the loan was and therefore the amount of capital the bank had to hold. King & Tarbert, supra note 2, at 2.
9. Id.
11. King & Tarbert, supra note 2, at 2.
12. See infra Part III.C.
13. See infra Part III.C. By analogy, if your nutritionist has rules about how much fat or calories you should eat per day, depending upon your weight, that is fine as long as your scale is accurate. But if you use a faulty scale, the nutritionist’s rules will cause you to either eat too much or too little fat, depending upon whether the scale under- or overestimates your weight.
CRAs were entirely accurate. Neither option was ideal at objectively measuring risk; each one contained its own unique set of problems.

III. MEASURING RISK UNDER BASEL II

A. Standardized and Internal Risk-Based Approaches

In an attempt to make its application more flexible, the Basel Committee broadened Basel I’s “one size fits all” approach into roughly two categories. Basel II therefore provided banks with a choice: use risk categories based on CRAs or use the bank’s own credit risk models.

The first approach, known as the “standardized approach,” relies on CRAs. This method is the simpler of the two and “is designed for smaller banks with less sophisticated risk-modeling and risk-management systems.”

The second, more complicated option is the “internal risk-based approach” (“IRB”). This approach allows a bank to make its own assessment of risk, rather than rely on CRAs. The IRB option applies to banks that already have sophisticated risk modeling and risk management systems in place. A bank can use its own data to determine the risk level of its loans by analyzing 1) the probability of default in one year, 2) the bank’s exposure and losses if there is a default, and 3) when the borrower will likely repay if it does not default. Within IRB, there are two further options: advanced IRB and foundation IRB. Foundation IRB entails more oversight than advanced IRB. The foundation approach allows banks to estimate the probability of default for each asset but requires the bank supervisors to estimate the three other factors. The advanced approach (which is only available for the most sophisticated
banks) permits a bank to make most of the estimates, provided the bank supervisors approve them.\textsuperscript{26}

\textbf{B. Assumptions of Basel II}

Basel II based its increased flexibility on two assumptions: 1) that regulators can adequately supervise a bank’s IRB decisions, and 2) that market discipline will incentivize banks to make prudent decisions.\textsuperscript{27} Overall, the Basel Committee believed “that the cumulative effect of implementing strict supervisory review and market discipline, used in conjunction with risk assessment analysis, [would] create a far more stable international banking environment.”\textsuperscript{28} Both assumptions, however, have been subject to criticism.\textsuperscript{29}

First, the idea that regulators can adequately police large banks may have been too optimistic. One problem with relying on national regulators is that they tend to focus on default risk alone. If, for example, a large bank’s portfolio leaves it exposed to other risks such as changing interest rates, regulators may miss these potential risks.\textsuperscript{30}

Second, the idea that market discipline will ensure that banks act prudently may be incorrect.\textsuperscript{31} Basel II requires banks to make public information about their assets and liabilities and explain how they measure credit risk. Some have argued that this requirement does not really depend upon market discipline but “transparency and disclosure.”\textsuperscript{32} If regulators wanted to rely more heavily on market discipline, they could require banks to issue publicly-traded, subordinated debt, or abolish deposit insurance.\textsuperscript{33} Such transparency and disclosure may not be as motivating as the threat of possible bank failure.

\begin{itemize}
\item \textsuperscript{26} Id.
\item \textsuperscript{28} Id.
\item \textsuperscript{29} See generally One Basel Leads to Another, supra note 5.
\item \textsuperscript{30} Id.
\item \textsuperscript{31} Id. at 12.
\item \textsuperscript{32} Professor George Kaufman of Loyola University in Chicago makes this criticism.
\item \textsuperscript{33} Id.
\end{itemize}
C. Problems with Basel II’s Standardized and IRB Approaches

1. Standardized Approach

Basel II’s standardized approach ultimately relies on the judgment of CRAs, whose responsibility is to make it easier for investors to make informed decisions. The two principal purposes of CRAs are to promote capital market efficiency and to manage risk. In theory, CRAs provide an important function by helping investors mitigate risk, avoid bad investments, and make more efficient use of their resources. In practice, however, this has not always been the case. The relationships between CRAs, investors, issuers of securities, and regulators create a number of problems.

Criticisms of CRAs center around a few basic issues: a conflict of interest incentivizing CRAs to give inflated ratings; so-called “rating shopping” among issuers of securities; CRAs that advise issuers on how to obtain a certain rating; and the dependence of government regulations on credit ratings.
CRAs are profit-driven companies that must provide objective ratings.\textsuperscript{44} Furthermore, CRAs are paid by the same people whose securities they rate.\textsuperscript{45} The higher the rating a CRA can provide, the more securities an issuer can sell, and the more likely it is that the issuer will hire that CRA again.\textsuperscript{46} CRAs thus have an incentive to inflate their ratings.\textsuperscript{47} These conflicts can lead to “rating shopping.”\textsuperscript{48} Rating shopping occurs when an issuer discovers beforehand the rating that a CRA will give a particular issuance. An issuer can obtain this information either by running a publicly-available rating model or paying a CRA for a preliminary opinion. The issuer then “shops around” and employs the CRA that will provide the most favorable rating.\textsuperscript{49} This race-to-the-bottom scenario is one principal argument against the issuer-pays model.\textsuperscript{50}


\textsuperscript{45} Id. at 652–53.

\textsuperscript{46} See id. One counterargument, however, theorizes that reputational concerns mitigate perverse incentives. Id. at 629–30. A CRA that inflates its ratings, the argument goes, would quickly lose its reputation for objectivity, which would lead to a loss of business. Id. at 631, 633. Others have dismissed this line of thought, countering that reputational integrity does little to balance the fact that CRAs are “captured” by the firms they rate. Jonathan R. Macey, A Pax on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules, 81 WASH. U. L.Q. 329, 342 (2003).

\textsuperscript{47} See Frank Partnoy, Infectious Greed: How Deceit and Risk Corrupted the Financial Markets 250–51 (2003). Such a conflict can lead to reluctance to downgrade a security that is clearly poorly performing. Id. One prominent critic of CRAs, Professor Frank Partnoy, professor of law and finance at the University of San Diego, notes that in the 1990s, for example, CRAs “downgraded companies only after all the bad news was in, frequently just days before a bankruptcy filing. Nevertheless, investors continued to trust the credit-rating agencies, and regulators continued to rely on them.” Id. Moreover, after the recent mortgage crisis, the SEC found that the “conflicts created from the ‘issuer pays’ model in rating structured finance products; particularly RMBS [residential mortgage-backed securities] and related-CDOs, may be exacerbated.” SEC, EXCH. COMM’N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 1, 31 (2008) [hereinafter RATING AGENCIES].

\textsuperscript{48} Crawford, supra note 35, at 44.

\textsuperscript{49} Id.

\textsuperscript{50} Id.
b. CRA Consulting

CRAs often advise issuers on how to organize securities in order to receive a particular rating. Mortgage-backed securities (“MBSs”) and collateralized debt obligations (“CDOs”), both of which were prevalent leading up to the financial crisis, are both malleable and complex. Their complexity, however, makes their risk level difficult to estimate. Frequently, CRAs give issuers advice on “credit enhancement” (ways to improve the rating by insuring or collateralizing the security), and on how to separate the security into different pools of risk. Although the SEC later issued a rule preventing the same CRA from both advising and rating the security, most CRAs employ similar methodologies, and thus advice from one CRA often translates to another.

c. Government Reliance on CRAs

A related problem is the fact that numerous laws and regulations rely upon CRA ratings. In the 1970s, the SEC decided to only recognize government-approved CRAs (known as Nationally Recognized Statistical Rating Organizations (“NRSROs”)). Since then, the number of regulations relying on these agencies now extends beyond securities to the areas of

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51. See infra Part IV.A; RATING AGENCIES, supra note 47. MBSs and CDOs are malleable in that the issuer has lot of discretion in deciding what to include in the security. By analogy, in the same way that a cook can vary a dish’s spiciness by altering the number and variety of hot peppers in it, the issuer can vary a security’s riskiness by changing the pools of loans that compose it. The designer of a CDO increases its risk level by choosing to include, for example, risky sub-prime mortgages. See infra Part IV.A.

52. See infra Part IV.


54. Id. at 632.


57. Rusznak, supra note 55, at 832–34.


59. Id. at 624–26. This rule was the “net capital rule” for broker dealers, which the SEC would only allow NRSROs to rate. Id. The three major CRAs—Moody’s, Fitch, and Standard & Poor’s—are all NRSROs. There are ten firms registered as NRSROs. Sec. Exch. Comm’n, Credit Rating Agencies—NRSROs, http://www.sec.gov/answers/nrsro.htm (last modified May 12, 2011).
pensions, banking, real estate, and insurance regulation. Professor Frank Partnoy argues that giving the NRSROs such market power permits them to grant “regulatory licenses.” Professor Partnoy suggests that a private entity, rather than a regulator, can essentially determine the substantive effect of legal rules. Thus, the ratings “are essentially only valuable because they reduce the issuer’s regulatory costs, not because they are credible or accurate.”

For example, certain federal rules require institutional investors to buy only investment grade debt or better. If one CRA rates a given security above that level, then that CRA, rather than a government regulator, has the ability to control whether that security is “government approved.” Basel II’s standardized approach, which relies on CRAs, is also an example of this.

2. The IRB Approach

Under Basel II’s IRB approach, banks that are more sophisticated can use their own models to measure credit risk. These models are similar to the models that CRAs use. Banks, however, also lack incentives to be wholly objective in their analysis.

60. Darcy, supra note 58, at 625–26.
62. Id.
63. Darcy, supra note 58, at 626.
65. RATING AGENCIES, supra note 47, at 1–2. Despite years of regulatory reliance on CRAs, some government agencies have admitted that CRAs have not always performed well. See generally id. In July 2008, the SEC published a report based on its investigation of the CRAs’ performance around the mortgage crisis. Id. Among its conclusions, the SEC found that due to the increased volume and complexity of MBSs and CDOs, “some of the rating agencies appear to have struggled with the growth [of MBSs and CDOs],” that the CRAs needed to create better conflict of interest procedures; and that there needed to be more comprehensive documentation and justification of the methods that were used to rate the securities. Id. at 1–2. The SEC also found that the surveillance processes used by the rating agencies (used to monitor a security’s performance after it has been rated) appear to have been less comprehensive than the initial ratings. Id. at 21.
66. See supra Part III.A.
67. The use of these models began in the 1980s when Wall Street began employing mathematicians to help them more effectively manage risk. Erik F. Gerding, The Dangers of Delegating Financial Regulation to Risk Models, 29 BANKING & FIN. SERVICES POL’Y REP., April 2010, at 1. Because these models could quantify risk, they were also used “to develop and price complex financial products, including novel forms
First, capital adequacy rules generally require banks to hold more capital for riskier assets and less for safer ones.\textsuperscript{69} Banks may then use unreserved capital elsewhere to make money. All things being equal, banks would rather hold a small amount of reserve capital than a large amount. Thus, banks have an incentive to underestimate the risk of their assets. And if regulators do not closely monitor banks but rather “use their discretion to shy away from demanding that banks improve their risk models, these models are more likely to underestimate the actual risk and allow banks to arbitrage around the leverage ratio more easily.”\textsuperscript{70} In short, banks have some leeway to consider their assets lower risk, which means they hold less capital.\textsuperscript{71} 

Second, bank models are not always precise. CDOs and MBSs in particular are complex and difficult to measure accurately.\textsuperscript{72} Additionally, the models may not account for atypical situations: “[w]hile these models were quite accurate when used to assess risk under normal market conditions, the financial crisis proved that these same models drastically underestimated losses when assessing risk in extreme stress situations.”\textsuperscript{73} Unfortunately, the financial system moved into abnormal territory.\textsuperscript{74} As a result, the computer models “crashed spectacularly in the global financial crisis. Risk models failed to predict the massive losses that started in residential mortgages and cascaded in waves throughout the U.S. and international financial markets.”\textsuperscript{75} The IRB approach is only as effective as the model the bank uses and the integrity of the people applying it.

of mortgages and other consumer loan products, asset-backed securities and credit derivatives.” \textit{Id.} These models facilitated the explosion of sub-prime lending by helping create individually-tailored interest rates, securitizing MBSs, and pricing derivatives that were used to insure against risky MBSs and CDOs. \textit{Id.} at 1–2.

Thus, financial institutions including CRAs, banks and regulators, came to rely heavily on computer models to quantify risk. \textit{Id.} Faith in these computer models “was animated by a belief that risk models enabled financial institutions to price and manage risk effectively.” \textit{Id.} at 1. Regulators expressed this belief in the IRB approach in the Basel II accord, which “authorize[d] national bank regulators to allow certain large banks to set their own capital requirements according to the internal risk models of the individual banks.” \textit{Id.}

\textsuperscript{68} \textit{Id.} at 1, 4.
\textsuperscript{69} See Revised Framework, supra note 17, at ¶¶ 720–723.
\textsuperscript{71} \textit{Id.}
\textsuperscript{72} See infra Part IV.A; supra Part III.C.1.
\textsuperscript{73} King & Tarbert, supra note 2, at 16 n.18.
\textsuperscript{74} See Gerding, supra note 67.
\textsuperscript{75} \textit{Id.}

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IV. THE MORTGAGE CRISIS: AN EXAMPLE OF HIDDEN CREDIT RISK

One reason it was difficult to measure credit risk was the increased popularity of a new kind of asset: the MBS.\(^76\) The process of obtaining a mortgage was changing drastically.\(^77\) Historically, the process involved two parties: the bank and the individual.\(^78\) Because a bank would ultimately suffer for making a bad loan, banks were careful to analyze critically the borrower’s ability to pay the loan back.\(^79\) If the bank believed the borrower was unable to make the payment, it would not issue the loan. Securitization, however, transformed the relationship between the borrower and the creditor.\(^80\)

A. Securitization

Securitization turned mortgages into commercial investments.\(^81\) Instead of banks holding an individual’s debt, an investor would hold pieces of debt from numerous borrowers.\(^82\) The process of turning a mortgage into a security consisted of numerous stages, each performed by a different party.\(^83\) First, the brokers who made loans to the individuals sold the mortgages to the bank. The banks could then sell the loans in bulk to entities that repackaged them into securities. The investment banks created these entities, called “special purpose vehicles” (“SPVs”), and traded them as MBSs.\(^84\) Now packaged as securities, they were available for investors to purchase.\(^85\) Just as easily as buying stock in IBM, an investor could purchase a share of the right to receive a part of a stream of mortgage payments.\(^86\) Thus, instead of borrowers repaying the bank, they essentially repaid investors.\(^87\)

\(^76\) See Dam, supra note 53, at 617.
\(^77\) Id. at 611–13.
\(^78\) Id. at 611.
\(^79\) Rusznak, supra note 55, at 827–28.
\(^80\) See Dam, supra note 53, at 611–19.
\(^82\) See id.
\(^83\) Rusznak, supra note 55, at 829.
\(^84\) Id. at 830.
\(^85\) Id.
\(^86\) Id. at 829; see also Wilson, supra note 81.
\(^87\) Rusznak, supra note 55, at 30.
Securitization also created perverse incentives. Before securitization, a bank had reason to avoid making risky loans because it might lose money, but mortgage brokers did not. Mortgage brokers only needed to pass the loans along, like a hot potato. Since mortgage brokers would not ultimately hold the debt, they were not concerned with the borrower’s ability to repay. Instead, they earned money by selling the loans to the bank. Banks, which were similarly situated, were primarily concerned with moving the mortgages along as fast as possible. Like mortgage brokers, banks earned their money from fees, instead of charging interest and holding the loans. Finally, SPVs packaged the loans into securities and sold them to investors.

Although the concept of securitizing mortgages was not entirely new, it was the first time commercial and investment banks employed the idea so feverishly. As a new and competitive market, securitization also attracted innovation, and banks created novel and complex ways to repackage securities. Two such examples are collateralized mortgage obligations (“CMOs”) and collateralized debt obligations (“CDOs”). CMOs are formed when different parts of various MBSs are combined together into a new security. Thus, instead of buying a share of a group of mortgages, an investor buys a share of several groups of mortgages, and essentially owns the debt of numerous debtors. CDOs are formed by combining parts of a MBS with different kinds of loans—for example, auto loans, student loans, credit card receivables, or small business loans. The resulting security is a CDO. Thus, instead of owning the debt of a group of mortgages, the investor buys a share of a number of different groups of loans—some mortgages, some not. CDOs can be further

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88. Id. at 834.
89. Id.
90. Id.
91. Id.
93. Id. at 612.
94. Another benefit to the banks was the fact that they did not have to wait for interest to accrue since they earned the fees up front. Id.
95. Id. at 617.
96. See Rusznak, supra note 55, at 830. Mortgage securitization had been done since the 1980s by government-sponsored enterprises like Fannie Mae and Freddie Mac. Id. at 830–31.
97. Dam, supra note 53.
98. Id.
99. Id.
100. Id.
101. Id.
102. Id.
103. Id.
combined with other CDOs to create a CDO squared (“CDO2”).\textsuperscript{104} CDO2s are similar to CDOs in their variety but include exponentially more loans than CDOs.\textsuperscript{105}

In the short run, this new way of selling mortgages appeared profitable for everyone.\textsuperscript{106} First, it made the American dream of owning a home a reality for people who otherwise would not be able to do so.\textsuperscript{107} No longer concerned with loaning to people with bad credit, banks approved more people for mortgages.\textsuperscript{108} Second, mortgage brokers profited from increased lending,\textsuperscript{109} as did the SPVs for packaging the loans.\textsuperscript{110}

Finally, banks benefitted in two ways. First, banks, like the mortgage brokers and SPVs, earned increased revenue from fees.\textsuperscript{111} Second, banks were able to maneuver around capital requirements by taking the loans off the banks’ balance sheets.\textsuperscript{112} Normally, if a bank held an asset like a risky loan, it was required to hold more capital.\textsuperscript{113} Securitization, however, allowed banks to sell the loans they issued, thus taking the loans off of the banks’ books. Because the banks did not continue to hold the loans, capital adequacy rules like Basel II no longer applied to those loans, and banks still profited from the transaction.\textsuperscript{114}

The popularity of these securities caused them to be sold around the world.\textsuperscript{115} In fact, by the summer of 2007, the Bank of China held $9 billion worth of MBSs.\textsuperscript{116} But the international diffusion of these securities also created new risks for the global economy.\textsuperscript{117} Although very profitable, securitized mortgage loans were “vulnerable to crisis, especially because institutional purchasers of the securities borrow[ed] to finance the purchase.”\textsuperscript{118} Also contributing to this global risk was the fact that regulators were often unaware of the dangers these securities posed.

\begin{itemize}
  \item \textsuperscript{104} See id.
  \item \textsuperscript{105} Dam, supra note 53.
  \item \textsuperscript{106} See Rusznak, supra note 55, at 834; Dam, supra note 53, at 612–13, 616–17.
  \item \textsuperscript{107} Rusznak, supra note 55, at 848.
  \item \textsuperscript{108} Id. at 831.
  \item \textsuperscript{109} See supra Part IV.A.
  \item \textsuperscript{110} See supra Part IV.A.
  \item \textsuperscript{111} See supra Part I.
  \item \textsuperscript{112} Dam, supra note 53, at 616.
  \item \textsuperscript{113} See supra Part I.
  \item \textsuperscript{114} Dam, supra note 53, at 616.
  \item \textsuperscript{115} Id. at 615.
  \item \textsuperscript{116} Id.
  \item \textsuperscript{117} Id.
  \item \textsuperscript{118} Id. Institutional investors also used the increased leverage to increase the yield from their investment. Id.
\end{itemize}
B. Lack of Regulation

In the United States, many aspects of mortgage securities were left unregulated. First, most of the institutions that originated the mortgage loans were not technically banks and therefore were not subject to banking regulations. Many were mortgage brokers who made the initial loans but did not hold them to maturity.119 Left to their own devices, these companies focused on selling as many mortgages as possible, often without regard to the likelihood of repayment.120

Second, the emergence of a financial system that functioned like a bank but was not subject to banking regulations added to the risk.121 In the process of mortgage securitization, these entities served as middlemen between the borrowers and the investors.122 The similarities between this new system and traditional banking were apparent enough that the new system became known as the “shadow banking system.”123 Shadow banking generally refers to institutions like investment banks, finance companies, money market funds, hedge funds, SPVs, and other entities that amass and hold financial assets.124

Despite being comparable in size to the traditional banking system and functioning like a bank, the shadow banking system was not subject to banking regulations.125 Because some “shadow banks” were highly leveraged, others relied heavily on short-term funding markets, and none had explicit government support prior to the crisis, the shadow banking system was susceptible to panics similar to the kind banks experienced before the existence of the Federal Deposit Insurance Corporation.126

Third, regulators failed to adequately police the CRAs.127 Compared to typical security analysis of a corporation or government’s ability to pay its debt, analyzing MBSs and CDOs was exceedingly complex.128 In the case of MBSs, there were hundreds or thousands of different borrowers compiled into a single security.129 CDOs compounded that difficulty by taking pieces of various MBSs, each made up of hundreds

119. Id.
120. See supra Part IV.A.
122. See supra Part IV.A.
123. Shadow Banking, supra note 121.
124. Id.
125. Id.
126. Id.
127. See supra Part III.C.1.
128. Dam, supra note 53.
or thousands of borrowers, and combining them with other MBSs, also made up of hundreds or thousands of borrowers. Thus, instead of making a judgment about a single borrower, investors had to assess hundreds of thousands of borrowers. In practice, this was impossible. As a result, investors had to look elsewhere for guidance. Because MBSs and CDOs “were especially hard for purchasers to evaluate, [there was a] tendency to rely on [CRAs].” Thus, in the era of MBSs, CRAs gained substantial influence.

Meanwhile, regulators did little to ensure that CRAs were accurate. This was in part a result of inadequate oversight in the shadow banking system; “the lack of transparency in the financial markets for structured products meant that neither investors nor regulators were aware of who precisely held the subprime mortgage risk.” More importantly, CRAs were ignoring essential information in their assessments because “[t]he securities regulators did not consider how the loans underlying the securities were created and did not appear to grasp that rating agencies had failed to adequately account for the loosening underwriting standards when assigning ratings.”

C. The Financial Crisis

A combination of factors led to the mortgage crisis. First, the new method of packaging and selling mortgages removed incentives for mortgage brokers to be cautious about lending money. Second, banks started to depend on the fees they earned from selling bundled mortgages. Third, an opaque shadow banking system free from regulation made it difficult for CRAs to provide accurate ratings. Fourth, the inaccurate
ratings caused investors to assume more risk than they had intended.\textsuperscript{141} Finally, an unstable system crashed.\textsuperscript{142} Worried about the security of their investments, panicked investors pulled their money out of various shadow banking institutions.\textsuperscript{143}

The run on the shadow banking system directly affected the commercial banking system because agreements between commercial banks and entities within the shadow banking system often required banks to provide funds in the event of a market disruption.\textsuperscript{144} “Thus, the commercial banks came under funding pressures themselves. Even commercial banks that had not provided these backstop agreements reduced the amount they were willing to lend in interbank or other money markets.”\textsuperscript{145}

Ultimately, the government had to intervene.\textsuperscript{146} The unregulated shadow banking system was in dire need of funding that only the U.S. government could provide.\textsuperscript{147} And the U.S. government provided it.\textsuperscript{148} “With each of these extraordinary measures, the Federal Reserve effectively extended to the shadow banking system its role as the lender of last resort, a role that the central bank had traditionally reserved for commercial banks and savings institutions.”\textsuperscript{149}

\textbf{D. Assigning Blame}

In the aftermath of the mortgage crisis, CRAs received much of the public’s blame.\textsuperscript{150} The heads of the major CRAs were brought before Congress and scolded.\textsuperscript{151} One congressman compared their conflicts of interest to a sporting event stating, “[W]hen the referee is being paid by the players, no one should be surprised when the game spins out of control.”\textsuperscript{152} An infamous email exchange between two Standard & Poor’s employees epitomized the CRAs’ lack of due diligence.\textsuperscript{153} Referring to a particular MBS, the email exchange admitted “[the] deal [was] ridiculous,”

\begin{itemize}
\item \textsuperscript{141} See supra Part IV.B.
\item \textsuperscript{142} Shadow Banking, supra note 121.
\item \textsuperscript{143} Id. This happened in three separate periods: the liquidity crisis of 2007, the run on Bears Stearns, and the panic of September 2008. Id.
\item \textsuperscript{144} Id. at 27.
\item \textsuperscript{145} Id.
\item \textsuperscript{146} Id. at 28.
\item \textsuperscript{147} Id.
\item \textsuperscript{148} Id.
\item \textsuperscript{149} Id.
\item \textsuperscript{151} Sanati, supra note 150.
\item \textsuperscript{152} Rowland, supra note 150.
\item \textsuperscript{153} Id.
\end{itemize}
and that S&P’s analysis “definitely does not capture half the risk.” Candidly, the email continued to say, “[S&P] should not be rating it,” but that “[securities] could be structured by cows and we would rate it.”\footnote{154} Such public shaming prompted governmental action. The attorneys general of California, New York, and Connecticut began investigations of the three major agencies: Standard & Poor’s, Moody’s Investors Service, and Fitch Ratings.\footnote{155} The investigations focused on whether the agencies had failed to conduct due diligence, whether they had employed compromised standards and safeguards for profits, and whether they had conspired with the companies they rated.\footnote{156} In short, fairly or unfairly, the CRAs became scapegoats for the mortgage crisis.\footnote{157} In a 2007 article, The Economist put it succinctly: “The only truly upbeat firms in America nowadays are the accounting giants, which for once are not being blamed for a financial disaster (this time that honour belongs to the rating agencies).”\footnote{158}

\footnote{154} Id. Another email demonstrated the arbitrary analysis CRAs often used. There, an employee of Standard & Poor’s was asked to rate a CDO backed by home loans. When he tried to get information about the security from his superior, he received an email stating that “[a]ny request for loan level tapes is TOTALLY UNREASONABLE!!! Most investors don’t have it and can’t provide it. Nevertheless we MUST produce a credit estimate. It is your responsibility to provide those credit estimate [sic] and your responsibility to devise some method for doing so.” Sanati, supra note 150. At the Congressional hearing, CRA profits were also highlighted. Representative Henry Waxman declared that “total revenues for the three firms doubled from $3 billion in 2002 to over $6 billion in 2007.” Waxman also said, “Moody’s had the highest profit margin of any company in the S&P 500 for five years in a row.” \textit{Id.}


\footnote{157} In 2009, the IMF concluded that a lack of regulation was principally responsible for the crisis, particularly in regard to CRAs. \textit{What Went Wrong: The IMF Blames Inadequate Regulation, Rather than Global Imbalances, for the Financial Crisis}, \textsc{The Economist}, Mar. 6, 2009, \url{http://www.economist.com/node/13251429}.

\footnote{158} \textit{At the Gates of Hell: Banks and Brokers are Having a Terrible Time. Now the Misery is Spreading}, \textsc{The Economist}, Nov. 22, 2007, \url{http://www.economist.com/node/10181281}. 

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V. MEASURING RISK UNDER BASEL III

Responding to the failures of the financial crisis, the Basel Committee on Banking Supervision (“BCBS”) revised its capital rules in an attempt “to strengthen the regulation, supervision and risk management of the banking sector.”159 In September 2010, BCBS released a summary of the reforms called Basel III.160 In short, under the reforms, most banks will have to hold more capital than under previous Basel frameworks.161 Because the Basel III standards are not binding on member states, each country must implement its own legislation to give them the force of law.162 As a result, the actual rules applicable to each bank will likely vary.163 In particular, the ways that banks will assess credit risk will vary depending upon the jurisdiction.164

Basel III is similar to Basel II, but the two schemes differ in some important respects.165 Although Basel III still permits reference to CRAs, it amends the standardized approach, requiring banks to assess exposures and determine whether the risk estimates based on CRAs are appropriate.166 Basel III also requires that external credit ratings be “publicly available, on a non-selective basis and free of charge.”167

A. Implementation of Basel III

1. European Union

Banking in the European Union (“EU”) involves a complex web of domestic and international banking regulators.168 Each EU nation,

161. Id.
163. See infra Part V–VI.
164. See infra Part V–VI.
166. Global Regulatory Framework, supra note 165, at 52.
167. Id. at 53.
168. Recently, the European Commission (EC) created two new regulatory bodies to deal with the challenges presented by the interconnectedness in global banking. See Eric J. Pan, Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks, 11 CHI. J. INT’L L. 243, 277–81 (2010). These regulatory bodies are the European Systemic Risk Board (“ESRB”)
however, is ultimately responsible for adopting and enforcing its own banking regulations. Consequently, “supervision remains decentralized at the level of the Member States.” Therefore, like the Basel agreements that rely on the G20 members’ domestic legislation for their force, banking regulations passed by the European Commission (“EC”) still require implementation by the EU’s members.

The EU will implement the Basel III proposals through its Capital Requirements Directive IV (“CRD IV”), which is planned to be in force by January 1, 2013, and fully implemented by January 1, 2019. CRD IV generally permits both reference to CRAs and the use of internal models. The EC recommends that when banks make decisions about which assets to hold, “external credit ratings may be used as one factor among others in this process but shall not prevail. In particular, internal methodologies shall not rely solely or mechanistically on external ratings.”

In making credit assessments, the EC officially states that it prefers internal ratings wherever possible, but that in some circumstances it may and its parent agency, the European System of Financial Supervisors (“ESFS”). Id. at 278. The ESRB has the duty to prevent another European financial crisis, while the ESFS must “monitor and assess threats to financial stability.” Prudential Supervision of the EU Financial Institutions Moves to the Centre, GIBSON DUNN, June 22, 2009, http://www.gibsondunn.com/publications/Pages/PrudentialSupervisionofEUFinancialInstitutions.aspx. Believing national regulators to be in a better position to influence day-to-day banking, the ESFS’s role is essentially to coordinate initiatives among national regulators. Pan, supra note 168, at 278–79. The ESFS also includes the following three sub-agencies: the European Banking Authority (“EBA”), European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority. Id. at 278.


170. Id.

171. This is true for CRD IV and other EC directives.


173. Id.

be preferable to rely on CRAs. For example, the EC warns that “internal ratings are not a panacea” and notes that in the case of securitization, use of CRAs may be preferable because banks lack “reliable approaches” and have “incentives . . . to underestimate risk.” In short, CRD IV attempts to improve reliability by including both methods of measuring risk but prefers particular methods be used for specific types of assets. Finally, the EC recommends that the European Banking Authority (“EBA”) publish annual reports on what banks and supervisors have done to reduce overreliance on CRAs.

2. Germany

Historically, Germany’s central bank, the Bundesbank, regulated Germany’s banks. In 2002, the Bundesanstalt für Finanzdienstleistungsaufsicht (“BaFin”) assumed this role and is now its principal bank regulator. In late 2006, Germany implemented Basel II into national law by amending the German Banking Act. In October 2011, Germany fully implemented CRD III (passed by the EC in 2010, enhancing Basel II). Germany plans to implement the Basel III rules by the end of 2012. A BCBS progress report notes that Germany (and the other European countries) will follow the EU’s July 2011 proposal for implementation.

3. United Kingdom

The Financial Services Authority (“FSA”) conducts banking regulation in the United Kingdom (“UK”) under the Financial Services and
Markets Act of 2000. However, the FSA and the Bank of England, the UK’s central bank, are currently in the process of drastically revising the banking supervisory framework by disbanding the FSA and creating new regulatory agencies.

The UK has fully implemented Basel II through the Prudential Sourcebook for Banks, Building Societies and Investment Firms Instrument ("BIPRU") rules implementing the CRD. The BIPRU rules became effective January 1, 2007. Banks in the UK may choose the standardized approach or one of the two IRB approaches. Under the standardized approach, banks may only refer to authorized CRAs. In the UK, the only authorized CRAs are Moody’s, Standard & Poor’s, Fitch, and DBRS. Banks that prefer to use the IRB approaches must apply for approval by the FSA. The UK, however, neither requires nor prohibits a bank from using the advanced IRB approach.

185. Id. One new agency, the Prudential Regulation Authority ("PRA"), will be responsible for supervising “both insurance companies and deposit-taking institutions.” Id. The PRA will supervise both UK-incorporated banks and foreign branches of banks doing business in the UK. Id. In addition to the PRA, there will also be a new independent Financial Policy Committee ("FPC") in the Bank of England and an “independent conduct of business regulator, the Financial Conduct Authority (‘FCA’).” Id. The FPC and PRA will operate as subsidiaries of the Bank of England, effectively replacing the FSA’s supervisory role with the Bank of England. Garicano & Lastra, supra note 169, at 602–03. These renovations are expected to be completed in 2012. Id.
187. See Pillar 1-Standardised, supra note 186.
188. See The Prudential Sourcebook for Banks, Building Societies and Investment Firms, FSA HANDBOOK, July 2012, at 2.
190. Pillar 1-Standardised, supra note 186.
191. Id.
193. See id.
The UK has fully implemented the Basel II enhancements (informally “Basel 2.5”), which became effective on December 31, 2011. Like Germany, the UK also plans to follow the July 2011 EU proposals implementing Basel III.

4. Hong Kong

The Hong Kong Monetary Authority (“HKMA”) regulates banking in Hong Kong. Pursuant to the Banking Ordinance, the HKMA has the authority to make capital adequacy rules, which it exercised on January 1, 2007, by implementing Basel II. Under these rules, the HKMA generally follows the Basel II framework, offering the standardized approach and the two IRB approaches. In addition, the HKMA offers a fourth option called the “basic approach.” Developed as a response to concerns by banks that implementing the Basel II framework would be expensive, the basic approach is intended for use by banks with “small, simple, and straightforward operations, and as an interim approach for those [banks] developing IRB systems.” The basic approach is “essentially a modification of the existing framework,” and like the IRB approaches, it requires approval from the HKMA. Hong Kong has followed the EU and updated recent changes to the Basel rules. According to the BCBS progress report, Hong Kong has fully implemented Basel 2.5.

194. See Basel Comm. on Banking, BIS, Progress Report Table on the Basel 2.5 Adoption, (Mar. 2012), http://www.bis.org/publ/bcbs/b2_5prog_rep_table.htm [hereinafter Basel 2.5].
196. Id. at 7-8.
198. Arner, supra note 197.
199. Id.
201. Id.
202. Id.
203. Id.
204. Id. When Basel II was implemented in Hong Kong, both the basic and IRB approaches were popular. Fourteen of Hong Kong’s larger banks, “representing over 80% of the total assets of all Hong Kong incorporated [banks],” had an interest in using the IRB approach. Id. At the same time, forty smaller banks had been approved to use the basic approach. Id.
205. Basel 2.5, supra note 194.
stage of implementing Basel III. Hong Kong’s Legislative Council recently passed a bill “creating rule-making power for the implementation of Basel III.”206 However, the Council has only just begun industry consultation for policy proposals to be included in these rules.207 The HKMA has stated, however, that it is planning on implementing Basel III reforms by January 2013, and that the scheme should be fully implemented by January 2019.208

5. United States

Due to the dual nature of a federalist system, bank regulation in the U.S. involves multiple regulatory agencies at both the federal and state levels.209 Although a member of the G20, the U.S. has been slow to implement Basel II. Twenty-two of the twenty-eight members (including.....
the EU) have fully completed the process of implementing Basel II.\textsuperscript{210} Although the U.S. is in the final stages of implementation, the process is still ongoing; only Turkey, Russia, Indonesia, and China share this status.\textsuperscript{211} The delay was caused in part by small banks’ concerns that Basel II’s complex risk measurements would be costly and burdensome to implement.\textsuperscript{212} This resulted in proposals to make the Basel II rules mandatory “only for the largest, most internationally active banks.”\textsuperscript{213} Somewhat paradoxically, small banks were also concerned that not requiring them to use sophisticated risk models would be disadvantageous.\textsuperscript{214} Ultimately, regulators enacted rules that addressed both concerns.\textsuperscript{215} This entailed, however, applying Basel I to small banks and Basel II to large banks.\textsuperscript{216}

The U.S. has been similarly slow to update the Basel 2.5 changes, as that legislation has yet to be implemented.\textsuperscript{217} Given the incomplete and delayed application of Basel II and U.S. bank regulators’ recent statement that they support the Basel Committee’s efforts “to strengthen the position of large and internationally active banks,” there is reason to believe that Basel III will not be fully implemented in the U.S.\textsuperscript{218} Even more problematic is the fact that parts of the recently passed Dodd-Frank Act directly conflict with aspects of Basel III.\textsuperscript{219}

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  \item \textsuperscript{210} Basel III Implementation, supra note 183, at 5–6; Basel Comm. on Banking, BIS, \textit{Progress Report Table on the Basel II Adoption}, http://www.bis.org/publ/bcbs/b2 prog_rep_table.htm (last visited Sept. 20, 2012).
  \item \textsuperscript{211} Id.
  \item \textsuperscript{212} See Robert Boudreau, \textit{Basel II}, 26 \textit{ANN. REV. BANKING \\& FIN. L.} 176, 180 (2007).
  \item \textsuperscript{214} Small banks argued that large banks would gain a competitive edge from using sophisticated risk measurements because it would result in lower capital requirements. Rebecca Christie, \textit{Rules on Bank Capital Draw Fire; FDIC Move May Delay Final Accord Covering World Financial System}, \textit{WALL ST. J.}, Dec. 8, 2003, at B8.
  \item \textsuperscript{216} Id. Specifically, large, internationally active banks have to comply with the advanced IRB approach. Yohan Gohng & David Hesford, \textit{Basel II}, 25 \textit{ANN. REV. BANKING L.} 50, 52 (2006).
  \item \textsuperscript{217} Basel 2.5, supra note 194. Currently, Basel 2.5 revisions being consolidated with the Basel III revision and are anticipated to be issued for comment in mid-2012. Id.
\end{itemize}
\end{footnotesize}
\end{flushleft}
particular, Basel III permits banks to rely on either CRAs, internal models, or both. In contrast, Section 939A of the Dodd-Frank Act requires that any reference to CRAs be removed from U.S. banking regulations. The BCBS implementation status report noted as much, stating, “Basel 2.5 and Basel III rulemakings in the United States must be coordinated with applicable work on implementation of the Dodd-Frank regulatory reform legislation, in particular with regard to the use of credit ratings.”

VI. BASEL III AND CREDIT RISK: PROBLEMS AND SOLUTIONS

From the standpoint of banking stability, the question for Basel III is whether it will improve banks’ ability to accurately measure credit risk. Several reasons exist to doubt that Basel’s rules on credit risk assessments will be any better under Basel III than they were under Basel II.

A. Persistently Poor Incentives

Basel III does not eliminate a bank’s incentive to attempt regulatory arbitrage. Regulatory arbitrage occurs when “firms capitalize on loopholes in regulatory systems in order to circumvent unfavorable regulation.” In the context of capital requirement regulations like Basel, this usually happens when a bank tries to maximize the spread between its actual risk and the risk implied by its regulatory position. Essentially, a bank wants to hold the riskiest asset it can while staying within the lowest risk-weight category. As a result, the bank can hold as little capital as possible but still earn a return from the risk in those assets. Because Basel III has not changed its risk weights, the same incentives to engage in regulatory arbitrage still exist.

220. See supra Part V.A.
225. Holman, supra note 70, at 725.
226. Id.
227. Id.
228. N.M., supra note 223.
Basel III attempts to offset these incentives to engage in regulatory arbitrage by stating that “[i]n 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.”\textsuperscript{229} Essentially, Basel III states that whenever an asset’s risk is underestimated, the banks must voluntarily opt for the riskier evaluation, potentially increasing the capital charge for that asset, and lowering the banks’ potential returns.\textsuperscript{230} In practice, such a requirement might be difficult to enforce because banks have a propensity to compete with other banks to take whatever advantages might increase their profitability.\textsuperscript{231} Banks could easily adjust their complex internal risk models to reach a more favorable outcome.\textsuperscript{232}

The incentives toward regulatory arbitrage might manifest themselves slightly differently depending upon whether the bank employs the standardized or IRB methods.\textsuperscript{233} Basel III still provides the standardized approach, which permits reliance on CRAs.\textsuperscript{234} Banks that choose the standardized approach still need to make their own evaluation as to whether those risk weights are appropriate.\textsuperscript{235} In a sense, Basel III converts the standardized approach into a “modified IRB” approach because under the standardized approach the bank must still make its own risk judgments.\textsuperscript{236} A profit-driven and rational bank applying the standardized approach will likely try to find some basis to conclude that the least risky CRA evaluation is appropriate.\textsuperscript{237} The more complex the security, the more likely it is that reasonable minds will disagree about a security’s risk level. A bank would probably pick the analysis that best supports its interest in holding less capital.\textsuperscript{238}

A bank that chooses to employ the IRB approach will face similar incentives to discount the risk assessment of a given asset.\textsuperscript{239} The difference

\textsuperscript{229} Global Regulatory Framework, supra note 165, at 52.
\textsuperscript{230} Id.
\textsuperscript{231} N.M., supra note 223.
\textsuperscript{232} Id.
\textsuperscript{233} See supra Part VI.A.
\textsuperscript{234} See supra Part V.A.
\textsuperscript{235} Global Regulatory Framework, supra note 165, at 52. “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 assess 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.” Id.
\textsuperscript{236} Id. at 52–53.
\textsuperscript{237} N.M., supra note 223.
\textsuperscript{238} Id.
\textsuperscript{239} See id.
will be that instead of deferring to a favorable rating issued by a CRA, the bank may use its own methodology to support that conclusion.\textsuperscript{240}

For CRA ratings to be valid under Basel III, the CRA must make “credit assessment, procedures, methodologies, assumptions, and the key elements underlining the assessments” publicly available.\textsuperscript{241} This information must also be available on a “non-selective basis and free of charge.”\textsuperscript{242} If the ratings are made available only to the parties in a transaction, then they do not satisfy Basel III’s requirements.\textsuperscript{243} Despite these stipulations, Basel III includes a footnote that permits a CRA to charge the issuer, as long as it “provide[s] an adequate justification, within their own publicly available Code of Conduct.”\textsuperscript{244} Basel III aims to make CRAs more reliable by requiring that the CRAs disclose “whether the issuer participated in the assessment process” as well as “the general nature of [the CRA’s] compensation arrangements with assessed entities.”\textsuperscript{245}

In short, banks can still rely on CRAs as long as the CRAs comply with a handful of new requirements.\textsuperscript{246} The increased disclosure might help create a consensus about a given security’s riskiness. At the same time, it might simply lead to competing and widely differing theories about a security’s risk. Additionally, Basel III does not prevent CRAs from advising issuers on how to structure a security to receive a given rating.\textsuperscript{247} Nor does Basel III prohibit CRAs from being paid by the same people whose securities they will rate.\textsuperscript{248} Therefore, the same basic framework that leads to conflicts of interest, rating shopping, and CRA consulting is still permitted under Basel III.\textsuperscript{249} Further, the incentive that banks have to engage in regulatory arbitrage under Basel III still allows substantial room to massage numbers to fit the interests of the banks or

\begin{itemize}
  \item \textsuperscript{240} See supra Part III.C.2.
  \item \textsuperscript{241} Global Regulatory Framework, supra note 165, at 53.
  \item \textsuperscript{242} Id.
  \item \textsuperscript{243} Id.
  \item \textsuperscript{244} Id. at 53 n.46.
  \item \textsuperscript{245} Id. Basel III also requires CRAs to fulfill six general requirements: objectivity, independence, international access/transparency, disclosure, resources, and credibility. Id.
  \item \textsuperscript{246} Id.
  \item \textsuperscript{247} Id.
  \item \textsuperscript{248} See supra Part III.C.1.
  \item \textsuperscript{249} See supra Part III. In the U.S., however, the Dodd-Frank Act requires that any reference to CRAs be removed from U.S. banking regulations. See supra Part V.A.5. The incentives for the banks to employ internal models that produce favorable and less-than-objective credit risk assessments will still be in place. Id.
\end{itemize}
CRAs. Because banks prefer to have less risky ratings and CRAs compete for the business of the issuers, incentives to stretch the numbers cuts only in one direction: towards a tendency to underestimate the risk level. Basel III’s only counterbalance to this phenomenon is to ask banks to voluntarily opt for a higher risk-weight whenever the bank determines that Basel III’s risk-weight prescription underestimates the asset’s risk.

Basel III’s remedies for these systemic problems are probably not enough. Improving the problems inherent in CRAs will likely require a serious restructuring of how they do business. For example, instead of having the issuer choose and pay the CRA for a rating, a government could set up a system where CRAs are randomly assigned to issuers. The government could pay the CRA a fixed-fee for each security it rates. Each issuer would pay into a fund that the government would use to pay the CRAs. To ensure quality ratings, the government could set a baseline threshold for quality that the CRA must meet to be eligible to rate securities. This would remove the incentive of CRAs to cater to the needs of banks, and instead encourage them to compete on the basis of quantity, subject to baseline quality standards. A rotating or random matching of CRA to issuer could better prevent socially-detrimental relationships between CRAs and issuers. Furthermore, the government could employ CRAs to audit banks that choose to employ the IRB method. CRAs have more expertise in risk modeling and would therefore be better equipped to complete such an analysis. By removing the incentive for CRAs to be biased in favor of the issuer, the government could better ensure that a bank’s IRB models accurately reflect the risk on its books.

Such drastic restructuring of the CRA framework could also mitigate regulatory arbitrage. Banks, however, will likely still be able to predict with reasonable accuracy the ratings that their assets will receive and therefore will likely still try to maximize the difference between the predicted risk-weight they will receive and the actual risk of the asset. The difference under this hypothetical scheme is that banks would have much less influence in the final decision; if a CRA found the security to be too close to the threshold, it could more easily award the higher risk rating.

250. See N.M., supra note 223; see supra Parts III.C.1.a, II.C.2.
251. See supra Part III.C.1.a.
252. See supra Part III.C.2.
253. See Global Regulatory Framework, supra note 165.
B. Variance Among Countries

Another difficulty with Basel III is that there is no single entity that has the power to enforce its standards uniformly across borders. Basel III’s recommendations are simply guidelines; each country will still have to adopt and implement its own rules.

This problem exists for all G20 members, but the EU also faces an analogous problem. Even if the EU adopts Basel III (as it plans to with the CRD IV), member states of the EU will still be individually responsible for implementing their own legislation. The EU has anticipated this problem and created the “single rule book” approach, which attempts to harmonize Basel’s implementation as much as possible across EU member states. The extent to which member countries will comply, however, remains to be seen. In January 2012, Germany and France expressed a desire to relax Basel III’s implementation, apparently to combat a perceived “negative effect” on growth. This resulted in strong disagreements with UK regulators who were pushing for stricter standards. With a debt crisis and about six years until Basel III becomes fully implemented, it is not unreasonable to believe that EU member countries will continue to disagree about how best to implement its rules. Even if the EU implements uniform rules, global banks will still face a variety of regulatory environments. For example, a bank that operates in Hong Kong will have four options (standardized, basic, and two IRB approaches), permitting it a wider array of choices about how to best assess its credit risks. In contrast, if the U.S. does not repeal the Dodd-Frank Act but instead adopts non-conflicting provisions of Basel III, the

254. See supra Part V.
255. See supra Part V.
256. See supra Part V.A.1.
257. Lyons, supra note 218, at 29.
259. Alex Barker & Brooke Masters, Paris and Berlin Seek to Dilute Bank Rules, FINANCIAL TIMES, Jan. 22, 2012, http://www.ft.com/intl/cms/s/0/7f8485a8-4500-11e1-a719-00144feabdk0.html#axzz1mf9Wu3jV. However, Germany’s Finance Minister later rejected the claim that both countries were seeking to relax the rules. France, Germany to Implement Basel III Rules: Schaeuble, REUTERS, Jan. 23, 2012, http://www.reuters.com/article/2012/01/23/eurozone-schaeuble-idUSL5E8CN15X20120123;
260. Barker & Masters, supra note 259.
261. See supra Part V.A.1.
262. See supra Part V.A.4.
same bank would essentially have two choices (foundation IRB and advanced IRB). In Europe and the UK, these banks would have three options (standardized and the two IRB approaches).

The variance in rules among Hong Kong, the UK, the EU, and Germany is actually relatively minor, at least as it relates to measuring credit risk. Hong Kong’s additional basic option is not so drastically different from the standardized or IRB approaches. In effect, banks in these countries will still choose either to use CRAs or their own models, and that choice is mostly determined by the size and resources of the bank.

The U.S. approach, on the other hand, is much more limiting. Dodd-Frank’s prohibition of the use of CRAs means that smaller banks will no longer be able to rely on CRAs to determine the risk level of their loans. (Of course, the shift in policy away from the use of CRAs will not affect banks that have already been using their own internal models, which tend to be larger banks.) Smaller banks will either have to develop their own internal models or wait until the U.S. develops its own objective criteria. Until this issue is resolved, this variance will likely create confusion and extra expense for some banks.

Banks that choose the standardized approach might have a number of choices of CRAs, depending upon the country. The EU and UK recognize only four CRAs: Moody’s, Standard & Poor’s, Fitch, and DBRS. The U.S. currently recognizes none. Notably, before Dodd-Frank, banks had ten possible options. Hong Kong recently approved the use of two more CRAs: Japan Credit Rating Agency and Credit Analysis and Research Limited. Again, too much competition among CRAs may impair the objectivity of the ratings.

263. See supra Part V.A.5.
264. See supra Part V.A.1–3.
265. See supra Part V.A.4.
266. See supra Part V.A.
267. See supra Part V.A.5.
268. See supra Part V.A.5.
271. Japan Credit Rating Company can be used for banks that have their headquarters in France, Belgium, Luxembourg, Germany, or Hong Kong. Press Release, Japan Credit Rating Agency, JCR Recognized as an Eligible ECAI by Hong Kong (Dec. 22, 2011), available at http://www.jcr.co.jp/reportqa/pdfen/2011122210c.pdf. Banks in Hong Kong can use Credit Analysis and Research Limited’s ratings to measure credit risk of exposures to Indian corporations. Press Release, Capital Ratings, Analysis and Research
Differing timelines for implementation will create another problem. Germany, the UK, and Hong Kong have all stated that they intend to follow the same implementation schedule as the EU, and although the EU has attempted to harmonize the implementation schedule by agreement, countries may still disagree about when the best time to implement Basel III will be.

The U.S. has historically been slow to implement Basel rules. Despite being a vocal proponent of Basel II’s recommendations, the U.S. did not fully implement Basel II and then only did so after significant delay. Basel III’s conflicts with the Dodd-Frank Act will likely further delay the implementation of Basel III, if it is adopted at all.

VII. CONCLUSION

Even ignoring the lack of uniform global standards, Basel III’s rules regarding credit risk assessment still need improvement. The standardized approach needs to either end its reliance on CRAs or find some way to restructure the incentives driving the CRAs’ business models. The IRB approach can be appropriate and reliable as long as supervisors can adequately understand and critically analyze the models that the banks use.

Moreover, temporal and geographic differences may create an uneven regulatory environment. Banks looking to maximize their competitive advantage will have reason to evaluate the relative regulatory benefits of doing business in one country over another. Whether these differences are extreme enough to impair Basel III’s goal of stabilizing global banking is unclear. Much turns, however, on how accurately credit risk
is measured. If the risks inherent in MBSs had been accurately assessed, the mortgage crisis in the U.S. may have been less severe.

In general, however, Basel III’s rules on measuring credit risk are similar to those in Basel II. Unless financial instruments become less complex in the future, regulators need to find a way to ensure that banks hold an appropriate level of reserve capital. Because financial instruments will likely remain intricate, banks will still have an incentive to game their capital requirement levels, often with the assistance of CRAs.

282. See supra Part II.
283. See supra Part II.
284. See supra Parts III.A-B, V.
285. See supra Part II.
286. See supra Part VI.A.