Federal Advisory Council comments on the Basel Capital Accord
May 7,2004
Regulations H and Y; Docket No. R-1154
Draft supervisory guidance; Docket No. OP-1153

At a meeting with the Board on May 7,2004, David **A.** Spina, President of the Federal Advisory Council and Chairman and CEO, State Street Corporation, Boston, Massachusetts, presented the views of the Federal Advisory Council on Basel 11.

Competitive Effects of Basel II Capital Standards: In the United States, institutions with more than $250 billion in assets or $10 billion of on-balance sheet foreign exposures would be required to adopt more risk-sensitive capital standards (Basel **11).** Other depository institutions could choose to do so if they have the necessary infrastructure, but otherwise would remain on the current capital standards (Basel I). Recently, two Federal Reserve staff studies were released on potential competitive effects of this proposed bifurcated system for capital regulation, one on merger and acquisition activities and another on small business lending.

(1) Would Basel **II** adopter banks likely increase their acquisition activity?

- Overall, the Council does not expect Basel II to be a major driving factor in the level of U.S. adopter banks' acquisition of other banks. Regulatory capital can be a consideration in adopters' decision-making relative to acquisitions, but numerous other strategic and financial factors are at least as significant. In addition, market factors, such as the views of the rating agencies, often dictate higher levels of capital than those imposed by regulation, further limiting the impact of potential lower regulatory capital for adopters.
- As a result, the Council's consensus view is that Basel II changes to regulatory capital may increase acquisition activity by adopter banks, but only at the margins. Several Council members, however, disagree with this consensus. One Council member, for example, suggests that Basel II adopters will leverage their capital allocation models to acquire companies with "consumer/small business book of business," or otherwise "bring advanced risk methods to bear on less sophisticated companies.'' Another Council member indicates there is "no significant compelling competitive differential or currency for acquisitions" created by Basel 11.
- While the effects of Basel II on the level of acquisitions within the banking industry will likely be modest, the potential changes in regulatory capital under Basel II for adopter banks may still significantly change the competitive dynamics of the financial services industry. Both adopter and non-adopter banks may expand or contract certain business lines, depending on the relative capital requirements for various portfolios and the resulting competitive positions of adopter banks, non-adopter banks, non-banks, and overseas competitors.

**(2) What would be the competitive effect on non-adopters in the small-business lending market?**

- Most Council members agree that Basel II will likely have limited competitive impact on very small community banks, which focus on a different market segment than potential Basel II adopter banks.
- However, in small-business lending market segments where adopter banks are active, the competitive impacts of Basel II may be more significant. Likely adopter banks already have efficiency and cost advantages over smaller institutions due to economies of scale. In addition, Basel II may provide adopter banks focusing on higher-quality portfolios a significant capital advantage, especially banks which choose to take advantage of Basel II's favorable portfolio treatment for small-business lending. The competitive dislocations created by Basel II may not be immediately apparent in small-business loan pricing, since today's lending markets are highly competitive, and pricing tends to be market, rather than cost, driven. Over time, however, Basel I1 adopter banks will likely increase market share in small-business lending, especially for high-quality credit risks.

**(3) What adjustments, if any, should be made in the regulatory capital structure for non-adopters? Why?**

- A few Council members identified possible adjustments to certain portfolios under Basel I, including small-business lending, first mortgages, credit cards, and home equity. Overall, however, the Council appears reluctant to recommend such adjustments, based largely on the potential increased cost and complexity which may result for non-adopter banks. Even absent such adjustments to Basel I, non-adopter banks are concerned by potential "regulatory creep," which may require adoption of Basel 11-type regulatory concepts without corresponding regulatory capital relief.
- Much of the underlying competitive concern with Basel II by U.S. banks is a result of the U.S. regulators' decision to permit use of only the most advanced approaches to both credit and operational risk. U.S. regulators have proposed a very high barrier to adoption of Basel II's risk-based concepts, and provided little incentive for non-adopter banks to make incremental progress towards the more advanced risk management approaches.
- U.S. regulators can address these concerns by adopting a more flexible approach to implementing Basel 11. U.S. banks should have the option of adopting Basel II's more risk-sensitive concepts at a level of cost and complexity appropriate to the size and scope of each individual institution. The ability of non-U.S. banks to make such choices between Basel II approaches is viewed by several Council members as a competitive disadvantage for U.S. banks. In addition to making available a greater range of Basel II capital approaches, such flexibility could include, for example, a relaxation of the proposed requirement that any bank seeking to use an advanced approach to credit risk also use an advanced approach to operational risk, or simply allowing U.S. banks to address operational risk under Pillar 11.
- The negative competitive impacts of Basel II on U.S. banks in small-business lending, and in other banking sectors, can be minimized and, to a significant extent, mitigated by identifying a reasonable path to wider adoption of Basel II by U.S. banks.

**(4) If the agencies want to retain near-capital neutrality for non-adopters, what portfolio sectors should receive a higher capital charge?**

- Under any risk-sensitive capital approach, riskier exposures should receive higher capital charges, regardless of the portfolio sector. While Council members identify a few risks which might appropriately draw higher capital charges (e.g., less-than-365-day commitments, lower-rated corporates), the Council is not prepared to nominate portfolio sectors for arbitrary higher capital requirements in the interest of retaining near-capital neutrality.

**(5) Are the predictions contained in the two staff studies plausible (and why or why not)?**

- In general, Council members consider the two staff studies plausible, within their limited scope.
- The primary finding of the small-business-lending study—that larger non-adopter banks will face adverse competitive consequences in the small-business-lending markets—appears consistent with the views of most Council members. One Council member suggests, however, that the competitive impact may be understated in the study, since the study did not also include commercial real estate as a component of small-business lending.
- As noted by its authors, the findings of the acquisition study are inconclusive. Even if the findings of the study had greater statistical significance, it is doubtful that a study based on previous changes to capital requirements and the consequences of "excess" capital under previous capital regimes could adequately capture the dynamics of the U.S. regulators' proposed shift to a bifurcated capital regime.
- Numerous other competitive issues remain unaddressed. Some, such as issues related to credit cards and mortgages, will be the subject of future Federal Reserve studies. Broader competitive issues, such as those related to competition with non-banks, and with non-U.S. institutions, will have significant implications for both adopter and non-adopter banks. Many U.S. banks compete with non-banks, which are not subject to existing capital requirements, and will not be subject to Basel 11. Outside the U.S., banks (and other Basel II adopters) will be allowed the flexibility to choose between the range of Basel II approaches, for both credit and operational risk, and will not be subject to the additional U.S. leverage ratio and prompt corrective action regime. As a result, non-U.S. banks may enjoy a competitive advantage—both in the marketplace, and in relation to potential acquisition activity.
- Finally, the existing and anticipated staff studies do not consider the significant effect adoption of Basel II may have on business line and other strategic decisions by banks. Basel II likely will create incentives for banks to consider acquiring or divesting lines of business based, at least in part, on their capital treatment under Basel II. In business lines where non-bank competition is significant, for example, Basel II may create incentives to move activity outside of the bank regulatory environment. In other cases, banks may have an incentive to expand business lines that draw relatively little capital, and divest of business lines with less favorable capital treatment, perhaps to non-adopter banks.