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Gunfight at the Basel II Corral

BY CHRISTOPHER WHALEN

As the dispute brews, will the Federal Reserve misjudge the mood on Capitol Hill?

In 1988, the bank supervisors from the G10 countries agreed on a new set of capital guidelines for commercial banks that became known generally as the Basel Accord, after the Swiss city where the Bank for International Settlements is located. The central focus of this relatively simple framework was credit risk and, as a further aspect of credit risk, country transfer risk—a legacy of the Latin American debt crisis. The new capital rules were hailed as an important tool to avoid bank collapses and the ultimate bogey man, "systemic risk."

By the end of the transition period in 1992, all banks were expected to maintain a minimum level of capital equal to 8 percent of total assets, of which core capital (Tier 1, equity and reserves) was at least 4 percent. The basic elements of the original Basel capital guidelines are shown in the chart. Since the early 1990s, the BIS has hosted a consultative effort among the G10 regulators to keep the capital standards and bank management practices up-to-date with the evolving marketplace, especially the growth in the use of derivatives and financial alchemy à la Enron. Andrew Crockett, then-general manager of the Bank for International Settlements, said in an October 22, 1998, speech in Sydney: "When properly used, [derivatives] can be a powerful means of controlling risk that allows firms to economize on scarce capital. However, it is possible for new instruments to be based on models which are poorly designed or understood, or for the instruments to give rise to a high degree of common behavior in traded markets. The result can be large losses to individual firms or increased market volatility."

As the financial markets have grown more complex, the ability of the regulators to understand much less supervise the activities of the major banks has diminished considerably. The largest banks have also grown increasingly dependent upon principal trading, especially trading in derivatives contracts, for a large portion of their prof-

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its. Thus, the transition to the new "Basel II" capital proposal that was supposed to begin in December has as its central premise the idea that banks should use their own internal risk models to assess the appropriate level of capital required to support various types of business. In return for developing the internal capability to assess specific operational and credit risks, banks get to lower their effective capital cost.

The Federal Reserve Board and the thirty or so largest banks constitute the pro-Basel II tendency, while the smaller banks (representing 99 percent of all depository institutions) are increasingly allied with the Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency in opposing the new capital standards. The huge cost and complexity of achieving the third level of Basel II, the level that allows the bank to use internal models for gauging capital requirements, means that only the top twenty or thirty banks in the United States will ever attempt to join this elite club.

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Doubts about the advisability of letting the biggest banks set their own capital levels and the considerable cost advantage that will accrue to the participating institutions has caused a schism among the major bank regulators. Comptroller of the Currency John Hawke, whose agency is the regulator of national banks, has publicly expressed skepticism about whether Basel II will ever be implemented: "I am much more skeptical about the currently stated goal of achieving implementation of Basel II by the end of 2006," he told the *Financial Times.* "There is a staggering amount of work confronting both us and our banks before Basel II can be implemented, and I am absolutely confident, based on past experience, that as we move into the implementation phase we will uncover a myriad of issues not previously thought of or addressed," Hawke opines.

The FDIC published a report in December saying that Basel II will sharply reduce bank capital and hurt the ability of U.S. officials to ensure the solvency of the largest banks. The FDIC suggests bluntly that the public interest is best served by retaining some sort of minimum capital requirement—that is, Basel I. The anti-Basel II tendency led by the FDIC believes, quite correctly, that the new rules will leave the big banks relatively undercapitalized and give them an unfair advantage over the community and regional lenders.

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—C. Whalen

The Fed, which has always been the apologist for the largest banks, is pushing the Basel II proposal as a way to boost profitability at the money centers by increasing the leverage they can carry on a given capital base. The crux of the debate is the fact that Basel II allows the largest banks to use their own internal risk models to establish the amount of capital required to support a given activity. This is like allowing the patients in the asylum set their own medication levels, but that is the stated intention of Basel II.

A November 3, 2003, letter from the Independent Community Bankers of America to regulators states: "Community banks are concerned that Basel II may place them at a competitive disadvantage because the A-IRB approach will yield lower capital charges for residential mortgage, retail, and small business loans, which are the bread and butter credits of community banks." One risk manager at one of the largest money center banks says that implementation of Basel II will spur a new wave of bank consolidation.

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Basic elements of the original Basel capital guidelines:

Tier 1	Tier 2
(a) Paid-up share capital/common stock	(a) Undisclosed reserves
(b) Disclosed reserves	(b) Asset revaluation reserves
	(c) General provisions/general loan-loss reserves
	(d) Hybrid (debt/equity) capital instruments
	(e) Subordinated debt

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By no coincidence, on November 3 House Financial Services Committee Chairman Michael Oxley (R-OH) and a number of other Republicans and Democrats also sent a letter to Fed Chairman Alan Greenspan and the other regulators. The thirteen-page correspondence echoes the concerns of the Independent Community Bankers, one of the most powerful industry groups in Washington, and threatens to block the proposal with "additional steps" if the Fed does not address the Committee's concerns.

Other than the *Financial Times,* the media has ignored the brewing dispute between the Fed and its clients among the largest banks (including Fannie Mae and Freddie Mac), on the one hand, and the FDIC, OCC, and the allies of the smaller banks on Capitol Hill. Fed Vice Chairman Roger Ferguson has been deputized by the Board of Governors as the public point-man in this political debate, while Chairman Greenspan has stayed above the public fray—a possibly fatal mistake.

Ferguson has assured the larger banks and European leaders that the objections raised by Chairman Oxley and other House members will not stall the "timely" implementation of the Basel II guidelines. But a spokesman for Oxley says that Ferguson and the Fed are mistaken. "We will insist that the concerns we have raised are addressed," says the senior Committee staffer. The letter is signed by all of the Republican subcommittee chairmen as well as Rep. Barney Frank (D-MA) and the other ranking Democrats on the Committee. Expect hearings by the Committee on Basel II early in 2004.

Comments one close observer of the Basel debate in Congress: "The Oxley Committee is trying to intervene on behalf of smaller banks in order to get more lenient capital treatment. The Fed, on the other hand, looks like it's trying to satisfy its largest clients, including Fannie and Freddie, by validating the concept that the banks' internal risk models should be accepted at face value. This is a really dangerous idea. What comes through in the Oxley letter is that the Committee is more concerned with 'competitive equity' than getting workable capital standards. Barring some compromise by the Fed, there is a good chance that Basel II will be killed by the Congress and replaced by modifications to Basel I."

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The Basel Committee has extended to June 30, 2004, the deadline for the G10 bank regulators to sign the new accord. That deadline may also be missed, especially in an election year. The current Fed chairman is renowned for his political acumen, but the central bank has underestimated the complexity of the Basel II process and the domestic politics that go with it. In particular, sources on Capitol Hill say that the Fed misjudged the mood of Chairman Oxley and his Democratic colleagues when it comes to protecting smaller banks from the voracious appetite of the larger institutions. If Basel II does not go into effect this summer, it won't be anyone's fault but the Fed's. ◆