Measuring bank capital

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Since the credit crisis, the debate surrounding Basel II has been akin to film buffs discussing the sequel to Die Hard – most agree it is an improvement, but does it actually matter? The first Basel accord was a stab at regulating bank capital. The riskier the assets, the more capital banks had to set aside. Twenty years on, Basel II aims to make a number of improvements, most importantly refining and broadening the measurement of risk.

A common criticism is that Basel II relies to some degree on banks' own modelling. There are also geographic discrepancies, and it is being implemented in fits and bursts, making comparisons tricky. But these quibbles miss a bigger problem: when calculating regulatory risk, what is the correct weighting to give each asset class? Basel II may be refined, but it still largely relies on statistical analysis to calculate the probability of a loss within a given degree of confidence. Triple-A sovereign debt requires no capital, while credit card lending has a 75 per cent weighting.

The trouble is, different methodologies spew out different weightings. Standard & Poor's also measures capital adequacy using historical data, but the risk weighting it assigns to a double B-rated securitisation, for example, is up to 3 times higher than that derived under Basel II. Taken across all assets, the differences add up. S&P case studies show that Tier 1 capital ratios for Japanese or Middle Eastern banks, using its risk weighted methodology, are almost half that calculated under Basel II. Conversely, S&P's Tier 1 ratio for a sample Nordic bank is 1.3 percentage points higher.

Such variation raises questions about the usefulness of risk weighting, however detailed the analysis. The still-preferred approach in the US of comparing unweighted assets to tangible book equity may be blunt, but at least there is little room for subjectivity. There are powerful conceptual arguments for risk weightings, but when fear reigns, most investors are happy to sacrifice detail to know that their bank is, very roughly speaking, not going bust.

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