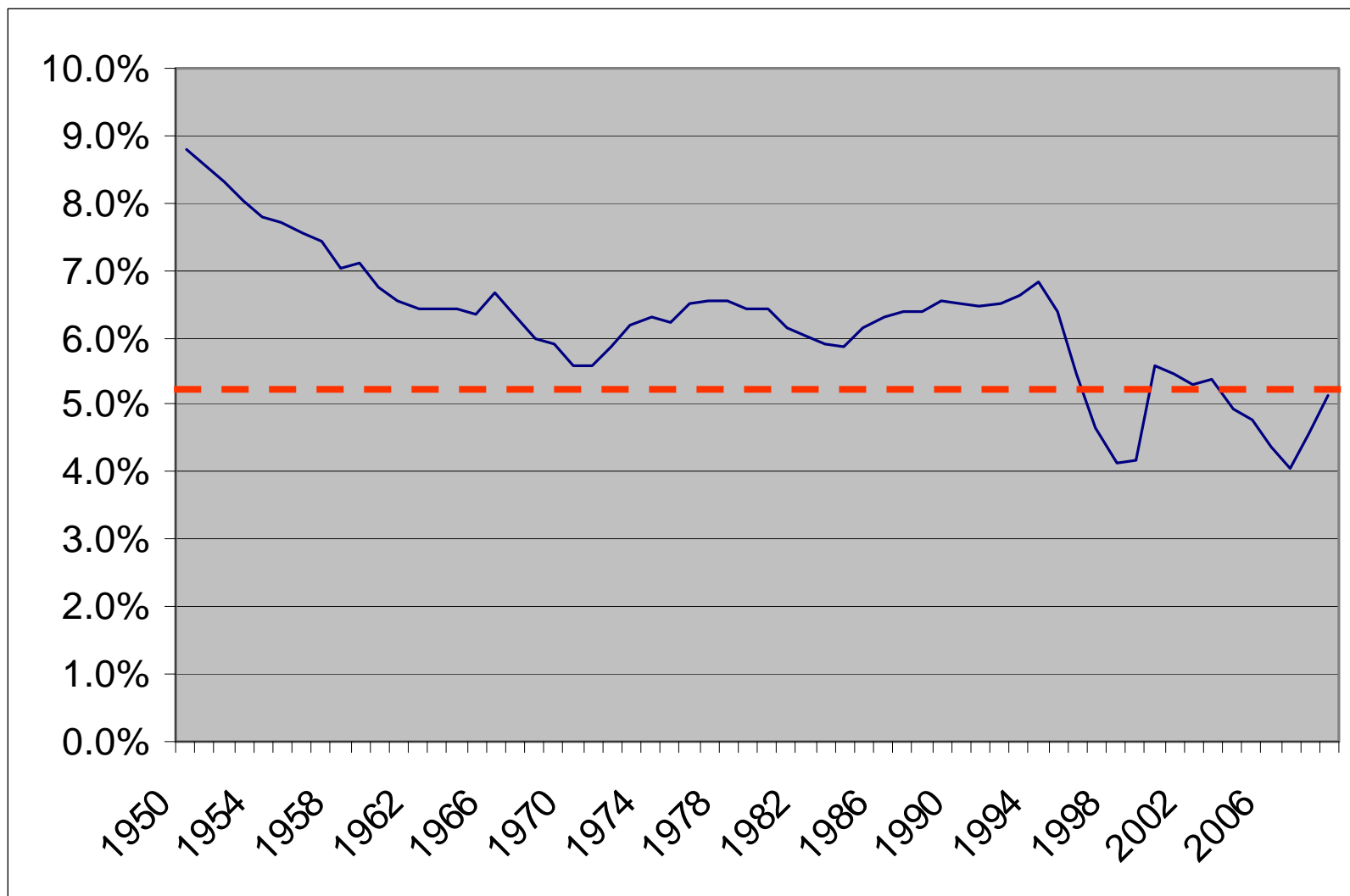


Regulating and Supervising Banks or Risks in Banks ?

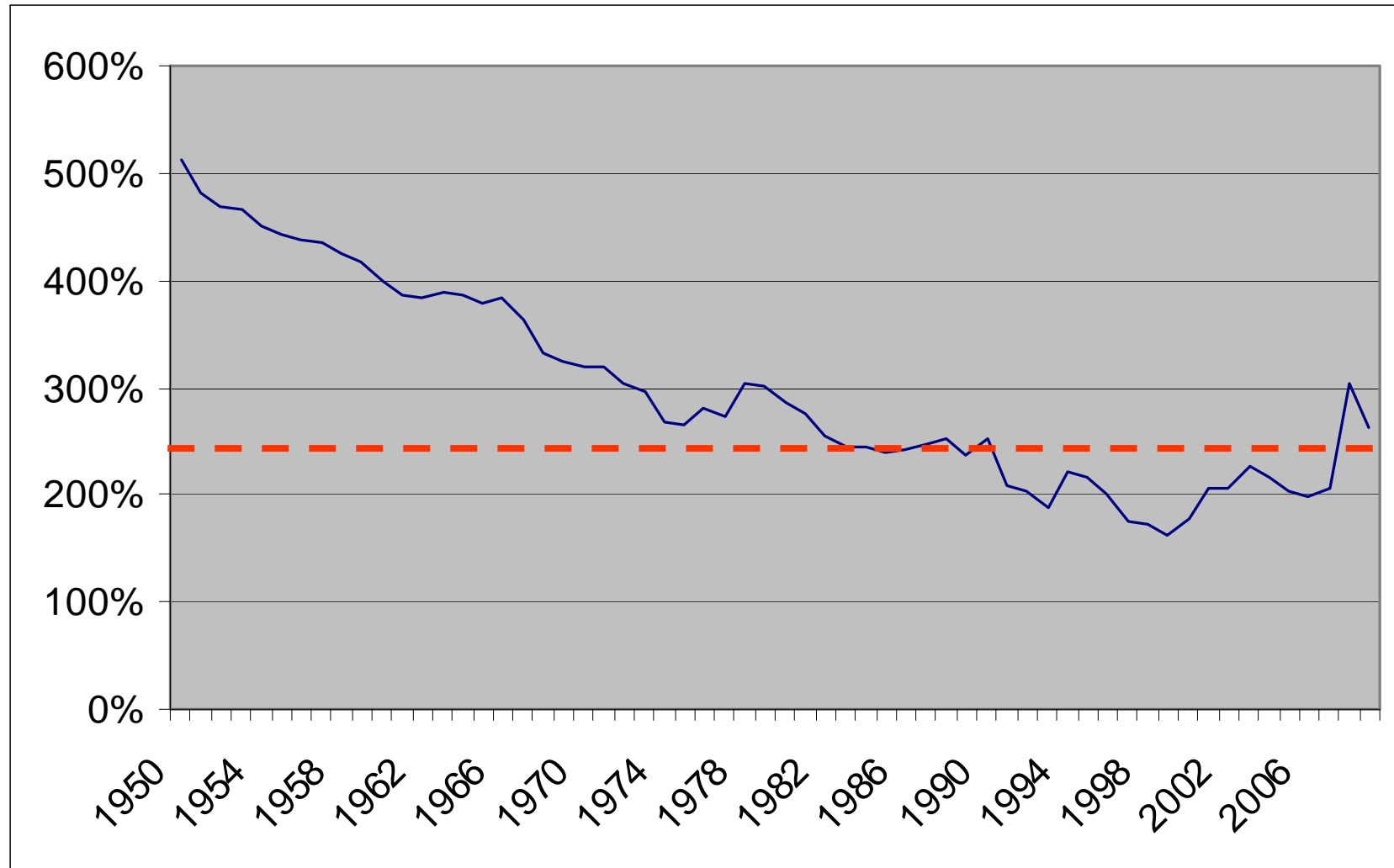
1. It is about capital
2. A bit of history
3. Modern capital framework: Assumption about man
4. The most stupid risk measure for regulation

Hans Geiger
Professor Emeritus Banking
Universität Zürich, ISB

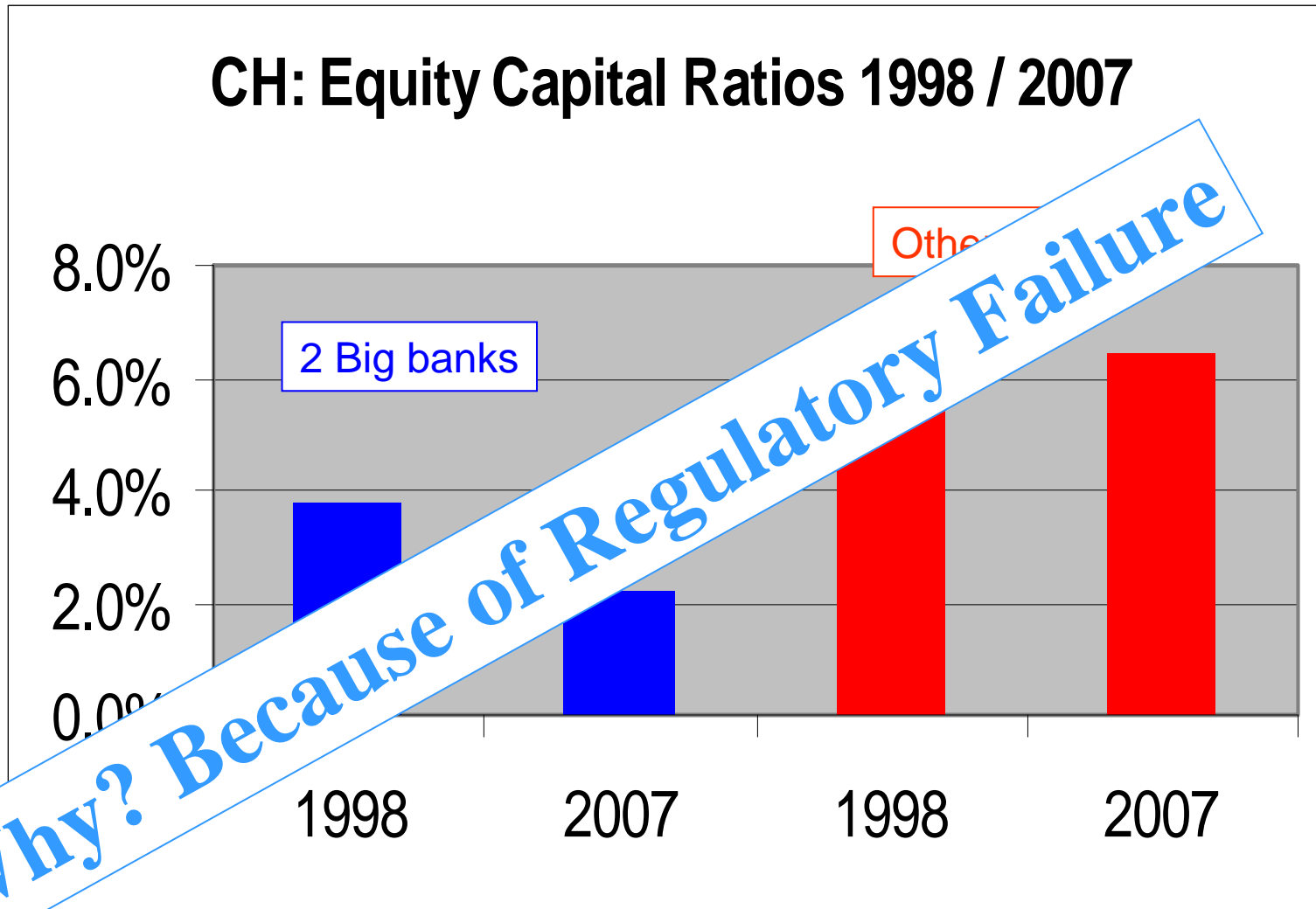
Banks in Switzerland: Equity as % of Total Assets



Banks in Switzerland: Equity as % of Gross Income



The Leverage Game of the Big Banks (Swiss Example)



Quelle: Konzernrechnungen Grossbanken; SNB Daten nicht konsolidiert

Equity Requirements of BankG 1934 and BankV 1935

Law of 1934: BankG Art. 10:

Banks have to maintain an adequate relation between

- a. Own funds and total liabilities;
- b.

Implementing Ordinance of 1935 VV Art. 10 - 12:

Art. 10

Own funds consist of ...

Art. 11

Total liabilities consists of ...

Art. 12

Own funds must as a minimum amount to:

- a) For cantonal banks 5 % of total liabilities.
- c) For other banks 5 % up to the level covered by domestic mortgages, 10 % for the remaining of total liabilities

2007 New Capital Regulation in Switzerland

1. One article of the law (Art. 4 BankG)
2. A new implementing ordinance exclusively for capital rules (ERV)
3. 6 directives (“Rundschreiben”) of FINMA

Size of documents: 240 pages (plus Basel II)

Objectives of Basel I

“INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT
AND CAPITAL STANDARDS” July 1988

“Two fundamental objectives [...] are, firstly, that the new framework should serve to **strengthen the soundness and stability of the international banking system**; and secondly that the framework should be in fair and have a high degree of consistency in its application to banks in different countries with a view to **diminishing an existing source of competitive inequality among international banks**”.

Minimal Capital = 8 %

Size of document: 30 pages

The Regulatory Sins of 1996: AMENDMENT TO THE CAPITAL ACCORD TO INCORPORATE MARKET R 1

The main feature of the April 1995 proposal was to respond to the industry's request to allow banks to use proprietary *in-house models* for measuring market risks as an alternative to a standardised measurement framework

Methods of measuring market risks 2

In measuring their market risks, a choice between two broad methodologies [...] will be permitted, subject to the approval of the national authorities. One alternative will be to measure the risks in a standardised manner [...] the alternative methodology, which is [...] conditional upon the explicit approval of the bank's supervisory authority 3

QUANTITATIVE STANDARDS

Banks will have flexibility in devising the precise nature of their models, but the following minimum standards will apply [...]

(a) "*Value-at-risk*" must be computed on a daily basis.

4

Objectives of Basel II

1. **Continue** to promote safety and soundness in the financial system
2. **Continue** to enhance competitive equality
3. **Constitute a more comprehensive approach to addressing risk**
4. **Contain approaches to capital adequacy sensitive to the degree of risk involved in a bank's positions and activities**
5. Focus on **internationally active banks**, although underlying principles should be suitable for application to banks of varying levels of complexity and sophistication

Size of document: 333 pages

Vision of Basel II

“The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy [...]. It seeks to improve on the existing rules by **aligning regulatory capital requirements more closely to the underlying risks that banks face.**

In addition, the Basel II Framework is intended to **promote a more forward-looking approach** to capital supervision, one that **encourages banks to identify the risks they may face**, today and in the future, and **to develop or improve their ability to manage those risks**. As a result, it is intended to be more flexible and better able **to evolve with advances in markets and risk management practices.**”

Source: <http://www.bis.org/publ/bcbsca.htm>

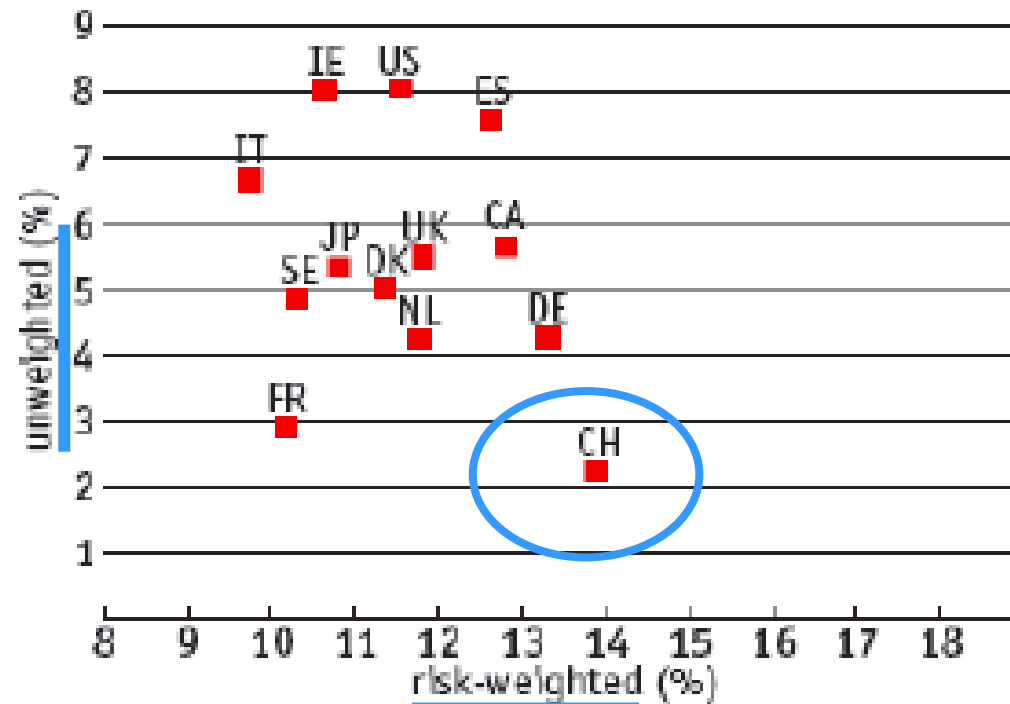
Adam Smith: Assumption About Man

“He [the individual] generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. [...] he intends only his own security; [...] he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.”

If, in a world with the visible hand of the regulator who follows the vision of the Basel Committee, bankers behave as Adam Smith assumed human beings do, then “safety and soundness in the financial system“ will be at risk.

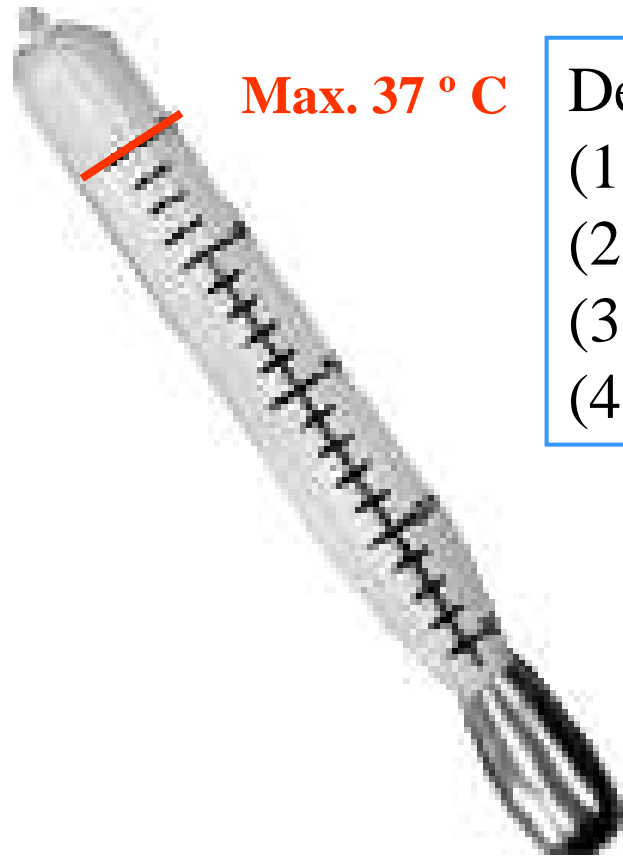
FINMA: “ Big Banks with Above Average Capitalization”

Capital ratios of major international banks Graph 19



Sources: 2004 and 2005 annual reports

The Risk Measure of Basel II: Value at Risk VaR



Max. 37 ° C

Defining VaR: VaR summarizes the

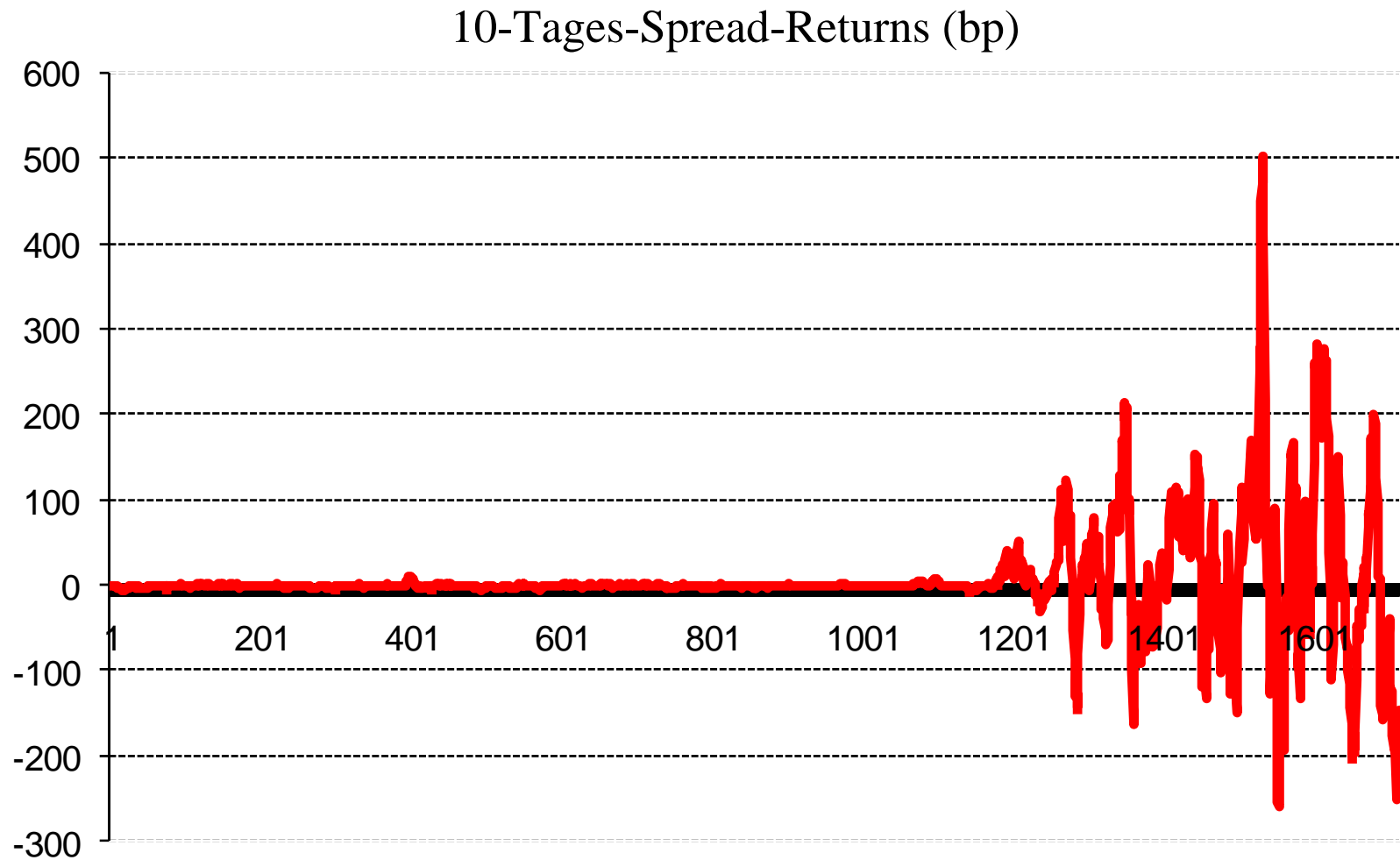
- (1) predicted
- (2) maximum loss (or worst loss)
- (3) over a target horizon (e.g. 10 days)
- (4) within a given confidence interval (e.g. 99 %)

“Regulators like Value at Risk, because they can regulate it“

(René Stulz, 1996)

VaR is like a fever thermometer, which only measures body temperature in 99 % of the cases, i.e. when the person is healthy.

AAA Home Equity Subprime 2003 – Juli 2009



Quelle: FINMA, 9.09

