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Highlights

Highlights of GAO-07-253, a report to Congressional Committees

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RISK-BASED CAPITAL

Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework

Why GAO Did This Study

Concerned about the potential impacts of the proposed risk-based capital rules, known as Basel II, Congress mandated that GAO study U.S. implementation efforts. This report examines (1) the transition to Basel II and the proposed changes in the United States, (2) the potential impact on the banking system and regulatory required capital, and (3) how banks and regulators are preparing for Basel II and the challenges they face. To meet these objectives, GAO analyzed documents related to Basel II and interviewed various regulators and officials from banks that will be required to follow the new rules.

What GAO Recommends

With safeguards, it is appropriate for U.S. banking regulators to proceed with finalizing Basel II and begin the transition period. GAO recommends that they (1) clarify some aspects of the Notice of Proposed Rulemaking (NPR); (2) issue a new NPR if material differences from the current NPR, or a U.S. standardized approach option, are planned for the final rule; (3) issue periodic public reports on progress, results, and any needed adjustments; and (4) at the end of the transition period, reevaluate the appropriateness of Basel II as a long-term framework for setting regulatory capital. The Federal Reserve said it agreed with our recommendations and the other banking agencies said they will consider them as part of the rule-making process.

www.gao.gov/cgi-bin/getrpt?GAO-07-253.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Orice Williams at williamso@gao.gov or Tom McCool at mccoolt@gao.gov.

What GAO Found

Rapid innovation in financial markets and advances in risk management have revealed limitations in the existing Basel I risk-based capital framework, especially for large, complex banks. U.S. banking regulators have proposed a revised regulatory capital framework that differs from the international Basel II accord in several ways, including (1) requiring adoption of the most advanced Basel II approaches and by only the largest and most internationally active banks; (2) proposing Basel IA, a simpler revision of Basel I, and retaining Basel I as options for all other banks; and (3) retaining the leverage requirement and prompt corrective action measures that exist under the current regulatory capital framework.

While the new capital framework could improve banks' risk management and make regulatory capital more sensitive to underlying risks, its impact on minimum capital requirements and the actual amount of capital held by banks is uncertain. The approaches allowed under Basel II are not without risks, and realizing the benefits of these approaches while managing the related risks will depend on the adequacy of both internal and supervisory reviews. The move to Basel II has also raised competitiveness concerns between large and small U.S. banks domestically and large U.S. and foreign banks internationally. The impact of Basel II on the level of required capital is uncertain, but in response to quantitative impact study results showing large reductions in minimum required capital, U.S. regulators have proposed safeguards, such as transitional floors, that along with the existing leverage ratio would limit regulatory capital reductions during a multiyear transition period. Finally, the impact on actual capital held by banks is uncertain because banks hold capital above required minimums for both internal risk management purposes as well as to address the expectations of the market.

Banks and regulators are preparing for Basel II without a final rule, but both face challenges. Bank officials said they were refining their risk management practices, but uncertainty about final requirements has made it difficult for them to proceed further. Banks also face challenges in aligning their existing systems and processes with some of the proposed requirements. While regulators plan to integrate Basel II into their current supervisory process, they face impediments. The banking regulators have differing regulatory perspectives, which has made reaching consensus on the proposed rule difficult. Banks and other stakeholders continue to face uncertainty. Among the issues that regulators have yet to resolve are how the rule will treat bank portfolios that do not meet data requirements, how they will calculate reductions in aggregate minimum regulatory capital and what they will do if the reduction exceeds a proposed 10 percent trigger, and what criteria they will use to determine the appropriate average level of required capital and cyclical variation. Increased transparency going forward could reduce ambiguity and respond to questions and concerns among banks and industry stakeholders about how the rules will be applied, their ultimate impact on capital, and the regulators' ability to oversee their implementation.