Federal Advisory Council comments on the proposed implementation of the new Basel Capital Accord
Advance notice of proposed rulemaking; Regulations H and Y; Docket No. R-1154
Draft supervisory guidance; Docket No. OP-1153
September 5, 2003

At a meeting with the Board on September 5, 2003, the Federal Advisory Council submitted the following views on the proposed implementation of the new Basel Capital Accord.

The Basel Committee on Banking Supervision has issued a consultative paper and the agencies have published an Advance Notice of Proposed Rulemaking on The New Basel Capital Accord. What is the committee's view of these documents?

Council members generally support the direction of Basel II and believe the Committee's objectives should reduce inefficiencies related to the current regime and promote stronger risk management practices. Members are encouraged by the trend to allow banks to use their own risk inputs, believing that to be the most effective way to reduce the divergence between regulatory rules and market practice. There are concerns with the proposal, however, some of which are discussed below and others of which are detailed in the industry's CP3 response letters.

Will this proposal enhance safety and soundness in the ways anticipated by the committee?

While the qualifying criteria for the new accord could well increase diligence in certain areas where institutions may be weak, a flexible implementation will be required for more sophisticated firms to ensure that innovation is not stifled. In addition, supervisors should be mindful that some resources devoted to regulatory compliance would be diverted away from other risk management priorities. Most firms believe the new accord would benefit from less prescription in favor of more principle-based approaches. Some in the industry are concerned that the flexibility afforded to banks in Basel II would result in different regulatory capital requirements for similar risks.

Certain provisions of the new accord unintentionally undermine best banking practices, the treatment for credit hedging being an example. The new accord gives benefit to a credit hedge simply by replacing the default probability of the borrower with that of the protection provider when determining the capital for the hedged position. This treatment ignores the fact that a bank will only lose money if the original obligor and the guarantor default simultaneously, a lower risk than the separate default of either party. It also ignores the fact that the bank is able to pursue recovery from both the original obligor and the protection provider. Such a conservative treatment sends the wrong signals about the benefits of hedging credit portfolios with credit derivatives.

What are the implications of the proposal on securitization?

The new rules about securitizations are directionally sensible but the resulting capital levels can be excessive. Preliminary results indicate that regulatory capital levels could exceed a bank's own economic capital requirements. Particularly hard hit are the lowest risk positions, where capital requirements are out of proportion to the de minimis risks as evidenced by

historical performance. Examples include senior tranches, liquidity facilities for ABCP (Asset-Backed Commercial Paper) conduits, and low-correlation retail ABS issuances that are supported by generous excess spread mechanisms.

The rules that require access to updated information on the underlying assets will create significant operational difficulties for banks classified as sponsors. Such rules should be restricted to true originators.

Updating the formulaic and control-oriented rules to keep pace with innovation will not be easy. Coupling a simpler core set of rules with more Pillar II emphasis would be welcomed by the industry.

Some institutions warn that the additional cost and burdens could negatively impact the attractiveness of securitization financing for institutions. It also could have an impact on the funding of U.S. consumer loans and other asset classes where securitization techniques are important. This could create negative consequences for consumers, banks, corporations and the U.S. economy as a whole.

Does the Basel proposal create any competitive inequalities among financial institutions?

The largest and most diverse banks base their banking strategies on economic assessments which should be unchanged by the new accord, provided the applicable regulatory rules constitute a minimum standard that is non-binding in the normal course of business. These institutions typically do not believe the decision to apply the new accord only to the largest banks creates a competitive inequality issue. Likewise, they do not believe the new operational risk capital charge raises competitive inequality issues. Operational risk is increasingly a feature of the internal capital framework at large banks. These institutions believe that the market expects all firms, even unregulated ones, to be able to withstand failures of their people, processes and systems.

However, specialized banks in business lines such as investment servicing believe that the prescriptive operational risk capital rules will create regulatory arbitrage opportunities between themselves and institutions that are either smaller, unregulated or residing in a more lax national jurisdiction, or are non-banks. They believe that it is too early in the development of a robust operational risk capital model to adopt a specific capital charge approach. These banks warn that their business lines may move to unregulated or unsophisticated institutions, potentially increasing systemic risk to the financial system. In addition, the specialized banks will realize little or no offsetting benefit from the changes to the credit risk regime. The adoption of the highly complex Advanced IRB measurements could result in significant expense for these banks with little risk management benefit.

Smaller banks are worried that Basel II banks will be required to hold less capital than themselves and therefore be able to reduce pricing for the best customers. They note that U.S core and opt-in banks constitute two-thirds of total domestic assets. Therefore, the consequent capital allocation adjustments will have a significant impact on their competitive environment. Some of these banks believe that their portfolio mix will change because of the separate (and more onerous) treatment of commercial real estate. Other banks are concerned that the decision to opt in

to Basel II carries unknown impacts, including the reaction of key constituents such as debt and equity analysts and institutional investors.

In practice, how would the proposed new Basel accord change capital management at banks, given that most banks already hold substantial amounts of capital above minimum regulatory requirements?

If the new accord is calibrated properly to generate a true minimum capital standard, most members do not believe it will change a bank's capital management practices. However, members are concerned that the cumulative effect of consistently conservative choices tends to move Basel II away from being a true minimum capital standard. One example of such conservatism is the high confidence interval (99.9%) that is used for the capital measurement. This particular choice would be more appropriate for an insolvency standard for a Double-A bank, rather than one that is intended to establish a minimum investment grade threshold. Another example is the requirement to use model input parameters that are measured during recessionary periods of the credit cycle. This would result in banks holding stressed levels of capital at all times. In addition, this requirement would pose practical challenges related to statistical analysis. The new accord could have an impact on the capital management of a bank that bases its practices solely on regulatory requirements.

If the Council could make one change in the proposal, what would it be? Why?

The Council did not agree on a single recommendation for urgent change. Members' suggestions included the following:

- The Basel Committee should exclude the Expected Loss (EL) component of the capital charge and define capital in terms of Tier 1 elements to make the new accord consistent with standard industry practice.

- To deliver a true minimum standard the Committee should redefine the confidence interval to be consistent with a BBB/BBB- insolvency standard (e.g. 99.5%) and not require the use of stressed input parameters.

- Elimination of the overall leverage constraint, in recognition of the detailed capital calculations.

- The prescriptive Pillar I Operational Risk capital requirements should be eliminated in favor of a principles-based approach incorporated into Pillar II.

- Pillar II should be allowed to increase <u>or</u> decrease the one-size-fits-all Pillar I capital requirements.

- Supervisors should introduce the Foundation IRB Approach in the United States, thereby providing an incentive for a broader range of banks to invest in their risk management capabilities.

- Given that the final rules have not been established, the Basel Committee should move the deadline for implementation back accordingly.