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Federal Advisory Council comments on the Basel Capital Accord
September 10, 2004
Basel II

At a meeting with the Board on September 10, 2004, Thomas A. Renyi, Chairman and Chief Executive Officer of The Bank of New York, New York, New York, presented the views of the Federal Advisory Council on Basel II.

The Basel II framework was published at mid-year, with an effective date of 2008. While there may still be revisions as a result of additional research and discussions, quantitative impact studies, and public comments, supervisors and bankers are now focusing on implementation. There will be about ten banking organizations required to adopt the Basel II framework.

Do Council members believe that banking organizations are beginning to plan for or to make the investment in the infrastructure necessary to adopt the advanced approach to Basel II by 2008? Within a year or two thereafter?

- Mandatory banks are making the infrastructure investments now to implement Basel II. Opt-in banks will likely lag mandatory banks' implementation efforts.
- The speed of implementation for opt-in banks will depend on the level of capital benefit resulting from the conversion.

How many other banks do Council members believe are planning to "opt-in" by meeting the infrastructure requirements by, say, 2010?

- Estimates of the number of banks planning to opt-in and make the required infrastructure requirements range from "only a few" to a range of 20-30.
- An ABA survey indicated that five banks are committed to opting-in, although the time frame for adoption was not specified.
- We believe that in excess of ten banks will opt-in with timing delayed an average of one year.

What factors are influencing banks' decision on whether to opt into the Advanced Internal Ratings -based (AIRB) approach?

- The net economic benefit is primary. Institutions with significant regulatory capital savings will opt-in and implement AIRB quickly – providing that rating agencies and investor constituents accept reduced regulatory capital levels as guidance for reducing their required capital levels.
- The market's perception of Basel II compliance – banks' failure to opt-in may be perceived as a competitive disadvantage.
- We believe a second wave of opt-in banks will be driven by reduced uncertainty around implementation as best practices emerge and the costs of implementation lessen.

For mandatory and opt-in AIRB organizations, what are the major implementation issues?

- Regulators' material divergence from Basel II or delay in providing the rules will significantly increase the cost of the implementations already in progress by mandated banks.
- Inconsistent application of rules across jurisdictions will create asymmetries in the marketplace and distort competition.
- Given the differences in the nature of bank portfolios in the U.S., disclosure requirements under Pillar III are too prescriptive, overly burdensome, and rigid to provide the market with useful information to evaluate risk. The market will have large amounts of data without a coherent picture of banks' risk profiles. Simplification of the tables and requirements could improve market intelligence and reduce regulatory burden.

Regardless of whether or not banks will be adopting the advanced approach, are organizations modifying internal capital allocation or risk management processes to reflect the AIRB framework? In what ways?

Yes. Principal evidence includes banks' conversions to economic capital frameworks for evaluating risks, the development of new rating systems that reflect probabilities of default and losses given default (critical for economic and Basel II capital calculations) and an increase in consulting dollars being spent on risk systems and processes. Banks are also reviewing operational processes and building models to evaluate risks in this area. Many mandatory banks have already made these investments in anticipation of the Basel II rules; opt-in banks are now accelerating their conversion.

What information and support from supervisors would be the most valuable to banks to implement Basel II?

- Because of the high costs of implementing Basel II, it is critical for supervisors to provide timely review of institutions' implementation efforts <u>before</u> investments are made, not afterwards. Supervisors must act as partners in the implementation effort.
- Recognition by supervisors that one process will not suit all banks. Flexibility is needed when evaluating the methods banks adopt to comply with Basel II requirements.
- Assurance that the rules can evolve over time, as modeling techniques improve and best practices emerge.