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"Mass delusions are not rare. They salt the human story. The hallucinatory types are well known; so also is the sudden variation called mania, generally localized, like the tulip mania in Holland many years ago or the common-stock mania of a recent time in Wall Street. But a delusion affecting the mentality of the entire world at one time was hitherto unknown. All our experience with it is original. This is a delusion about credit. And whereas from the nature of credit is it to be expected that a certain line will divide the view between creditor and debtor, the irrational fact in this case is that for more than ten years debtors and creditors together have pursued the same deceptions. I many ways, as will appear, the folly of the lender has exceeded the extravagance of the borrower." - Garet Garrett "A Bubble that Broke the World" page 1(1932)

So, for most of modern history financial institutions, regulators, legislators, policymakers and the public have been keenly aware of the risks borne by financial institutions and the effects ineffective risk management could pose to borrowers, economies and financial stability. Although problems in credit markets are never considered to be good experiences, while they are playing out, the lessons they may provide – assuming they are being considered – are invaluable as reminders of the value of effective risk control environments and in crafting policies that enhance efficacy and efficiency in safety and soundness.

With that view in mind the timing of our current convulsive episodes, on the eve of the implementation of the Basel II framework, could not be better. Although the implementation has taken far longer than anybody would have desired I am hopeful that regulators and policy-makers choose to slow implementation down until the lessons of this period can be identified and the more material appropriate changes to Basel II can be included in the initial rollout. Caution is justified given the Financial Stability Forum's recent statement that "There remains a risk that further shocks may lead to a recurrence of the acute liquidity pressures experienced last year" and that "It is likely that we face a prolonged adjustment, which could be difficult".

I would also hope that the international safety and soundness community would consider requiring a final QIS, as the US regulators have, before the full, live implementation becomes effective. Furthermore, I would hope (and expect) that more regulators would consider the need to retain a leverage ratio, at least during the first post-Basel II economic cycle.

The lessons to be gleaned should not only relate to obvious risk considerations such as the role of rating agencies, the assignment of risk weighted capital such as that for residential mortgage assets, the encouragement of standardized structured products, stronger rules on asset securitization and liquidity regulations but they should also support:

- Enhanced discussion and deliberations about the need to consider reputational risks impacts on capital adequacy especially those implied by off-balance-sheet exposures;
- The need for significantly enhanced public disclosures about holdings and risk model assumptions;
- The use of non-economic transactions for capital arbitrage (including securitization incentives); and
- The now fully detailed shortcomings of the excessive reliance Basel II places on institutions statistically derived internal models for measuring risks in newer collateral classes and structured product classes.
- Clear proscriptive guidance on valuing illiquid securities.
- Clear focus and guidance on what Through the Cycle analysis is and how it should be properly considered in order to be statistically relevant and predictive.

I cannot, in the short time allotted me today, address all of the facets of Basel II that deserve discussion. Similarly, while I view many of the approaches in Basel II to materially enhance safety and soundness, relative to Basel I, by necessity I will focus on some of the more significant aspects of Basel II that warrant further consideration, review and enhancements.

The Irony of the IRB model

Those institutions whose businesses are more complex, who by proscribed standards have more sophisticated risk management environments, who have the physical and financial resources to develop and maintain their own risk models are able to use the IRB approach and benefit from a significant reduction capital relative to the standardized approach. This functional incentive seems intended to encourage institutions to become increasingly sophisticated in their risk management. Unfortunately, as can be seen by recent events sophistication is not the same as complexity and it was precisely those institutions that would benefit under Basel II's IRB approach who have taken the largest charges as a result of having been most exposed to the worst model risk and most complex instruments. As I have said before I expect this chapter in our economic history could be labeled “when models fail”, given that reality should we really tie regulatory capital to models that have not been subject to real world cycles? I should point out the repeated calls from Roger Ferguson and Susan Schmidt Bies, during the design phase of Basel II, to consider the risk of mis-modeling. If truth is stranger than fiction shouldn’t we run these models for a full cycle before we assume they will hold up in the real world?

I should add that unlike Basel I, Basel II requires institutions to set aside capital not for expected losses but for unexpected losses. Well, maybe I haven’t had enough coffee today but I can’t wrap my brain around that concept? The argument is that any rational business would reserve for expected losses so why tell them to, instead, the argument goes, you only need to tell them to reserve for unexpected losses. Well, were it not for having the cushion of Basel I's expected loss requirement I have to wonder which institutions would not have survived the recent direct hits from unexpected losses? Remember, Credit Suisse was recently disavowing any exposure to the current market problems and then unexpectedly announced a significant loss tied to a combination of operational risk failures and valuation failures. To steal a quote from a recent letter in the Financial Times; Basel II “main thrust is on solvency, ignoring the golden rule of banking: most banks fail because of a lack of liquidity, not a lack of capital. The UK Treasury was insisting that Northern Rock was solvent (as it was), even as it was

collapsing under the weight of depositor withdrawals”.

This speaks to a larger shortcoming of Basel II that I wont spend time on today and that is the considerable issue of pro-cyclicality. Who anticipates unexpected and outlier risks in good times, in those times where markets are believed only to go up?

Risk Weightings

I would briefly mention that the risk weightings of assets, under Basel II, might be worth reconsideration given recent default experience in residential mortgages.
The reduction in risk weightings from Basel I's 50% to Basel II's 35% (for loans with an LTV up to 80%) might have been justified if there had been no significant innovation or change in mortgage preference from prior periods, the reality is that product innovation and the emergence of large Alt-A and subprime markets has perverted the value of historic experience in assessing risk.

Valuation, Asset Pricing and Double Default Risk

Late last year the Basel Committee published a Consultative Document detailing how banks should calculate and consider an Incremental Default Risk. While I applaud their recognition of the need to consider such risks I am unconvinced that their work on this subject goes far enough. One Fed Official stated about Basel II and Double Default that “Joint default probability is generally much lower than either marginal default probability”

I am certain that view does not adequately consider that the default correlations between third-party obligors and counterparties rise in the same environment that formerly liquid instruments become illiquid.

In the wake of the recent experience regarding the monoline insurers it is readily apparent and conceivable that obligors and counterparties could realistically both default, if even not at the same time, and that the higher rated could default first.
Moreover, that it is nearly impossible to gain confidence in the fair values of the underlying illiquid securities or even a fair consensus estimate of the expected default of the underlying instruments suggest that the current Basel II program is inadequate and more work needs to be done in this area.

Reputational Risk is a Call on Capital

Reputational risk is another area where Basel II should be strengthened and, in fact, an area where the Committee should press hard on the rating agencies.
Last fall, when turmoil in the SIV market was beginning and the rating agencies appeared to be forbearing from downgrading SIVs, Moody_s seemed to justify their ratings by stating *“Bank sponsorship may make the difference between normal operations and wind-down. The formal protections enjoyed by bank sponsored SIVs are generally no greater than those enjoyed by SIVs sponsored by other institutions. However, it is clear that a bank sponsor, particularly a large commercial bank, can provide options to the SIV manager that another type of entity cannot. Banks have reputations to protect in business and political interests far removed from the world of SIVs, and the blow to a bank’s reputation that may be occasioned by a failure of a SIV*

may be more than the bank can tolerate…Even where the bank does not invest in the capital, the relationship with capital note investors may be such that it behooves the bank to avoid losses to capital note investors to protect that relationship".

While they appeared to be correct wouldn't this argument suggest the financial strength rating of the SIV sponsor should have always reflected some degree of support. Even Basel II, which would require the institution to hold capital against the guaranteed portion of an off balance sheet exposure would not have captured the ultimate reality that they would have to reconsolidate their entire exposure only after having their liquidity lines drawn down. Is it time to finally learn the lessons that we failed to learn in the wake of Enron but which are open to be learned from the current crisis; that off-balance sheet exposures through SPEs are only off-balance sheet in good times?

Ratings Agencies in Basel II

It has long been argued that Basel II's use of external ratings, as a basis of the capital risk weightings of assets, was a major advance. As a result the Basel Committee, by fiat, has abandoned much of their historic oversight responsibilities to these loosely regulated institutions.

The basis of the argument was a belief that external ratings would:
- Provide greater risk differentiation;
- Offered high correlations between risk grades and default rates; and
- More appropriately recognize credit risk mitigation techniques (**"as an aside many of those mitigation techniques such as CDS and financial guarantees have failed even though they were given the benefit in ratings")**

Recent events indisputably argue for a reconsideration of the usefulness of external ratings and highlight the fallacy offered by one senior regulatory official who stated, "Greater reliance on ECAIs can lead to even greater responsibility on the part of ratings agencies".

These organizations are supposed to be able to measure Probability of Default and Loss Given Default but have clearly demonstrated their inability to do so.
These recent events also suggest the likelihood that the already approved ECAI_s/Rating Agencies do not meet the benchmarks required of them under Basel II.

In an effort to make sure that ECAI_s/Credit Rating Agencies were at least minimally capable of meeting their responsibilities the Committee required the ECAI, among other criteria, demonstrate:

- Objectivity. The methodology must be rigorous, systematic, and subject to validation;
  o (In the world of structured products they are neither systematic nor subject to validation).
- Independence. An ECAI should be independent and not be subject to political, economic pressures
  o (Look at the forbearance in recent monoline reviews)
- Disclosure: An ECAI should disclose methodologies, time horizon, meaning or rating, default rates and transitions matrix;
- Resources: An ECAI should have sufficient resources to carry out high quality

assessments
o (So why don't the CDO and RMBS groups inform each other, why don't the analysts doing FS ratings seem to apply liabilities opposite to benefits given implicitly or explicitly to sponsored structures?)
- Credibility (need I comment on this)

Moreover, unless rating agencies broad protections from legal liability are removed there will continue to be a misalignment of incentives, incentives which I believe are, contrary to the view of those who suggest it is the issuer pays model, at the root of the weak control environment at the rating agencies.

Now, to be fair, I will point out that contrary to other voices on the subject I do not think that the problem with the rating agencies derive from the issuer pays model nor do I believe that the rating agencies are ill-equipped to rate all asset classes.
The same pressure that must be managed in the issuer pays model, specifically the pressure to please the paying client, exist in the investor pays model.
Management of these risks should be part of effective regulation. I can tell you from personal experience that, at my former firms, several clients strongly encouraged me to reconsider my views and were it not for a strong management and internal control culture I might have had to choose between my views and my employment.

I would, to the credit of the rating agencies, point out that in traditional single issuer asset classes they do a reasonably good job. They are armed with models that have been relatively unchanged through several cycles, in many cases have 100 years of empirical data on cycles, industries and in some cases on specific issuers. Moreover, given that traditional corporations and sovereign nations are assumed to exist in perpetuity, that they exist independent and prior to the rating process and that (in the case of corporates) there is greater public disclosure of financial data there is less need for financial institutions and investors to rely on ratings.

My concerns about the role of ratings in Basel II primarily relate to:

- The fact that they are rating instruments which are as subject to market and liquidity risk as they are to default risk but those risks are not part of their rating mandate. In fact, most of the losses thus far in rated instruments have resulted from mark to market losses while the credit losses are yet to come. This suggests that credit ratings are not the right benchmark and that they actually trail the markets in discounting risk;
- That the underlying collateral may have no empirical history from which to correctly model risk appropriately;
- That they often rate structures that have no prior history;
- The fact that their models are constantly evolving and that when they change their model for rating new issues they do not, systematically, go back and re-rate existing securities using these new methods;
- The fact that their assumed default rates at a given rating differ from asset class to asset class **(as an aside as of last July there were 27 AAA sovereigns, 67 AAA rated corporates, 160 AAA rated Munis, 8070 AAA RMBS, 6882 AAA CDOs and the yields on these ranged from about 3% to over 35%). This clearly highlights that AAA is not a well-defined or specific term. Wouldn't it be strange for a teacher to treat all people who had the same name equally?**

From a regulatory perspective is not a sensible approach.
- The fact that their processes are open to be gamed **(I can provide many examples from the initial rating discussions through to the secondary market where a BBB RMBS doesn't get re-rated before being put into a CDO, thus creating incentive for issuers to put the highest yielding asset in the CDO that still achieves a desired rating)**
- That they have ignored significant information about the underlying collateral in securities they rate such as one major CRA not using DTI as a primary driver in models until last spring
- That they fail to apply assumptions between asset classes (**pause and explain MICA "*I looked at an*** A-1/P-1 ***multi-seller ABCP conduit, fully supported by several of the largest financial institutions in the world, in which over 45% of the total assets held were not rated and over 15% were below investment grade. Between January and July of 2007 over 80% of the newer assets were not rated and 5% were below investment grade. What are those assets, we come back to a transparency issue given that over 40% of the total assets were classified merely as "other" and over 80% of those assets sold into the conduit between January and July were classified as "other". The agencies seemed not to care what the assets were given the liquidity guarantees BUT how then could they estimate the financial risk and impact to the ratings of the sponsoring institutions"* OR, in a similar miscue the fact that they are reviewing the monolines for possible downgrade but have been relatively quiet on the FS ratings of counterparties)**
- Even though we call them Nationally Recognized Statistical Rating Organizations I do not believe that any of them have a Chief Statistician nor any PhD in statistics to validate their models or changes to their models – rather they model on an impromptu learning by doing basis
- In the recent RMBS episode the rating agencies chose to re-rate securities primarily based on pipeline losses, in other words, those losses already visible, as opposed to rating to expected default rates as they do at issuance. This inconsistency is important to consider and raises questions as to whether ratings are predictive or merely recognition of the status quo. If they are the latter should we really be using them as a benchmark for capital regulations of safety and soundness?
- In the recent RMBS downgrades the CDO team didn't respond quickly based on the work of the RMBS team and part of the justification was that the CDO managers had an opportunity to manage exposures in the revolving period while RMBS were static. In reality this assumption, in an illiquid environment, was deeply flawed and demonstrated their ability to recognize changes in market environments until after the effects of those changes had been broadly recognized, thus undermining the predictive value of ratings.

Ironically, given that unrated assets will have higher risk weightings than lower rated assets it seems likely that the already stretched and poorly performing rating agencies will become ever more tied to bank capital regulation as more and more institutions seek to have assets rated.

I would suggest two rather easy to implement solutions that would vastly enhance the value of ratings and quality of rating assessments. They would not solve all of the problems but would correct the most significant problems.

First, I would require that precisely the same assumptions used in the initial rating (e.g. about the probability of default) are applied on an automated and monthly basis, using the monthly remittance and other due diligence data, to re-rate/monitor secondary market ratings. The use of such a method would make it functionally irrelevant whether the primary assumptions were accurate or not as the secondary market rating migration would result in clarity of the model failures at origination and result in a desire of the rating agency to fix their model to avoid the volatility of rating migration.

Secondly, I would require when an NRSRO changes their primary market models in structured finance they be required to concurrently apply those changes to all existing securities that were originally rated using the model that had been changed.

Conclusion

There are several areas that should be addressed to enhance the safety and soundness environment of Basel II. As it stands the Basel II plan is inadequate given what we have learned over the past year.

Thankfully, I expect that many of these issues with Basel II will be considered, either directly by the Committee or by national safety and soundness regulators, securities regulators and legislatures. While it is not yet clear whether the Basel II Committee members fully appreciate the seriousness of the current problems other policy-makers clearly do.

In September the EU put forward new rules that require all listed firms to disclose and detail any significant arrangements they have with SPEs. This is an appropriate disclosure item and should be adopted globally. In April the Financial Stability Forum will put forward specific recommendations to enhance market stability and safety and soundness and by October the EC will propose desired changes to Basel II and the role of rating agencies.

Domestically, the picture is less clear and a failure to take the lead in suggesting and supporting necessary changes may well undermine the leadership of the US in the areas of safety and soundness, transparency and market regulation.