

## **Remarks by Vice Chairman Roger W. Ferguson, Jr.**

Before the Institute of International Bankers, New York, New York

June 10, 2003

### **Basel II: Scope of Application in the United States**

I am delighted to join you today as you gather for your Annual General Meeting of the Institute of International Bankers. Larry Uhlick suggested that I might provide an overview of key trends and developments in the regulation and supervision of internationally active banks. Basel II, of course, is the key issue today, and given that the U.S. agencies' position on scope of application has clear implications for your banks' operations in this country, choosing Basel II and its scope of application in the United States as my topic was not difficult.

As you all know, Basel II refers to the proposed new capital accord developed by the Basel Committee on Banking Supervision. The committee's third consultative paper was issued for public comment about six weeks ago, and the U.S. agencies plan to issue their preliminary proposals for implementation in this country next month in an Advance Notice of Proposed Rulemaking (ANPR). At the same time, the U.S. authorities will release the first of a series of draft supervisory guidelines to assist bankers in understanding what supervisors will be expecting of U.S. banks. The agencies are actively seeking comments on all these documents. It is not too late to shape Basel II's final form or the way it will be implemented in this country, provided that comments are directed at the way to improve methods and procedures for obtaining the same objectives. We are open-minded and are willing to make changes that meet such criteria.

Even though the U.S. ANPR has not yet been released, the authorities have already made known their intended scope of application in this country: which banks will be required to apply Basel II, which banks may choose to adopt the new accord, and which banks may choose to remain under Basel I. This decision is of particular interest, I would think, to this audience because it raises the risk that non-U.S. banks will be required to operate in the United States under rules that will differ from those that apply to their parent bank in their home country and affiliated banks in third countries. I hope that, by the time you leave this room, you will see that such potential conflicts are more apparent than real.

### **Scope of Application in the United States**

The major goal of the Basel Accord of 1988 (Basel I) was to align the capital requirements of institutions that competed across national boundaries. The Group of Ten and other nations that subsequently adopted Basel I applied it to all their banks, but the Accord focused, and its proposed new version continues to focus, on obtaining a level playing field for cross-border banks. Throughout the discussions and negotiations of Basel II, the United States has emphasized that its interest is in ensuring that banks competing in each other's countries be subject to the same capital regime. Of course, we also want at least those banks to benefit from more-risk-sensitive capital requirements that call for more-sophisticated systems for risk measurement and management.

We have concluded, therefore, that the U.S. chartered banks (including subsidiaries of foreign banks) that both are large in scale and have significant foreign activities should be required to adopt Basel II. These U.S. banks are significant competitors in foreign markets and must, if we are to honor our commitments to other countries, be subject to the new Accord. The exact parameters that establish this core set of U.S. banks, those that will be required to adopt Basel II, will be released in the ANPR next month. There are about ten such banks, and each one has been notified about the requirement.

The U.S. authorities are also proposing to permit any U.S. bank that can meet the infrastructure requirements for the advanced approaches for handling credit and operational risk to choose to follow Basel II capital requirements. Our best guess is that another ten or so banks will choose Basel II capital requirements in this country in the first round. We believe that the decisions of these banks will reflect their perceptions of their self-interest from either their implied new capital charges under Basel II or the message they want to send their counterparties about their risk-management techniques. We expect that, as time passes, additional larger banks, responding to market pressures, will opt for Basel II. Moreover, the current activities of still other banks suggest that current trends will put them in the mandatory core group in coming years.

As U.S. supervisors have previously stated, in this country we expect to apply, for regulatory capital purposes, only the advanced internal-ratings-based (A-IRB) approach for credit risk and the advanced measurement approach (AMA) for operational risk. In line with our additional goal of improving risk-management techniques, the authorities believe that the largest, most complex, internationally active banking organizations in the United States--those that our screening criteria determine to be core banks--should be subject to the most sophisticated version of Basel II. To be clear, we are not proposing to implement either the standardized or the foundation internal-ratings-based (F-IRB) approaches within the United States.

The twenty banks that we are assuming will be under Basel II in this country either by, or shortly after, the initial implementation date would account for about 99 percent of the foreign assets held by the top fifty domestic U.S. banking organizations. We believe that this high percentage clearly signals our intent to meet our obligation to ensure cross-border competitive equality of capital regimes. That the same twenty banks also currently account for approximately two-thirds of the domestic assets of U.S. banking organization indicates their importance to our banking and financial system. These entities must operate under the best risk-management standards with the most risk-sensitive capital treatment.

We do not intend to require the thousands of other banking organizations in the United States, including U.S. subsidiaries of foreign banks that do not meet the mandatory criteria, to adopt Basel II.<sup>1</sup> Unless they choose to adopt Basel II, they will remain under our current regulatory capital rules, which are based on Basel I. Those banks remaining under Basel I will not be subject to an explicit regulatory capital charge for operational risk. To be sure, any of these organizations can choose the Basel II requirements whenever they want, provided they meet the infrastructure prerequisites of the A-IRB and the AMA approaches to Basel II. We believe that the cost-benefit nexus will make this option infeasible for most of these banks in the years immediately ahead, but ultimately that decision resides with the banks themselves. Nonetheless, as the cost of risk-management techniques decline with their wider dissemination and as counter-parties and stakeholders seek the comfort that comes with banks' application of more-sophisticated risk-management techniques, the larger

regional banks may wish to migrate from rules based on Basel I to those based on Basel II. Even if larger regional banks do not formally choose to operate under Basel II for regulatory purposes, we expect they may wish to make use of the risk-management process that underlies Basel II. Indeed, I should emphasize that the movement toward more-sophisticated risk management, the prerequisite of A-IRB and AMA, is occurring, and would continue to occur, independent of Basel II. This movement is clearly a market trend reflective of evolving technology, growing complexity, and the understanding of modern finance.

For thousands of U.S. banks, the migration to a regulatory capital regime based on advanced risk-management techniques is unlikely to occur for many years, however. As a supervisor who believes strongly in a safe and sound banking system, I want to share with you why it is totally acceptable that these entities, whose activities are almost completely limited to those within the United States, remain on the less risk sensitive capital rules based on Basil I.

First, their balance sheet and operational structure are relatively straightforward and do not require the sophisticated risk-management techniques of modern finance, although most of these institutions have adopted some of them, like credit scoring.

Second, most of these banks already hold considerable capital: More than 93 percent of them have risk-weighted capital ratios in excess of 10 percent--fully 2 percentage points over the minimum and a capital buffer of 25 percent.<sup>2</sup> In part, this strong capital position reflects market realities required of entities whose scale makes raising additional capital, especially under duress, very difficult and whose geographic concentrations of credit risk require greater capital support. In part, it reflects the desire of bank management to hold buffer capital--above regulatory minimums--for the flexibility and survivability that additional capital provides for smaller banks. And in part, it reflects statutory provisions in the United States that link permissible activities to capital positions--including minimum leverage ratios of equity to unweighted total assets; thus as capital ratios decline, supervisors are required to take action. These "prompt corrective action" provisions play a significant role in maintaining the strong capital position of U.S. banks, above and beyond the Basel minimums.

Third, as this audience well knows, the United States for some time has had an effective Pillar II, or procedure for supervisory review and guidance. That supervisors evaluate and review banks' operations and policies and discuss their views and suggestions with bank managers has been part of our institutional framework. In certain cases, supervisors may encourage institutions to hold additional capital for risks, such as concentrations, that the Basel I rules do not capture directly. For the United States banking authorities, Pillar II of Basel II requires nothing new.

Finally, banks in this country have for quite a while disclosed their capital ratios. The banks that are publicly held and those that issue publicly held securities are required to disclose even more data, although admittedly less than the requirement proposed under Pillar III of Basel II. Moreover, even for smaller banking organizations, considerable information is publicly disseminated--for example, through our Call Reports--and is available for counterparties.

When the U.S. authorities considered the cost-benefit ratio of requiring thousands of our banks to become subject to Basel II--presumably the standardized version--we saw the benefits as (1) only slightly more risk sensitivity in the calculation of the minimum regulatory capital requirements under the Standardized version that presumably these banks would

select, and (2) more disclosure under Pillar III. In exchange, smaller banks (1) would have to bear additional costs, even though they already maintain far more capital than any change in the required regulatory minimum would produce; (2) would not need, nor be required to adopt, any different risk-management techniques under the Standardized approach; (3) would benefit from no new supervisory oversight under Pillar II; and (4) already disclose considerable information. For all these reasons, the U.S. authorities did not believe that requiring most U.S. banks to bear the cost of shifting from Basel I-based rules to Basel II was reasonable.

Of course, supervisors of banks using Basel I-based rules in the United States will continue to seek a full understanding of each bank's process for risk measurement and management as part of their usual efforts to fully evaluate a bank's operations. Asking questions about these important management responsibilities is simply a part of appropriate supervisory oversight.

I underline that not many jurisdictions outside the United States have smaller banks--those likely to move to the Standardized version if they adopt Basel II--with the capital position, the intimate supervisory review, or the existing disclosure rules of U.S. banks. Thus, the proposal in this country has no implications for the desirability and benefit of applying Basel II to smaller banks in other jurisdictions that might benefit significantly from the Standardized Basel II approach. Indeed, the U.S. experience proves the value of enhanced supervision and greater transparency even for the smallest institution.

### **Implications for the Treatment of U.S. Banks Abroad**

As many of you know, the Basel Committee has established a separate subgroup to deal specifically with cross-country implementation issues. The Basel Accord Implementation Group (AIG) comprises line supervisors directly involved in the supervision of large, complex banks in member countries. The AIG has already begun to explore and develop solutions for some of the complex issues arising from cross-border implementation. In addition, the members of the AIG have already established a constructive dialogue with a working group representing non-G10 jurisdictions on the practical challenges of implementation.

As I noted, we anticipate that U.S. banking organizations that account for 99 percent of the foreign assets and two-thirds of all assets of our domestic banking system will be under the A-IRB and AMA version of Basel II and thus will be fully compliant with the letter, and certainly the spirit, of the new Basel Accord. U.S. institutions operating under Basel II will apply the framework to the consolidated organization, so that the foreign branches and subsidiaries of these U.S. organizations thus will be in full compliance with the home country rules of the new Accord. We anticipate that these institutions, by operating under A-IRB and AMA, will also be in compliance with the regulatory capital rules of any host country in which they operate. Of course, foreign branches and subsidiaries of U.S. organizations will also have to comply with any special rules applied in the host country.

In addition, some U.S. organizations engaging in a relatively small amount of cross-border activity may decide to remain on Basel I-based rules in this country. We anticipate that, so long as their capital position remains strong and they present no supervisory issues, these entities will be able to continue their cross-border activities. In effect, we believe that our well-capitalized standards, combined with our strong supervisory framework, will allow U.S. banks to meet any requirements for consolidated capital requirements in foreign countries and that those standards result in capital requirements at least as prudent as Basel II approaches for their home country banks. In this case, too, any foreign subsidiary of a U.S.

bank would naturally have to adhere to the host country rules applied to bank subsidiaries there. We acknowledge that some of these details still have to be clarified--exactly the task that the AIG has undertaken. But I would like to emphasize that these issues relating to Basel II are not necessarily new, since we have been dealing with differences in capital rules among countries for many years, but just perhaps more complex.

### **Implications for the Treatment of Foreign Banks in the United States**

Now we have arrived at the point that you all have been waiting patiently to hear. What does the proposed scope of application of Basel II in the United States mean for the treatment of foreign banks that operate subsidiaries and branches in this country? It has, of course, few implications for branches in the United States because they are not directly subject to U.S. capital requirements. In addition, U.S. supervisors expect that whichever Basel II approach a foreign bank chooses for its consolidated operations will be acceptable for allowing branch and subsidiary operations in the United States or for evaluating the financial holding company well-capitalized criteria that are applied at the consolidated level. For that matter, we anticipate continuing to accept Basel I-based calculations for such purposes if that is the approach that the home country supervisor continues to employ.

Any U.S. bank subsidiary of a foreign bank will, of course, have to comply with U.S. rules for banks, just as foreign bank subsidiaries of U.S. banks will have to do in their host countries. The principle that subsidiaries must comply with host country rules has been discussed by the AIG, and this long-held view has been widely accepted. Moreover, national treatment requires that the rules that apply to purely domestic banks will apply equally to subsidiaries of foreign banks operating in a host country. In the U.S. context, this principle means that a U.S. subsidiary of a foreign bank will eventually have to choose whether it wants to be under the A-IRB and AMA approaches of Basel II, requiring it to meet the same infrastructure prerequisites as other U.S. banks, or to remain under the current Basel I-based rules.

Admittedly, this policy path chosen by U.S. supervisors may present some important choices for foreign banks that operate a U.S. bank subsidiary. For foreign banks operating under A-IRB and AMA on a consolidated basis under their home country rules, choosing A-IRB and AMA for their U.S. bank subsidiaries would not present any particular problems. Granted, there could be some differences in areas of national discretion for specific elements of the Accord; but in terms of the overall approach, things should align well.

The U.S. authorities understand, however, that some foreign banks, including those with subsidiaries here, are targeting the F-IRB approach as their preferred global starting point for Basel II. There would, of course, be no significant issue for such organizations if their subsidiary banks in the United States chose A-IRB and AMA while their parent remained on F-IRB. In this instance, the U.S. subsidiary would have to meet the U.S. requirements for A-IRB and AMA, but in so doing it would be able to deliver all the necessary inputs for F-IRB at the consolidated level.

A more difficult problem arises if the U.S. bank subsidiary remains on Basel I-based rules. The subsidiary would not be generating IRB parameter inputs for its U.S. regulatory capital requirements that could naturally feed into calculations for consolidated capital requirements for F-IRB at the home country level. Clearly U.S. supervisors see that this latter case could be burdensome for foreign banks, and we are prepared, with our colleagues on the AIG, to assist local subsidiaries in developing the inputs they need for the consolidated parent. In general, most of these banks already employ sophisticated risk-measurement techniques in

order to compete in the U.S. market. Moreover, their exposures are skewed toward large corporate firms for which information that can be used to estimate the necessary risk inputs is abundant.

The most difficult problem occurs for a foreign bank that chooses F-IRB at home and chooses A-IRB here. The bank here will have to determine parameters for loss given default (LGD) and exposure at default (EAD) for regulatory capital requirements on its corporate exposures here and use those parameters in the risk measurement and management of the U.S. bank, whereas the parent bank will have to develop and use only probability of default (PD) estimates for such exposures at home. Gathering the data and generating viable estimates of LGDs and EADs poses some challenges. To be sure, we believe that the availability of external data sources developed in the United States to help in the generation of these variables will be reasonably wide. Still, some effort will be required, and that effort will not be costless. The cost of developing these parameters and using them in their U.S. operations is likely to be the most difficult problem for foreign banks that do not adopt A-IRB at home.

The U.S. agencies did not make their decisions about implementing only the most advanced versions of Basel II lightly. We concluded that, in our markets, entities that are large enough to use IRB techniques should do so using the more-sophisticated approach that includes LGDs and EADs in the process of risk measurement and management. We felt it was important to tailor implementation of Basel II to our own individual banking and financial environment, as other authorities will be doing for their own markets, even though it means the reconciliation of the different approaches to implementation across countries will create some complications for banking organizations. The AIG is working hard to minimize those effects, and we have confidence in their ability to develop reasonable and effective solutions.

Nonetheless, we appreciate our responsibility to work with U.S. subsidiaries whose foreign bank parent will, at least initially, adopt F-IRB in their home country. For example, we are 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. If adopted, this approach would apply equally to fully domestic U.S. banks adopting A-IRB. For both sets of banks, any transition measures would need to be limited in both scope and duration. We are also willing to consider methodologies that would permit foreign banks to allocate a portion of their overall operational-risk capital charge for the consolidated entity to the U.S. bank subsidiary, possibly including allocations from non-AMA approaches for a limited period of time. Such transitional approaches indicate our willingness to approach the implementation of Basel II pragmatically.

The upcoming ANPR will lay out these issues in more detail, from the perspective of the United States, but we will also have to incorporate the parallel work of the AIG. To the extent that you have concerns about cross-border implementation issues now, we urge you to engage in discussions with U.S. supervisors and provide comments on any U.S. documents that address the issue. In what perhaps would follow naturally, we also suggest that you inform your home country supervisors about these same issues so that discussions at the AIG level will be that much more efficient.

In short, let us know what problems our scope of application proposal may cause you, and most particularly, please let us know your suggestions for how to address them. As I have

indicated, we are starting from the presumption that we intend to implement only the A-IRB and AMA alternatives of Basel II in the United States and are not eager to reverse course in that regard. Nevertheless, we do want to consider elements that would allow us to meet the objectives we consider to be important while limiting any unnecessary burdens on your institutions.

### **A Digression**

Please allow me to comment briefly on the treatment of capital requirements for commercial real estate (CRE) exposures. I understand that this issue is not of primary concern to most foreign banks, but it may have become confusing for many observers of the U.S. position on Basel II.

For many, but not all, U.S. supervisors, CRE exposures in general, and CRE exposures to finance certain property types in particular, are believed to involve more risk than, say, commercial and industrial (C&I) loans. This view has been maintained despite the clearly improved underwriting and appraisal methods that followed U.S. banks' experience in the late 1980s and early 1990s and the associated changes in regulations. The continuing perception of higher risks for CRE credits, despite these developments, reflects the judgment and evidence that losses on individual defaulted CRE properties increase when defaults rise. In other words, CRE exposures have a high asset correlation and thus require higher capital charges.

For this reason, the U.S. representatives on the Basel Supervisors Committee argued strongly for two CRE capital functions that translated the risk parameters into capital requirements: One would be identical to the C&I function and would be for CRE exposures with low asset correlation, and one would require larger capital for the same risk parameters and would apply to exposures with higher asset correlation. Further, the Committee proposed in CP3 that, with certain exceptions, all Acquisition, Development, and Construction (ADC) loans on CRE properties would be on the high asset correlation function and that nations would have the option of applying in their jurisdiction that higher function to those CRE loans on in-place property that they felt met thresholds for high asset correlation. Importantly, the Committee also agreed that, when countries did so, supervisors would ensure that all IRB banks--domestic and foreign--making similar loans in that jurisdiction would be subject to these definitions. Thus, for those of your institutions that finance office buildings in the United States, for example, this discussion is not purely academic.

The evidence available to the Federal Reserve seemed to support the need in the United States for the high asset correlation function for some types of CRE loans for in-place property. These data for banks, unfortunately, were for a limited period, and additional data that recently came to our attention for other lenders for a longer period produced conflicting evidence. Although our supervisory judgment still is that some of these exposures have high asset correlation, the mixed evidence does not support our position to the standard we believe necessary for applying such a distinction in the regulatory framework. Consequently, the ANPR to be released next month will propose that all CRE loans in the United States for in-place properties be on the low asset correlation function, as all C&I loans are. We will propose for comment the CP3 approach to ADC loans, with certain exceptions.

However, in reflection of supervisory concerns and judgment, we will propose that estimates of loss given default--a key risk parameter under Basel II--for CRE loans on in-place properties be based on historical loss rates during periods of high default. This approach, we believe, will capture some of the risk that has historically accompanied such exposures.



I would like to emphasize that this change in position reflects the evidence that was provided to us to supplement the evidence we gathered ourselves. It shows the willingness of the regulators to remain open-minded about the Basel II proposals, so long as comments are based on analysis and evidence and remain consistent with the objectives of Basel II.

## Summary

I will conclude by just noting a few highlights.

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

This proposal, the authorities believe, is consistent with a level playing field internationally in that it requires the banks that compete materially across national boundaries to be under a Basel II capital regime. It would apply the most sophisticated option to the largest U.S. organizations for which better risk measurement and risk management are most critical. It permits U.S. organizations that wish to choose the more-sophisticated approaches to do so. But it avoids additional costs and burdens on most U.S. banking organizations--those that have less pressing needs for improved risk-management techniques and already have high capital positions, are effectively subject to Pillar II supervisory oversight, and disclose considerable information.

The U.S. authorities believe that the few U.S. banks that will remain on Basel I but that have small offices or subsidiaries abroad should be permitted by host countries to maintain those operations so long as the organization retains a high capital position and strong U.S. supervisory oversight. Foreign subsidiaries of U.S. banks, of course, would be subject to whatever requirements the host country imposes on all banks operating in its jurisdiction, including Basel II requirements.

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 banking agencies here are also willing to consider transition methodologies to assist foreign banks that want to use IRB here to adopt A-IRB and AMA approaches. We urge U.S. subsidiaries of foreign banks, in commenting on the U.S. ANPR, to advise both U.S. and home country supervisors of any problems that our proposed scope of applications may cause them and, in particular, of their suggestions for addressing these problems, while recognizing the desire of the U.S. authorities to apply only the advanced portions of Basel II in this country.

---

## Footnotes

1. At the end of 2002, there were in the United States 4,998 bank and financial holding companies (some with more than one bank subsidiary) and 1,493 independent banks (not in holding companies), for a total of 6,491 banking organizations. [Return to text](#)



2. These well-capitalized banks account for 96.5 percent of the assets of all the U.S. banks that are not in the top twenty banks that are likely to be under Basel II. [Return to text](#)

▲ [Return to top](#)

[2003 Speeches](#)

---

[Home](#) | [News and events](#)  
[Accessibility](#) | [Contact Us](#)

**Last update: June 10, 2003**