The Federal Reserve Board

Remarks by Vice Chairman Roger W. Ferguson, Jr.

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Basel II: Some Issues for Implementation

I appreciate the opportunity provided by the Institute of International Finance to participate in your all-day session on Basel II. It has taken a long time to reach this stage in the negotiations for a new capital accord: five years, 3-1/2 quantitative impact surveys, three consultative papers, and numerous outreach meetings with industry representatives. The process is not yet complete. In a continuation of one of the most transparent efforts to vet a regulatory proposal, we are asking for comment, and again we will carefully consider suggestions to improve the proposal on the basis of evidence and analysis submitted. Perhaps some of those suggestions will come from the sessions today.

I think you will see from a comparison of the third consultative paper (CP3) with its predecessor that we are listening to what the public and the industry have been saying. Our response to comments has often added complexity to provide options in the context of a worldwide banking system in which countries and individual banks have different procedures and approaches. We have made every effort to avoid cookie-cutter rules for complicated banking structures. Those efforts continue. For example, in the United States, our Advance Notice of Proposed Rulemaking (ANPR) will seek further comment on additional options for securitization and risk mitigation as well as the treatment of various retail exposures, any one of which may require further negotiation at Basel. Complexity is also added because we are attempting to include principles of modern finance and risk-management, all of which involve complex statistical, and thus mathematical, techniques. Of course, it is exactly that direction that banking and its best-practice management have been taking over the last decade. In short, complexity in many cases provides options and in most cases is simply a part of modern finance.

The details are not yet cast in concrete. A point I want you to keep in mind is: We will seriously consider suggestions for furthering the objectives of more-risk-sensitive capital requirements and better risk measurement and management in the least costly and most efficient way. At this point, however, comments must be analytical and empirical if they are to be helpful and likely to modify the proposal.

The Framework

As we involve ourselves in the fine detail of Basel II, it is useful to keep in mind what we are trying to do. We are developing a replacement for the current capital accord, Basel I, an agreement that simply is no longer consistent with the way the world's largest banks conduct their business. From the perspective of banks, supervisors, and, let us not forget, counterparties and stakeholders, capital is a cushion to ensure safety and soundness and to provide a benchmark against which the financial condition of banks can be measured. The large banks of the world have so changed the nature of how they do business that for them Basel I neither provides an appropriate cushion nor an accurate risk benchmark. It must be

replaced, particularly in a world whose financial markets are so interrelated that substantial difficulties at any one of the largest banks, let alone a failure, could place all the large banks of the world at risk.

Indeed, with due regard for an international level playing field, which I will discuss later, we should consider that the need of all of our countries for economic stability should be paramount in our supervisory and regulatory judgments. It is worth emphasizing that substantial disruptions in our financial systems linked to a large bank failure could raise the risk of a regulatory, if not legislative, response that would likely add restrictions greatly limiting the flexibility and efficiency of our banking system. In addition, perhaps one of the largest risks to the safety of the world banking system is the competitor--either local or cross-border--that erroneously evaluates risk, acts on that evaluation, and induces a competitive response that increases risk exposures broadly.

For both reasons, action is imperative. It must be taken both by banks and by their supervisors to improve risk measurement and management; to link to the extent we can the amount of regulatory minimum capital to the amount of risk taken; to attempt to further focus the supervisor-bank dialogue on the measurement and management of risk and the risk-capital nexus; and to make all of this transparent to the counterparties and uninsured depositors that ultimately fund--and hence share--the risk positions. In a rather large nutshell, that is what Basel II seeks to do, while at the same time seeking a level regulatory playing field for banks that compete across borders.

Cyclicality

Many critics--in and outside of the industry--have raised concerns that the framers of Basel II have unintentionally overlooked a byproduct of the package that will tend to destabilize the world's economies. With all the world's banks on the same regulatory structure, these critics argue, the typical business cycle will be accentuated by Basel II as perfectly reasonable estimates of probabilities of default and of loss given default decline in economic expansions and rise as the economy weakens. The resultant changes in the cost and availability of credit will be pro-cyclical, that is, will exacerbate cyclical patterns in the real economy.

But we should recognize some important responses that have emerged from regulators and markets: flatter risk functions have been adopted in the Basel II proposal; banks maintain buffer capital stocks; Basel II requires that, under Pillar 2, supervisors and banks discuss the size of the necessary buffer capital that each bank should carry for cyclical purposes; and the proposed rules require stress-testing of risk parameters. Perhaps a more important point is that, in evaluating the pro-cyclicality argument, we should not forget the cyclicality in bank credit flows that we see in history. If we are to truly evaluate the critics' concerns with post-Basel II pro-cyclicality in bank credit flows, we should be sure that it is compared with the pre-Basel II pattern.

Until quite recently, systematically and formally managing many of the key risks taken by banks, in particular their credit risk, was quite difficult. The techniques for quantifying and measuring risk, and the technology and instruments to manage and distribute it, simply did not exist. Individual credit-risk decisions tended to be made by lending and credit officers who used their judgment to decide who was given credit and who was not. A characteristic of lending officers is that they are paid to make loans, and in competitive lending markets they want to make sure they maintain, if not increase, market share. This is not to say that lending officers are uninterested in risk management but rather that their focus is on finding

a way to make the loan. In a world of judgment, the risk manager had considerable difficulty in persuading lending officers, indeed management, about excessive risk when quantitative procedures and systems did not exist. Differences in judgment are difficult to resolve.

That is probably the reason that bank credit availability has historically demonstrated a clear cyclical pattern that is consistent with the credit-making decision process I have just described and that, in turn, has exacerbated real economic cycles. During economic recoveries, bank credit officers would become more optimistic and willing to lend, an attitude that only strengthened during booms; in such times the voices of risk managers, even supervisors, calling for caution were likely to carry less weight. During recessions, with losses clear and write-offs rising, caution would come to the forefront, and more-restrictive attitudes toward lending would be reinforced by the arguments of risk managers and supervisors who could point to the losses.

One can, I think, begin to notice a change in recent years in this typical pro-cyclical behavior in bank credit availability in the United States. The change first became apparent in the minimal credit losses at the large U.S. banks during the Asian debt crisis and Russian debt default in the late 1990s. It was also noticeable when these same entities began to tighten lending standards during the later years of the last expansion, in contrast to typical patterns, in which tightening occurred near or after the peak. The moderation of pro-cyclical behavior is also apparent in the continued strength in the portfolios of these organizations and in the modest spreads on their subordinated debt during the recession. To be sure, part of the explanation is new techniques and instruments for shifting and sharing risks. But at bottom, I would argue, we are beginning to see the payoff from more-formal and rigorous quantitative risk-management techniques for credit decisionmaking, techniques that have also been central to the development of new instruments for hedging, mitigating, and managing credit risk.

Basel II builds on and formalizes these developments in bank credit risk management. Such a regime of greater formal attention to risk exposures, as under Basel II, offers the hope of a more stable pattern of credit availability. Quantitative risk management should reduce the buildup of excessive unintended credit risks that have been assumed in expansions and thereby minimize the losses and associated tighter lending standards during recessions. Such lending behavior, in turn, might well reduce the cyclical pattern in minimum capital requirements that would occur without the better risk-management techniques required under the proposed Basel II. The response to more-formal risk management thus creates the reasonable prospect of a reduction in concerns about the pro-cyclicality of capital ratios under Basel II.

In the past, problems have arisen when banks have been too complacent in their judgments of risks during good times, too slow to react when the situation turns, and too risk-adverse once their losses have turned out larger than anticipated. A process that encourages banks to think more carefully and more pro-actively about all of these possibilities offers the hope of a significant improvement in the way that they manage themselves over the course of the business cycle.

Risk will continue to vary over time. Ignoring that fact is in no one's interest. In fact, capital ratios under Basel I by default fail to convey that pattern to managers, stakeholders, and supervisors because the risk categories are insufficient to recognize changing risk.

The proposed Basel II, in contrast, would convey to managers, to supervisors, and

importantly, to the public how risk changes as capital requirements respond to changes in the real underlying risk. A sufficiently risk-sensitive capital regime would impart timely information regarding risk. That, in turn, would allow adjustments in lending policies sufficiently early to limit excessive swings in lending behavior. Risk sensitivity in capital requirements would damp swings in credit availability and thereby reduce both credit sprees and credit crunches.

Supervisors prefer--or at least ought to prefer--the regulatory capital ratios that convey more information. Supervisors, banks, and the public should want to understand when bank portfolios are facing higher risks or when an updated estimate of risk relative to capital reveals a warning sign that requires attention. No such early warning system is provided by a system of capital requirements that does not signal that a bank has a problem until the problem is severe enough to have already eroded the underlying capital. That is, a capital system with little risk sensitivity creates the potential for problems to escape undetected for longer periods. Such delays increase the likelihood that the underlying problems will not be addressed soon enough and will grow larger.

Dispersion in Capital Requirements Under Basel II

Basel II is designed to deliver capital requirements that are more risk sensitive. As such, one can expect that some banks--those with less risk exposure--will see their required capital decline; those with larger risk exposures should see their required capital rise. On average, we expect capital requirements for the total of credit risk and operational risk to remain about unchanged for the banking system. As I have just discussed, the resultant dispersion of capital requirements seems desirable to supervisors for its portfolio inducements, for its aid in supervisory evaluations, and for its contribution to safe and sound banking.

The dispersion of capital requirements has also created an unexpected criticism from some observers: it will distort the competitive landscape, as if somehow lower capital requirements were a random gift and higher capital requirements a random penalty, rather than correctly reflecting underlying risk.

To be sure, some, but not all, of the concern in this country has reflected objections from banks that will not be required to apply Basel II--and thus will not see their capital requirements change at all. Some of these entities fear they will face a rival that will get a capital break because the rival is following Basel II and has lower risk exposures recognized by the new accord.

The extent to which regulatory capital requirements drive pricing or profitability is an empirical question. My own view is that in a world in which banks hold capital buffers and can securitize and sell assets, and with bank management increasingly allocating resources and making decisions on the basis of internal economic capital measures, the answer must be: not very much, if at all. Rather, I believe that we are increasingly observing that pricing decisions reflect economic capital allocations that are risk based. We have tried hard to set risk-based regulatory capital requirements in Basel II below economic capital measures so that regulatory requirements will not affect the allocation of capital within the bank. If we make a mistake and set the regulatory capital requirements too high relative to market-based economic capital, we can read the effect of our error right away in the securitization of the exposure; securitization is a release valve that relieves the pressure of our mistakes.

To be sure, as better risk measurement and management results in more sensitive risk-based pricing, we may well see that exposures with higher capital charges are priced higher than those with lower capital charges. But such observations should not lead us to confuse cause

and effect. The regulatory capital charges and price of credit will both be reflecting the same thing--risk; the higher price won't be a reflection of the higher capital charge.

U.S. Scope of Application
No discussion on Basel II with a room full of global bankers would be complete without a discussion of the intended scope of application of Basel II in this country. In particular, I would suspect that you want to hear about the implications for the integration of your U.S. and worldwide operations. A week ago, I gave a rather full presentation on that issue to the Institute of International Bankers, and I call your attention to that statement, which is available at the Board's web site[1]. But this afternoon let me present the highlights of what I said.

First, what do we plan to do? In this country, we intend to offer only the advanced approaches under Basel II: the Advanced version of the Internal Ratings Based approach (A-IRB) for credit risk and the Advanced Measurement Approach (AMA) for operational risk. There will be no Foundation IRB and no Standardized approach for credit risk in the United States for any U.S. chartered bank--domestic or foreign; nor will there be a Basic Indicator or Standardized method for calculating operational risk for any U.S. chartered bank. In this country, only the largest, most internationally active banks will be required to adopt Basel II: A-IRB and AMA. The proposed criteria indicate that about ten such banks will be in this "core" group. In addition, any U.S. bank--including any subsidiary of a foreign bank--that meets the infrastructure requirements of the A-IRB approach may choose Basel II; we expect that, initially, about another ten banks will do so. The twenty or so U.S. banks that we expect to operate in the near future under Basel II--the ten mandatory core banks and the ten banks choosing Basel II--account today for 99 percent of U.S. bank foreign assets and two-thirds of total domestic consolidated assets of all U.S. banking organizations.

Those banking organizations in this country not in the core group and not choosing to adopt Basel II will remain on the current capital regime (Basel I). They will not be subject to explicit operational risk capital requirements. These banks may also opt in to Basel II (A-IRB and AMA) whenever they wish, provided they meet the infrastructure requirements.

Why did we not make the other Basel II options available in the United States? We have made it clear from the outset that the new accord would apply in this country only to those institutions that genuinely competed across national boundaries to ensure, in so far as possible, a level competitive playing field internationally. Only a small number of U.S. institutions meet the test of truly operating across borders. They happen to be very large and, hence, the authorities here concluded that they should be subject to the most sophisticated Basel II versions so that they receive the very real benefits of improved risk measurement and management and a more risk-sensitive regulatory capital requirement and so that they operate under the increased market discipline that comes from improved disclosure and greater transparency. Indeed, very large banks that do not meet the internationally active criterion will also be required to become core banks for these reasons.

The banks that will remain under the current capital regime in this country have certain attributes that led the authorities to conclude that, for those banks, realizing the benefits of Basel II would impose costs that exceeded those benefits. Most of these banking organizations have relatively straightforward balance sheets that would benefit less from the Basel II risk-measurement and management requirements. In addition, in this country, our banks are subject to the requirements of prompt corrective action and minimum leverage and to statutory provisions that induce them to hold buffer capital far above the minimum

requirements. More than 93 percent of the expected Basel I banks hold capital that is in excess of 10 percent of their risk-weighted assets. Moreover, in this country, requirements of the sort found in Pillar 2 have been in existence for many years and are well ingrained into our supervisory process. The U.S. banking system also has a greater tradition of disclosure, as those of you with U.S. subsidiaries well know.

Thus, the cost-benefit analysis suggested that it would not be responsible to require most of our banks--entities that do not operate across national borders--to adopt Basel II, especially because thousands of them would probably choose the standardized version that adds only modest credit-risk sensitivity to risk-based capital requirements. Smaller banks in many other countries, we believe, would benefit from adherence to Pillars 2 and 3, and we hope they adopt Basel II, but our banks already operate under regimes fairly close to what the simpler versions of Basel II would provide.

In light of their capital and supervision, we anticipate that U.S. banks with modest overseas activities operating under Basel I rules would be able to continue their overseas operations without having to adopt Basel II. Their subsidiaries, of course, would be subject to the rules and requirements of the host country. And, U.S. authorities will make available to host-country supervisors whatever information is required.

U.S. branches of foreign banks would be basically unaffected by Basel II rules because they are not subject to direct capital requirements. And U.S. supervisors expect to find any variant of Basel II applied in foreign countries to be acceptable for our evaluations of well-capitalized standards at the consolidated parent level. However, U.S. subsidiaries would be subject to our rules for domestic banks and thus would have to choose either the A-IRB and AMA approaches or remain under the current Basel I rules.

We do understand that this could present some complications for foreign banks using approaches for their consolidated organizations that are not offered in the United States, such as Foundation IRB for credit risk. When the parent organization's approach does not align with what the U.S. subsidiary must choose (either advanced approaches or current rules), some adjustments will indeed be necessary. U.S. supervisors and their counterparts from Basel member countries are already working, through the Basel Accord Implementation Group (AIG), to resolve cross-border implementation issues and minimize burden created from differences in home and host-country rules. We understand, however, our responsibilities to work with foreign banks to address the remaining conflicts.

When foreign banks with U.S. subsidiaries adopt IRB variants at home and Basel I rules in the United States, U.S. supervisors would be prepared to assist them, and their supervisors, in helping the subsidiary bank here provide the requisite inputs for calculation of capital at the global, consolidated level. When the foreign bank adopts at home the IRB variant not available in this country, the Foundation IRB, the issues are more complicated; if the bank wants its U.S. subsidiary to also be on IRB, doing so would require that subsidiary to adopt the Advanced IRB version here. To meet the requirements for risk measurement and management required by the authorities for U.S. markets, that subsidiary would have to invest the resources to estimate loss given default (LGD) and exposure at default (EAD) parameters for their corporate exposures.

Such an effort is not without cost, but we are willing to work with such banks to ease their transition. We are, for example, prepared to explore the possibility of allowing U.S. subsidiaries of foreign banks to use conservative estimates of LGD and EAD for a finite

transitional period when data are not yet available for parts of some portfolios. This possible option would, if adopted, apply equally to fully domestic U.S. banks adopting A-IRB. We might also be willing to work out transition methodologies to permit foreign banks to allocate their overall operational risk capital charge for their consolidated entity between their parent and U.S. A-IRB bank subsidiary--for a limited time. Such transition approaches are indicative of our willingness to approach the implementation of our scope of application policy in a pragmatic way.

The U.S. authorities strongly encourage U.S. banks and foreign banks concerned about cross-border implementation to establish a dialogue with supervisors in their respective home jurisdictions and, for foreign banks in the United States, also with U.S. supervisors; we want these banks to comment on any documents addressing cross-border issues, so that AIG members can tackle these issues together. The authorities here want to hear your observations on how to avoid creating undue burdens on foreign banks while at the same time retaining our ability to shape the risk-measurement and management methods employed by banks in our own markets.

Summary

Basel I must be replaced for the large, internationally active banks of the world because it no longer produces an adequate indicator of the strength of such banks, and, moreover, that indicator does not vary as risk changes. Basel II is designed to improve risk management and measurement, to link required capital to risk, to focus supervision more closely on these variables, to make such relationships more transparent, and to facilitate a level playing field for banks that compete across national borders. Critics concerned about the pro-cyclicality of Basel I should compare the likely post-Basel II pattern with the pattern of earlier years; in doing so, they should consider the extent to which better risk management, a more risk-sensitive capital requirement, and the rise in market discipline that comes from greater transparency will modify bank lending patterns, particularly the unintended acceptance of risk during expansion periods.

The U.S. authorities are proposing that in this country the A-IRB and AMA approaches of Basel II be *required* of the largest, most internationally active banks that meet certain size and foreign-activity criteria and be *permitted* for any other bank that meets the infrastructure prerequisites of the A-IRB and AMA approaches. All other banking organizations would remain under Basel I. The proposal would not permit any banking organization in this country to operate under the Standardized or Foundation IRB approaches of Basel II.

We will be working with the AIG at Basel to minimize any issues that may arise because of different capital regimes for the consolidated operations of foreign banks and the choices available to their subsidiaries in the United States. U.S. supervisors will cooperate with foreign supervisors to provide any required inputs from U.S. subsidiaries of foreign banks that the home-country supervisors need for their consolidated supervision. The U.S. banking agencies are also willing to consider possible transition methodologies to assist foreign banks that want to use IRB here to adopt the A-IRB and AMA approaches. We urge the U.S. bank subsidiaries that are commenting on the U.S. ANPR to advise both U.S. and home-country supervisors of the problems that our proposed scope of application may cause them. In particular, we solicit suggestions that address these potential problems but still recognize the desire of the U.S. authorities to apply only the advanced versions of Basel II in this country.

Footnotes

1. http://www.federalreserve.gov/boarddocs/speeches/2003/200306102/default.htm Return to text

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