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Basel II Capital Accord: Extract the Benefits; Minimize the Adverse Consequences

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The Basel II Capital Accord is facing its moment of truth. The Accord, which is scheduled to be implemented by January 2008, will affect, directly or indirectly, the entire banking industry, including regional and community banks and savings institutions, and could result in fundamental changes in the number, size and business lines of all types of depository institutions.

It could also have a significant impact on the availability and cost of credit for the entire economy. As a result, the Accord has become a subject of controversy among the banking agencies, Congress, the financial services industry and academic experts.

This paper provides information on why the Accord was developed, the essential changes that it makes in capital policy, and the arguments for and against the proposal. It also offers some suggestions for implementation of the Accord that will mitigate some of the concerns raised with the current plan.

The Current Basel Capital System

In the early 1980s the world's banking system was in crisis. Capital levels of major international banks were deteriorating. At the same time, the risks associated with cross-border banking were increasing, and concerns were expressed that the debt load of many of the developing countries was too excessive. In fact, in 1982 Mexico announced that it was unable to repay its foreign debt obligations, and a group of 17 highly indebted countries asked for concessions on their loan terms.

In light of these developments, the central banks and other bank supervisory officials from the leading economic powers met in Basel, Switzerland to formulate a plan to enhance bank capital. The Basel Committee[1] determined that the best way to strengthen capital and to reduce competitive inequalities was to formulate a uniform international capital standard that reflected the riskiness of the institution's assets, including off-balance sheet assets (such as guarantees and long-term loan commitments).

In July 1988, a capital framework was approved by the members of the Committee and implemented by the individual countries represented on the Committee, as well as other countries. This standard is now referred to as Basel I.[2] Under Basel I, a bank's assets are assigned one of four risk weights or baskets, ranging from 100 percent to 0 percent, and a capital charge is assessed on the risk-adjusted value of the asset. For example, a commercial loan is risk-weighted at 100 percent and a residential mortgage loan is risk-weighted at 50 percent. Thus the minimum capital ratio of 8 percent requires $80 of capital for a $1,000 commercial loan, but

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[1] The Basel Committee was originally formed in 1974 by the Central Banks of the Group of Ten—the major industrial countries that are members of the IMF. The Basel Committee consists of Central Bank and banking supervisors from the Group of Ten, plus Spain and Luxembourg.

[2] Since its issuance in 1988 it has been amended on several occasions, for example in 1995 to take into account the beneficial effects of netting provisions, in 1996 to recognize the need to hold capital for market risk, and in 2001 to change the capital treatment of residual interests and direct credit substitutes.

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only $40 of capital for a $1,000 residential mortgage loan.

Origins of the New Capital Framework

It is widely recognized that the original Capital Accord significantly strengthened the capital levels and safety and soundness of the banking system, and helped provide competitive equality among banks operating internationally.[3] However, by the late 1990s the original Accord was also viewed as a rather crude instrument for setting risk-based capital levels.

For example, all commercial loans are placed in the same risk-weighted basket, despite considerable differences in the creditworthiness of the counterparties. Basel I also creates incentives for a bank to securitize its best assets and to hold in portfolio riskier assets within the same risk-weighted basket. Finally, the Basel I framework does not encourage the use of risk mitigation techniques.[4]

In response to these and other perceived weaknesses, the Basel Committee proposed a new capital framework in June 1999.[5] Following a public comment period, and several revisions, this framework evolved into the Basel II Accord that was agreed to on June 26, 2004, and is now being implemented internationally. The main objectives of the new proposal are to make capital requirements more risk sensitive, encourage institutions to improve their risk management techniques, incorporate more fully off-balance sheet risks, and enhance competitive equality among institutions operating internationally.

Basel II Basics

The Basel II Accord envisions a three-pronged approach to enhancing the safety and soundness of financial institutions: (i) new capital standards; (ii) enhanced supervision; and (iii) increased market discipline through additional public disclosures.[6] Most of the attention has focused on the first pillar, the new capital standards.

With respect to capital, the Accord permits depository institutions to adopt one of two methods for risk weighting of assets: the standardized model or the internal ratings based (IRB) model. In the United States however, only the internal ratings based model will be used.

The standardized model is easier to apply and closer in approach to the existing Basel I framework. Under the standardized approach, risk weights are assigned to assets based on the credit rating the counterparty (or the asset) has received from an independent third party rating agency, such as Standard and Poors. For example, a loan to a corporation that has an S&P credit rating of AAA would be assigned a risk weight of 20 percent, while a loan to a corporation with an A rating would be given a risk weight of 50 percent.

On the other hand, if the counterparty has a credit rating below BB- the risk weighting would be 150 percent. The standardized approach would assign a risk weight of 75 percent to a portfolio of retail loans to individuals or small business. Prudentially underwritten residential mortgage loans are assigned a weight of 35 percent. The standardized approach also provides beneficial capital treatment of loans that are collateralized or protected by enforceable guarantees.

[O]ne economic analysis estimated that the capital charge for prime mortgage loans with an 80 percent loan-to-value ratio could be as low as 29 basis points for Basel II banks.

As mentioned, the standardized approach will *not* be used in the United States. Instead, the U.S. bank regulatory agencies will institute the internal ratings based or IRB model. This is a much more complex system that requires banks themselves to determine required capital, based on the criteria and formulas contained in the framework.

Alternative Models. Under the Accord, there are two alternative IRB models, foundation and advanced, (A-IRB). The foundation model relies heavily on risk data inputs provided by the agencies, with limited computations required by the banks. However, in the United States the foundation model is not being proposed, and instead institutions using the Basel II standards will be required to use the advanced model.

Under the advanced internal ratings based (A-IRB) approach each covered bank must determine specified key data or inputs for its wholesale and retail exposures and equity holdings. The data that the bank must compute includes: (i) the probability of default (PD); (ii) the probable loss to the bank if a default occurs (LGD); (iii) the banks exposure at default (EAD), for example, the estimated outstanding loan balance at the time of default; and (iv) for certain loans, the maturity of the exposure at default (M).

For retail credits, the bank would determine the required data for pools of loans with similar risk characteristics, rather than on a borrower-by-borrower basis. After the bank determines these inputs, the Accord provides mathematical formulas for determining the amount of capital necessary to cover the banks exposure. Other rules would be used to provide a capital requirement for securitized and off-balance sheet assets.

In determining the required inputs, banks are required to meet minimum supervisory standards. While these standards have not been finalized, certain key requirements have been identified. For example, the bank would be expected to have adequate data to support its ratings and to continually monitor and validate the accuracy of these ratings. Bank requirements are expected to include a compilation of at least a five-year history of data relating to loans and other assets, and possibly longer if a period of stress for a particular class

[3] A New Capital Adequacy Framework, Consultative paper issued by the Basel Committee on Banking Supervision (June 1999).

[4] *Id.*; See also: Statement of Roger Ferguson, Member of the Board of Governors of the Federal Reserve System, Before the Senate Banking Committee (June 18, 2003); FDIC Staff Study, Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back.'' (January 14, 2003).

[5] *Id.*

[6] Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework, (June 2004).

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of borrower occurred prior to the five-year period. Some data will be obtained from external sources, while other information will need to be generated from the banks own experience.

Operational Risk

In addition to credit risk, the Accord requires covered financial institutions to hold capital to protect against operational risk, which is the risk to an institution presented by its normal operations, *e.g.* the risk that a natural disaster will disrupt business, that a computer system will fail or malfunction, that a employee will violate a fiduciary duty, or that the bank will be the victim of internal or external fraud. It also includes the risk posed by litigation and failure to comply with regulatory mandates.[7]

The Basel II Accord provides alternative means for computing a capital charge for operational risk. The basic approach simply requires a bank to hold additional capital equal to 15 percent of the banks average gross income for the previous three years. The standardized approach divides a banks activities into eight business lines, and then establishes a capital charge for each business line equal to a fixed percentage (ranging from 12 to 18 percent) of the average gross income from each line. The advanced measurement approach or AMA requires each covered bank to establish an operational risk capital charge based on its own calculation of risk. Only the advanced approach will be used in the United States.

In order to use the advanced approach, the financial institution would have to meet regulatory standards relating to the institution's management and oversight of its operations. The bank must also undertake a comprehensive identification and measurement of its operational risk and compile historical data on operational risk losses, both internal and external. Finally, the institution will be required to determine an amount of capital that would be able to cover potential losses due to operations with a 99.9 percent level of confidence.[8]

Mandatory and Opt-In Banks. The U.S. banking agencies have stated that only two groups of institutions will be subject to Basel II Capital: mandatory or core banks and opt-in banks. The mandatory banks include banks with total banking assets in excess of $250 billion and banks with total foreign exposures in excess of $10 billion. Opt-in banks are those banks that voluntarily wish to become subject to Basel II, and have the resources and technical capability to comply with its requirements. It is estimated that approximately 10 institutions will be subject to mandatory coverage.

Arguments for Basel II

Supporters of Basel II argue that it more accurately measures the risk of large financial institutions and better captures many of the complex transactions and activities of these institutions. The new system provides capital incentives for depository institutions to hold higher quality credits, and negates the benefits of financial strategies designed to remove high quality assets from a bank's books in order to obtain capital relief. By more closely aligning regulatory capital with the risk posed by an asset, the cost of credit will more accurately reflect the economic cost to make the loan.

Thus, for lower risk loans, such as home mortgages, banks and savings associations will be able to reduce the cost of the loan to the consumer. Basel II also permits financial institutions to benefit from the latest techniques in risk management and statistical analysis, and encourages financial institutions to utilize state of the art risk management techniques if they are not already doing so. Finally, in light of the fact that the major economic powers worldwide will be implementing Basel II for their internationally active financial institutions, failure to implement the new Accord for our institutions will place them at a significant competitive disadvantage when in the global marketplace.

Concerns With Basel II

Opponents of Basel II argue that the new standard is overly complex and too prescriptive. Opponents note that the required methodology is not necessarily the best approach for all covered banks, and that it does not always comport with the banks own internal models. Assessing a capital charge for operational risk is viewed as inappropriate in light of the difficulty in quantifying these risks, and the lack of methodology for obtaining meaningful results.

As an alternative, it is recommend that operational risks be dealt with in the supervisory process rather than through a capital charge. Concerns have also been raised that the new system will have the effect of lowering the capital cushion for many institutions thereby undermining prompt corrective action. Another concern is that the new Accord does not assess a capital charge for interest rate risk, and therefore does not accurately adjust for the true riskiness of the institution. Further, the ability of the bank regulators to effectively supervise and monitor the new system has also been called into question.

One very controversial issue relates to the competitive benefits that the Basel II Accord may provide to covered banks compared to the rest of the industry. For example, one economic analysis estimated that the capital charge for prime mortgage loans with an 80 percent loan-to-value ratio could be as low as 29 basis points for Basel II banks.[9] If correct, this disparity in required capital would provide a significant competitive advantage for Basel II institutions, since a lower capital requirement for a product reduces the cost to offer that product. The result could be a gain of market share for products that receive a lower capital charge under the Basel II framework.

Perils for Non-Covered Banks. Further, Basel II provides incentives for non-covered banks to concentrate on the riskier segments of the market within a product

[7] The 2004 Accord defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk. (2004 Accord, par. 644)

[8] One commentator estimates that U.S. financial institutions would have to hold as much as $67 billion in additional capital to comply with the operational risk requirement. See, Karen Shaw Petrou, Basel II Regulation: U.S. Market and Competitiveness Implications, Statement Before the House Subcommittee on Financial Institutions and Consumer Credit, (May 11, 2005).

[9] Calem and Follain, Proposed Competitive Impacts of Basel II in the U.S. Market for Residential Mortgages, Statement Before the House Subcommittee on Financial Institutions and Consumer Credit (May 11, 2005).

line (e.g. subprime loans), since the advantages of the Basel II system are diminished or even reversed as the riskiness of the credit increases. However, an increased concentration of riskier credits in smaller institutions would itself create risks for the banking system and deposit insurance funds.

More fundamentally, the leverage ratio would appear to be inconsistent with the principles of the new standard, and arguably should be adjusted or eliminated for Basel II banks.

Another concern is that Basel II may encourage further consolidation within the banking industry. To the extent that this new capital standard results in lower capital requirements for larger institutions, it makes these institutions more profitable for their shareholders and thus attracts additional capital that could be used to acquire less profitable banks. Moreover, the very act of acquiring a non-Basel II institution could free up additional capital for the acquiring bank.

When a Basel II bank acquires a smaller institution, the newly acquired assets would become subject to the Basel II framework as a result of the acquisition, potentially freeing up capital that prior to the acquisition was needed to support the smaller banks operations. One estimate predicts that as a result of Basel II, consolidation in the banking industry could double the existing rate of consolidation.[10]

The Leverage Ratio

In addition to the risk-based capital standards, the U.S. agencies currently apply a leverage ratio requirement to insured institutions. The leverage ratio is the non-risk adjusted ratio of tier 1 capital to total assets. The minimum leverage ratio is generally set at 4 percent (3 percent for certain highly rated banks).

It has been argued that even if the Basel II framework reduces a bank's capital, the institution would still have to comply with the leverage ratio, thus mitigating competitive and other concerns. However, the leverage ratio only takes into account on-balance sheet assets. A large bank could effectively reduce the impact of its leverage ratio requirement through financial transactions that move assets off the institution's balance sheet.

More fundamentally, the leverage ratio would appear to be inconsistent with the principles of the new standard, and arguably should be adjusted or eliminated for Basel II banks. The underlying rationale for Basel II is that it more accurately matches the capital of an institution to the risk presented by the institutions assets.

It is hard to rationalize requiring institutions to comply with the Basel II requirements, at a considerable cost to the institution, for the purpose of determining a more risk sensitive capital requirement, but then prevent the institution from actually benefiting from the new system by retaining a leverage ratio that does not recognize the true risk of the institutions assets. This result would be harmful not only to the institution, but to the economy in general, since requiring a lending institution to hold excess capital will increase the cost of credit for the economy. It would also be harmful with respect to the global competitiveness of our international banks, since other Basel member countries will not be imposing a leverage constraint on their international financial institutions.

In short, as a practical matter, if will be very difficult for the supervisory agencies to retain the leverage ratio in its current form for Basel II banks after the new Accord is implemented.

Current Status of Basel II Implementation

As previously mentioned, the Basel II framework was agreed to by the Central Banks and other bank supervisory authorities of the member countries on June 26, 2004. The Accord calls for the standardized approach to commence for non-U.S. institutions on January 1, 2007, and final implementation worldwide by January 1, 2008. Each member country is now proceeding to meet these deadlines pursuant to its own laws and customs.

In the United States, Basel II must be implemented through the issuance of new final regulations pursuant to the Administrative Procedure Act. As part of this process, the agencies issued an Advance Notice of Proposed Rulemaking on July 2003, as well as proposed supervisory guidance in October 2004 and in January, 2005. The original timetable called for the publication of a more formal notice of proposed rulemaking in the Summer of 2005.

On Oct. 29, 2004, the U.S. banking agencies asked 26 large banking organizations to participate in a qualitative impact study or QIS to determine the effects of the Accord. The results of this study, QIS-4, were released in the Spring of 2005. It indicates that the potential changes in capital that would be achieved under Basel II were significantly more substantial than previously estimated,[11] and that the banks calculations of key factors, such as the probability of a default and the loss given a default, differed widely for the same category of assets. In particular, QIS-4 found substantial reductions in capital for all but one category of wholesale and retail lending, and a large capital reduction for mortgage and home equity lending.

The current risk-based capital system needs improvement. It no longer effectively correlates capital and risk for many of our larger depository institutions.

As a result, on April 29, 2005, the banking agencies announced a postponement in publication of the notice of proposed rulemaking, during which time the QIS-4 results will be further analyzed and studied. Once this

[10] Karen Shaw Petrou, Basel II Regulation: U.S. Market and Competitiveness Implications, Statement Before the House Subcommittee on Financial Institutions and Consumer Credit, (May 11, 2005).

[11] Changes in effective minimum required capital for individual institutions ranged from a decrease of 47 percent to an increase in 56 percent.

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analysis is complete, the banking agencies plan on continuing the rulemaking process with the publication of a proposed rule.

Additionally, the agencies have announced plans to modify the Basel I standards applicable to the remainder of the industry. According to the Federal Reserve, the revisions to the Basel I standards are intended, among other things, to blunt the unintended harm that Basel II might impose on non-adopters.[12] Finally, on July 13, 2005 the Basel Committee announced that it rediscussed the schedules of national rulemaking processes within member countries and decided to review the calibration of the new framework in the Spring of 2006. In connection with this review, the Committee decided to undertake a new qualitative impact study (QIS-5) in October.

Conclusion

The current risk-based capital system needs improvement. It no longer effectively correlates capital and risk for many of our larger depository institutions. It creates perverse incentives for banks to sell or securitize their best assets and to retain riskier assets. It does not represent the state of the art in risk management or capital allocation. Basel II contains many improvements over the current capital framework system for our large and internationally active banks.

On the other hand, the proposed new framework may well cause unintended competitive effects with respect to non-Basel II institutions, and could also result in unexpected variations in capital requirements for similarly situated institutions. The task confronting our financial supervisory authorities is to extract the benefits of the new system while mitigating the potential for the unintended results.

While our very largest financial companies are capable of utilizing the advanced protocols of Basel II, there are many other depository institutions that could choose to use and benefit from the other models authorized by the international Accord, but rejected by the U.S. regulators. For example, implementation of the standardized approach (with modifications to reflect the unique nature of the U.S. financial system) would not only mitigate many of the potential anti-competitive effects of Basel II, but would also offer to all depository institutions in the United States the ability to be on the same level playing field as banks in Europe and Asia.

'Basel I-A' Option. In this regard, we note that the agencies are expected to unveil a proposed new capital standard for non-Basel II institutions, perhaps as early as this Fall. In developing this so-called ''Basel I-A'' option, the regulatory agencies should carefully consider whether the proposed changes will be sufficient to meaningfully mitigate the anti-competitive effects of Basel II, and the extent to which the proposal will make capital requirements more risk sensitive for all institutions eligible to comply. At a minimum, the current four risk baskets could certainly be modified and expanded into additional baskets that more closely align with risk

It is also important for the agencies to use the rulemaking process to reduce, to the maximum extent possible, the formulaic nature of the new Accord and to provide discretion for banking organizations and the supervisory authorities to adjust capital based upon the principle that capital should reflect the true risk of the institution.

Thus, for example, the regulations should provide incentives for banking organizations to use the best methods possible for determining the risk of assets, even if those calculations differ from the formulas set out in the Accord. Likewise, the banking agencies should be able to modify capital requirements, either up or down, based on their supervisory judgment and examination of the institution.

It is also important to allow the new system to be phased in over a period of time. This will permit the institutions and the regulators to monitor how the new system is affecting capital requirements. Considering the stakes involved, a go slow approach may well be the best approach, it will permit adjustments to the standards before unintended adverse consequences are widespread.

Finally, the regulators need to squarely face up to the fact that the current leverage ratio cannot be maintained after Basel II is implemented. The leverage ratio needs to either be phased out or significantly modified for those banks subject to the Basel II framework, and the recognition of this fact should be made part of the overall process of implementing the new framework.

[12] Statement of Susan Bies, Member of the Board of Governors of the Federal Reserve System, before the House Subcommittee on Financial Institutions and Consumer Credit (May 11, 2005).