TESTIMONY

Basel II Regulation: U.S. Market and Competitiveness Implications

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And

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It is an honor again to appear before you to discuss the pending rewrite of risk-based capital rules and their potentially profound market and competitiveness impact. It is often tempting to let these rules reside in the technical workrooms to which their length, complexity and – most alarming – math – lead many to consign them. However, your Subcommittees and the leadership of the full Financial Services Committee recognized early how important these rules will be. You led the way with the first Congressional hearings in February, 2003 and a subsequent round last year, and you have also filed several detailed comments with the U.S. banking agencies. This has ensured that the policy impact – not just the technical workability of the Basel II rules – is getting carefully and urgently-needed consideration prior to implementation in the United States.

Before I begin my testimony, let me say that I am managing partner of Federal Financial Analytics, a consulting firm that focuses on federal legislation and regulation affecting financial services firms. We engage in a wide range of Basel-related projects, advising firms on the strategic impact of the proposals. I also head the Financial Guardian Group, which is deeply concerned about the proposed regulatory capital charge for operational risk.

In previous testimony before your Subcommittees and the Senate Banking Committee, I have suggested that the Basel II rules and, in particular, the way the U.S. proposes to implement them, will have serious, unintended competitiveness and risk-management consequences. The proposed operational risk-based capital charge alone could cost U.S. banks an additional $67 billion in regulatory capital – a cost that would be added to substantial implementation ones during the long delay before any of these additional costs would be offset by reduced credit risk-based capital. This is not to say that Basel I should be retained – it should not. Rather, it is to argue for a gradual approach to rewriting Basel II so that improvements are well-understood, implemented across the board and tested before additional refinements are made. The current effort to do a global, complete rewrite of the risk-based capital (RBC) rules that deals with almost every variation of all banking products around the world at one time is a classic instance of the perfect proving to be the enemy of the good.

This problem – best beating better – is of particular concern in the United States. As you know, the banking agencies on April 29 delayed Basel II implementation because of concerns raised during the most recent quantitative impact survey. This delay is also postponing release of the rewrite of Basel I intended to allay growing competitiveness concerns – concerns that, as you know, some in the agencies also seek to dispel by arguing that regulatory capital has little bearing on business decision-making. Despite the Basel II and Basel I rewrite delays, though, banks are being told in no uncertain terms to get ready for Basel II and decide if they want to opt in. Incredibly detailed guidance on even minor Basel II points is being issued although the entire rule remains up in the air. Frankly, this is the worst of all options – agencies are demanding readiness for a rule not yet written because of an effort to get all its details totally right while all of the market distortions from the current requirements remain unaltered.

The complexity of Basel II also makes it easy to miss an important point: for all that, the rules only redefine how risk weightings for assets are to be set. The definition of "capital" has been left for another day – indeed, people are even now talking about a Basel III that will take on this task. However, regulatory capital is, at its heart, a ratio of capital to assets and this means that it's important to get both right. A more simple approach to assets would permit an immediate review of capital. This would, in turn, permit recognition not only of reserves (already on the table), but also of factors such as tax carry-backs that provide hard cash to banks to offset losses.

Today, I will argue:

- There needs to be quick implementation of the well-understood, agreed-upon parts of Basel II for all U.S. banks – not just the big ones. If the U.S. lags Basel II adoption abroad – as now seems likely – this will pose a serious competitiveness threat to U.S. banks. Analysts abroad are already characterizing capital as the "weapon of choice" in bank consolidation. Of course, a "bifurcated" adoption of Basel II here in the U.S. will pose comparable competitiveness problems for banks left out of the new capital accord. If Basel II has meaning – and one must think regulators believe it does given the huge effort behind it and the billions it will cost – then it will meaningfully affect bank pricing and profitability, with concomitant competitiveness impact.

- A leverage standard is incompatible with risk-based capital requirements. It is understandable that banking agencies wish to leave one in place as the complex, untested Basel II models are introduced, and the agencies appear also committed to retention of the 10% RBC level that also defines a "well-capitalized" bank. However, the current leverage and prompt corrective action thresholds are far above the right capital ratios for low-risk institutions and well beyond ratios that make sense as safeguards during Basel II implementation. If these ratios are retained under Basel II, they then should be considerably reduced under the authority already possessed by the banking agencies.

- Recent studies have suggested that Basel II will lead to wide variability among bank RBC ratios, with some institutions seeing significant drops and others coming under far higher regulatory capital requirements. This is as it should be if the big reductions are at low-risk institutions. The underlying purpose of Basel II is to make regulatory capital promote safety and soundness. Thus, low-risk banks should see low RBC. Trying to "top off" Basel II with fixes to the formulas or additional capital charges like the proposed one for operational risk undermine its important goals. The large drops in capital at some banks in the recent quantitative impact survey must be understood in light of the limitations of that study (current strong economic conditions and the lack of stress testing, for example).

- The proposed operational risk-based capital charge is problematic not only because of its "topping off" role, but also because there is as yet no agreed-upon methodology to measure and manage operational risk. Thus, an RBC charge for it would be arbitrary and unduly costly. In addition, these costs would create perverse incentives against proven forms of operational risk management – disaster preparedness and contingency planning, for example. Recent surveys have shown that many banks have yet to even institute these urgent measures, and they should not be diverted from vital qualitative risk-management improvements into a quantitative exercise designed to make the Basel II numbers add up to 8%.

Finally, I would like to thank the Committee leadership for its hard work on legislation to ensure that the U.S. position in Basel negotiations reflects a consensus among our regulators. This year, you have again introduced legislation to ensure such a consensus and also that reports on key points are given to Congress before the Basel II rules are finalized. As the process continues, however, you may wish to consider revising the legislation to focus not only on international negotiations – now largely complete on Basel II – but also on the scope of the U.S. risk-based capital regulations. As I shall discuss in detail, these rules will drive decisions about which banks can offer what types of mortgages, small business loans and other critical financial services at what price where. Thus, despite the daunting technical nature of these rules, Congressional review and, if necessary, direction is essential.

I should like now to proceed to discuss each of the points noted above in detail. I have attached to this testimony a brief discussion of the general issues in Basel II and its timeline both around the world and in the United States.[*]

Moving From Basel I to Basel II: Leave No Bank Behind

Getting the risk-based capital rewrite right is essential for two reasons:

- For all its complexity, RBC has economic impact. The Office of the Comptroller of the Currency (OCC) has already reached a preliminary decision that the Basel II rules will have major economic impact, and it is right about this.

- If the rules are wrong and unintended competitive consequences ensue – small banks are swallowed by big ones or specialized banks are gobbled by diversified ones – a revision to the rules won't put the banking system back together. Once charters are gone or lines of business disappear, they cannot be quickly brought back to life. Thus, Basel II impact will be both very significant and long-lasting, like it or not.

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[*] Much of this discussion is based on a study of the competitive impact of the operational risk-based capital rule prepared by Federal Financial Analytics on behalf of the Financial Guardian Group (copies of the study are available on request).

This go-slow recommendation is not, however, a no-go one. As indicated, Basel I is broken and needs to be revised. For all the suggestions that RBC has no competitive impact, Federal Reserve studies discussed in detail below at the start of the Basel rewrite argued that in fact it had major "arbitrage" implications. Low-risk assets have gone into the secondary market and high-risk ones have remained on bank balance sheets – the reverse of the incentives one would think supervisors would like to encourage for safety and soundness. Markets have also moved because regulatory capital treatment is easier on assets held in the "banking book" than on those held in the "trading book" – resulting in a bank competitive advantage over investment banks in key business lines. Basel II proposes to fix this, as well it should.

It is not necessary, though, to go immediately to the most technically advanced sections of Basel II to achieve its benefits. Indeed, too quick a move to these too-complex standards could have an array of unintended consequences – problems worsened by current moves in the U.S. to find ways to keep total regulatory capital numbers the same even as the RBC rewrite is implemented. The best way to end Basel I without the competitive and market consequences likely if the U.S. continues on its current course is to allow use here of the "standardized" Basel options – minus the operational risk-based capital rules – for all banks and savings associations. Bigger ones with more advanced systems can then elect the advanced internal ratings-based option over time, with supervisors learning more about this option and addressing the still unsolved problem of coordinating rules across national borders (the "home/host" problem) in an incremental way that limits sudden, unexpected shocks.

Cost Concerns

A long-established way to evaluate any regulatory proposal is to do a cost/benefit analysis. Let me start, therefore, with an evaluation of the costs of Basel II's operational risk-based capital (ORBC) charge and Basel II's overall implementation costs. Many in the industry hope that all of these costs will be offset by reductions in credit RBC for low-risk institutions. However, as discussed below, this may not occur because the U.S. plans to retain arbitrary leverage and other regulatory capital thresholds. Some have suggested that all of these costs and the limits on RBC reductions mean that Basel II will have no adverse competitive impact on small U.S. banks that stay under Basel I. If so, one has to ask why everyone is bothering with Basel II – if it's simply topped back up to Basel I levels with these costs, why impose it at all? Regulators must in fact expect that Basel II will still be meaningful, making these costs significant and the potential competitive impact important.

Academics have concluded that, "the ORBC charge could cost U.S. banks $50 - 60 billion without any positive benefit and with many negative implications."[1] Financial

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[1] *Sizing Operational Risk and the Effect of Insurance: Implications for the Basel II Capital Accord*, Andrew Kuritzkes and Hal Scott, June 18, 2002. This determination assumes: Total Risk Weighted Assets (RWA) for the U.S. banking system are approximately $5.9 trillion. The total regulatory capital requirement is

Guardian Group calculations confirm the very high cost of the ORBC charge. Assume that, as expected, the top twenty-five U.S. banks will either be required to come under the Basel II rules or will opt into them. These banks currently hold $517 billion in regulatory capital.[2] The Basel Committee has estimated that a Pillar 1 ORBC charge could add approximately 13% in regulatory capital.[3] Based on this, the current ORBC proposal would cost U.S. banks approximately $67 billion.

The high cost of the ORBC requirement comes atop the considerable one associated with Basel II implementation. One recent study estimates the total implementation cost for Basel II will exceed $11 billion by the end of 2005.[4] For the credit risk portion alone, the Financial Services Authority estimates that the UK banking industry will need to spend several hundred million pounds on just information technology systems.[5] Broken down by individual institution, consulting firms Mercer, Oliver, Wyman and Accenture both believe costs could run as high as $200 million per bank.[6] These costs will be particularly significant for banks using the advanced models – the only ones, of course, permitted in the United States.

These costs argue strongly that:

- There should not be a regulatory capital charge for operational risk. As discussed in more detail below, operational risk is better offset with effective risk management, and this high cost will divert urgently-needed resources from this incomplete effort.

- The final Basel II framework should justify its high implementation costs by permitting full recognition of risk in risk-based capital. Should this lead to fears that capital at low-risk banks will drop too far too fast, then gradual implementation – which will reduce the implementation cost – should ensue.

How Regulatory Capital Affects Competitiveness

As Basel II has become more controversial, especially in the face of criticism at Congressional hearings, some advocates of the revised RBC standards have started to argue that regulatory capital matters little to the competitiveness of banks or the pricing of the products they offer. These assertions are striking in light of all of the rhetoric from bank regulators at the start of the Basel rewrite. Then, regulators argued that the old rules needed to be reformed precisely because differences between regulatory and economic capital (the amount of capital demanded by the market) were creating areas of "arbitrage"

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fixed at 8% of RWA. The proposed 12% calibration would imply $56 billion of regulatory capital for operational risk.

[2] Third quarter, 2004 data. See www.ffiec.gov.

[3] *Third Quantitative Impact Survey of the New Basel Accord*, Bank for International Settlements, Basel Committee, October 1, 2002.

[4] *Impact of the New Basel Accord*, Christoph Sidler and Gabriel David, EDS, January 2003.

[5] *Banks face heavy IT bill over Basel II,* Deborah Hargreaves, Financial Times, January 27, 2005.

[6] *Basle II Prompts Strategic Rethinks*, Euromoney, Thomas Garside and Christian Pederson, December 2002; and *Basel II Requires a Billion Rand*, Acumen, January, 2003.

– that is, banks were changing business plans to take advantage of areas where RBC was lower than economic capital requirements and exiting lines of business where RBC was too high. As the Bank for International Settlements has found, "[The influence of regulatory capital on competitiveness of banks] was in fact one of the key factors behind the international efforts to harmonize capital standards in the 1980s."[7] Ending capital arbitrage was also key to the entire Basel II process, as the then-Chairman of the Basel Committee, former New York Federal Reserve Bank President William McDonough made clear when he said, "[T]he financial world has changed dramatically over the past dozen years, to the point that the Accord's efficacy has eroded considerably. Its broad brush approach to differentiating credit risk encouraged banks to undertake regulatory arbitrage transactions."[8]

Regulatory arbitrage has been a significant factor in U.S. and global financial markets since Basel I was finalized in 1988, making it clear that any differences between regulatory and economic capital left after Basel II will similarly restructure the markets. The Bank for International Settlements[9] and a Federal Reserve staffer[10] found that there were four main types of regulatory capital arbitrage after Basel I: "cherry picking," securitization with partial recourse, remote origination and the use of indirect credit enhancements. They also noted the use of credit derivatives/synthetic securitizations and short-term lending, a finding confirmed by others.

For example, a group of international regulators affiliated with the Basel Committee confirmed the importance of regulatory capital in business decisions when it concluded that, "The second motive for [credit risk transfer or CRT] activity is that regulatory capital requirements on credit risk are often above the economic capital the market requires to bear the risk. Banks cited reducing regulatory capital as a motive for their participation in CRT markets…"[11] Some have suggested that securitization resulting from Basel I incentives will offset Basel II competitiveness problems resulting from the mortgage requirement, but it is far more likely to be restructured to reflect changed RBC incentives in a fashion that alters the current competitive landscape with adverse implications for smaller banks.

As the BIS and Federal Reserve staff papers also noted, banks can reduce their regulatory capital requirements merely by originating and holding credit risk positions on their trading books, again an increasingly significant market phenomenon with sweeping impact on the relative competitiveness of commercial versus investment banks. The Basel Committee has recently proposed a rewrite of Basel II to correct this, showing that competitiveness implications are a major component of RBC drafting.

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[7] *Bank Capital Regulation in Contemporary Banking Theory: A Review of the* Literature, João A C Santos, Bank for International Settlements, Working Paper No 90, September 2000.
[8] *Update on the Major Initiative to Revise the 1998 Capital Accord*, William McDonough, Federal Reserve Bank of New York, June 19, 2000.
[9] *Capital Requirements and Bank Behavior: Impact of the Basle Accord*, Bank for International Settlements, Basel Committee, April 1999.
[10] *Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues,* David Jones, Journal of Banking and Finance 24, 2000.
[11] *Credit Risk Transfer,* Bank for International Settlements, The Joint Forum, October 2004.

Because regulatory capital drives profit expectations, it is also a key determinant of which banks win or lose in those business lines. When banks hold more regulatory capital, as will be the case for those remaining under Basel I in the U.S., their ability to compete against the banks receiving large credit risk regulatory capital reductions under Basel II is seriously affected. Similarly, diversified banks – the biggest of the big – can afford to engage in a line of business with unduly high RBC because this cost can be cross-subsidized by drops in RBC in other business lines. A specialized bank, in contrast, cannot offset the impact of inappropriately high RBC, making it difficult to continue as a free-standing franchise. If taken over by a large diversified institution, concentration and systemic risk increases. If taken over by a non-bank competitor, systemic risk may increase because the assets are now held by a less thoroughly supervised entity or organization.

Capital Could Compel Consolidation

Consistent with assertions that regulatory capital doesn't determine product decisions – incorrect, as demonstrated above – some Basel II advocates have also argued that the new rules will have no impact on merger-and-acquisition (M&A) activity. This assertion is also incorrect. And, it's an even more risky one than arguments that regulatory capital doesn't affect line-of-business decisions. After a bank exits a line of business because of RBC anomalies, it may be years before it re-enters the business, if it can do so at all. However, once a bank franchise is gone, it's gone for good. Thus, any errors in bank RBC that result in consolidation mean that the banking system will stay as restructured, even if major policy objectives are jeopardized by this consolidation.

Although Basel II's impact may be speculative in the United States, it is already evident in the European Union. There, the standardized options will be in place on the first of January, 2007, and markets are already reacting. As one analyst has found:

> "Basel II can be a strategic weapon: SCH's proposed takeover of Abbey provides the first hint….This means that for a period of time, capital adequacy has the potential to be a new battleground for competition far more than it has been in the past – the weapon of choice is the efficiency of capital....Basel II starts to look like a catalyst for increased M&A activity."[12]

Consolidation in the U.S. banking system is hard to dispute when it is the result of natural market forces like improved technology that creates economies of scale. However, it is quite another thing when consolidation results from – or worse – is even driven by, artificial regulatory action. In 2002, an analyst predicted that, "As a result of Basel II…consolidation in the banking industry will accelerate from the pace it has followed for

[12] *Q-Series ®: Basel II – New Capital Guidelines,* UBS Investment Research, August 2004.

the past 20 years. From 1980 to 2000, the top 10 firms doubled their market share from 20 percent to 40 percent. We believe that in the next five years, the top 10 firms will again double their market share, this time to 80 percent."[13]

This consolidation creates potentially serious systemic risk, since the failure of one large bank could suddenly throw financial markets into disarray and create a huge drain on the federal deposit insurance system. A fundamental axiom of portfolio theory is that diversification reduces risk, and it thus follows that the more banks there are in the United States, the less potential systemic risk. To the degree that aspects of Basel II promote consolidation, therefore, the RBC system will have the unintended consequence of increasing risk – not reducing it as hoped.

Consolidation in the U.S. banking system could also have adverse implications for industry customers. The U.S. has long had thousands of small banks and savings associations, in sharp contrast to the European Union, Canada and Japan. These nations, along with most others outside the United States, have banking systems dominated by as few as five giant banks. As a result, these systems consistently lag the U.S. in innovation, especially in developing products and services aimed at average consumers – in particular, those previously underserved by traditional commercial banks. Local economic needs are also far less well served in countries with a few nationwide banks than in the United States, where small banks in rural areas are often the bulwark of regional economic development. When banks consolidate and exit local markets, unregulated entities – finance companies, for example – often enter with potentially adverse consequences on the quality and cost of both credit and other bank products and services.

Risk-Based Capital Should Reflect Real Risk

As noted, a major goal – indeed, perhaps the major goal – of Basel II is to align regulatory and economic capital. Quantitative impact surveys – with all their methodological questions – are showing that this will in fact occur. Banks with low-risk books will get RBC well below the current 8% minimum, although some of the very low numbers are likely to rise a bit as stress-testing is added to the equation. Banks with high-risk books, in contrast, are seeing RBC hikes – sometimes significant ones. However, because the overall risk profile of the industry now is low, the overall QIS results show significant potential RBC reductions. This is as it should be in a meaningful RBC framework worth all the implementation costs noted above.

This is not, though, as it will be in the United States. Here, we have two unique regulatory capital requirements: a "leverage" standard that mandates a 5% capital ratio against all on-balance sheet assets regardless of risk and a 10% "prompt corrective action" (PCA) RBC ratio that banks must hold to be deemed "well capitalized." Thus, if a low-risk bank – one that held nothing but U.S. Treasury obligations or gold, for example – ran its Basel II numbers and arrived at an RBC ratio of, say, 1%, it would still have to hold the 5% and 10% ratios.

[13] *Financial Services Sector Braces for Basel II*, CIO Magazine, Andy Efstathiou, July 2002

This will clearly have adverse competitive impact. No other nation requires these ratios, so their low-risk banks around the world will realize Basel II benefits. Importantly, these unique U.S. ratios also do not promote the safety-and-soundness incentives argued by their advocates. A high-risk bank would still be "well capitalized" in the U.S. if it meets these ratios regardless of whether it otherwise complied with the higher Basel II RBC requirements. Banks that stayed under Basel I, of course, would not even be subject to any higher RBC, permitting high-risk institutions to portray themselves as sound even though risk-based capital in fact was far below economic allocations or market expectations.

Some have argued that these leverage and prompt corrective action ratios, while problematic, offset much of the competitiveness concerns for small banks noted above. They suggest that big banks will have to hold lots more capital than Basel II would require so that differences between big and small institutions will fade. However, big banks long ago learned to balance RBC in diversified portfolios to make it possible both to win competitive advantage where RBC is low and still comply with the leverage and 10% requirements. A big bank can, for example, add a layer of very high-risk assets – toxic ones, some would say – to capture Basel II advantages for the bulk of its assets. This is far more difficult for small or specialized institutions and it isn't good for any of them.

A more compelling defense of the leverage and PCA requirements is the fear that Basel II relies on untested models based on capital estimates drawn during the best of times. Under current law (12 U.S.C. 1831o(c)), the agencies must set leverage and PCA thresholds, but the law gives them total flexibility to do so, except with regard to the ratios that define "critically undercapitalized" banks. In conjunction with Basel II, the agencies should review current ratios and reset them to ensure that the leverage and PCA requirements do not undermine the risk incentives intended under Basel II or U.S. bank global competitiveness against institutions not subject to comparable requirements.

Indeed, the leverage and PCA standards could also have adverse domestic impact. As discussed in more detail regarding the operational risk-based capital requirement, large U.S. banks expected to come under Basel II compete against non-banks in many lines of business. Some have argued that adverse competitive impact will be offset by a new RBC standard set by the Securities and Exchange Commission (SEC). However, the SEC standards are wholly voluntary and, in any case, apply only to the biggest investment banks that own large broker-dealers. Even then, though, the SEC standard does not offset the adverse competitive impact of the banking agency leverage and PCA requirements.

The 2004 SEC rule[14] creates "supervised investment bank holding companies" and "consolidated supervised entities." Arguably, these firms are subject to Basel II. However, there are major differences between the SEC's rules and those contemplated by the U.S. banking agencies. Importantly, there will be no leverage requirement, nor any

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[14] 17 C.F.R. Parts 200 and 240.

threshold determining who is "well capitalized" on the RBC front – firms under the SEC regime need meet only the "adequate" capital thresholds applicable in the EU. They may also use the less advanced Basel II options not allowed for big U.S. banks. These differences ensure that the SEC approach will be less onerous for those large competitors subject to it.

Operational Risk Should Come Out

Under Basel II, operational risk (OR) is defined as:

> "The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. The definition includes legal risk, which is the risk of loss resulting from failure to comply with laws as well as prudent ethical standards and contractual obligations. It also includes the exposure to litigation from all aspects of an institution's activities. The definition does not include strategic or reputational risks."[15]

This approach raises many questions – the first of which is how a regulatory capital charge can be assigned to a type of risk for which even the definition is complex, subjective, and controversial. Many in the industry believe that OR definitional and measurement techniques are not yet developed enough to support a set capital charge. For example, one industry expert recently noted, "It's absolutely true that we are still in the infancy of understanding everything about operational risk."[16] Even the BIS's own Risk Management Group and Committee on the Global Financial System contends that OR cannot be defined or accurately measured[17] and attempts to do so have already distracted significant industry and supervisory resources from urgently needed improvements. The Group of Ten concurs, noting, "[T]he term 'operating risk' is a somewhat ambiguous concept that can have a number of definitions…. Operating risk is the least understood and least researched contributor to financial institution risk."[18] Finally, the ratings agency Standard & Poor's also weighed in, noting that, "The lack of consistent industry-wide operational loss data represents a large obstacle to the development of a statistical methodology that could carry the analysis beyond the qualitative and enable regulators to measure and compare OR across banks."[19]

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[15] *Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital*, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, July 2, 2003.
[16] *For Basel Opt-Ins, It's Time to Gather Data*, Damien Paletta, American Banker, January 21, 2005, quoting Charles Taylor, director of operational risk at the Risk Management Association.
[17] *Credit Risk Transfer,* Committee on the Global Financial System, Bank for International Settlements, January 2003 and *Sound Practices for Management and Supervision of Operational Risk*, Basel Committee on Bank Supervision, Risk Management Group, February 2003.
[18] *Report on Consolidation in the Financial Sector*, Group of Ten, January 2001.
[19] *Basel II: No Turning Back for the Banking Industry*, Standard & Poor's, Commentary and News, August 26, 2003.

Regardless of the criticism, the Basel Committee has gone forward and finalized its OR proposal. The Committee offers three different approaches. The "basic indicator" and "standardized" approaches assign a simple charge for OR based on the gross income of the institution. These approaches will not be allowed in the U.S. due to warranted concerns over their validity. Instead, U.S. regulators will apply only the advanced measurement approach (AMA), which will require banks to develop highly-complex and rigorously-tested internal models to calculate the capital charge. Although significantly more sophisticated than the other two approaches, this one also has its problems, including its limited recognition of risk mitigation (e.g. contingency planning and insurance) and the reliability of its complex internal models.

It is very difficult, if not impossible, to quantify the risks posed by events such as rogue traders, terrorist attacks and natural disasters. How does one quantify the risk posed by a 9/11-type attack or a tsunami? As a result, many in the industry, as well as those in the supervisory community have questioned the Accord's quantitative approach to OR. Specifically, the following concerns have been raised by the regional Federal Reserve Banks:

- The Federal Reserve Bank of St. Louis has noted that, "Operational risk is even more difficult to estimate [than other risks] because historical losses are not well-documented."[20]

- The Federal Reserve Bank of Chicago filed a comment with the Basel Committee on a previous draft of the framework which makes clear the numerous problems with the proposed version of ORBC. It states, "Definitions of operational risk categories continue to evolve, and while some banks and organizations have begun collecting data, this process has not been systematized."[21]

- The Federal Reserve Bank of Richmond also filed a comment noting that OR can be, "[A] difficult risk to quantify and can be very subjective."[22]

- The Federal Reserve Bank of San Francisco has argued, "[A] key component of risk management is measuring the size and scope of the firm's risk exposures. As yet, however, there is no clearly established, single way to measure operational risk on a firm-wide basis."[23]

[20] *Basel II Will Trickle Down to Community Bankers, Consumers*, William R. Emmons, Vaye Lskavyan, Timothy J. Yeager, *The Regional Economist*, April, 2005

[21] *Federal Reserve Bank of Chicago Response to BIS Capital Proposal*, Federal Reserve Bank of Chicago, May, 2001.

[22] *The New Basel Accord Second Consultative Paper, January 2001,* Federal Reserve Bank of Richmond, May 30, 2001.

[23] *FRBSF Economic Letter*, Federal Reserve Bank of San Francisco, January 25, 2002.

- The Foreign Exchange Committee, which is sponsored by the Federal Reserve Bank of New York, concludes that "[U]nlike credit and market risk, operational risk is very difficult to quantify."[24]

These Federal Reserve Bank conclusions have been buttressed by academic research. A Cambridge University study determined that, "No data now exists for evaluation of operational risk events similar to Barings, Daiwa or LTCM. The possibility of effectively pooling such data across institutions seems unrealistic for many years to come and is statistically invalid without further research."[25] Furthermore, U.S. scholars have stated, "Private insurance and process regulation would be more effective than capital requirements for regulating operational risk."[26]

In fact, the industry has historically managed operational risk through future margin income (FMI), pricing and reserves, as well as through insurance. In the case of legal risk, which is discussed further below, U.S. banks are required to establish significant reserves to offset potential penalties. Similarly, natural disasters or manmade ones, to the extent foreseeable, are offset with insurance – a proven form of risk mitigation demonstrated in the Basel Committee's Risk Management Group's operational risk loss data collection exercise.[27] While insurance is partially recognized as a potential mitigant by Basel, pricing, reserves and FMI – which cover the overwhelming majority of operational losses – are not. Thus, the Accord fails to recognize that operational risk is already well handled through various techniques and without threat to solvency.

The Basel Committee and the U.S. regulators have acknowledged the point noted above for credit risk. Like operational risk, expected losses related to loans or investments are first addressed through reserves and, then, earnings. Credit RBC is also offset by credit risk mitigation, including guarantees. The final Basel II rules and the pending U.S. proposal will only require that credit risk capital be held for unexpected losses, allowing insurance, reserves, FMI and pricing to account for expected ones. This creates a serious inconsistency within the Basel rules – credit risk-based capital covers only unexpected loss, but the proposal mandates ORBC for both expected and unexpected losses despite the fact that expected losses are handled in the same fashion in both of these risk areas. A senior Fed official recently admitted that few of the banks participating in the U.S. regulators' "loss data collection exercise"[28] (a necessary premise for the ORBC rule) have the information Basel II will require.[29] The *American Banker* has also noted that operational risk management lags far behind the Basel II requirements, with only about half of surveyed banks even having a defined OR management function, let alone all the

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[24] *Management of Operational Risk in Foreign Exchange*, The Foreign Exchange Committee, March 2003.
[25] *Operational Risk Capital Allocation and Integration of Risks*, The Judge Institute of Management, Cambridge University, Elena Medova, 2001.
[26] *The Regulation of Operational Risk in Investment Management Companies*, Charles W. Calomiris and Richard J. Herring, Investment Company Institute – Perspective, September 2002.
[27] *The 2002 Loss Data Collection Exercise for Operational Risk: Summary of Data Collected,* Bank for International Settlements, Basel Committee, March 2003.
[28] *2004 Operational Risk Loss Data Collection Exercise*, Federal Financial Institutions Examination Council, October 2004.
[29] *For Basel Opt-Ins, It's Time to Gather Data*, Damien Paletta, American Banker, January 21, 2005.

data required to comply with the rule.[30] Regulators have defended the rule in spite of this gap on the grounds that Basel II is a strong incentive to improve OR management, but only 7% of banks in the survey cited the coming capital rule as a reason they are beginning to improve operational risk management. Instead, they cited other regulatory pressures and market demand.

Because Basel II includes legal risk in its definition of OR, U.S. institutions will be particularly hard hit. Banks operating in the United States generally face a far broader range of regulation outside the banking area than their foreign competitors. This includes laws regarding tort liability, discrimination, suitability and others that have no EU or Japanese equivalent. Since the U.S. legal system poses the highest litigation risk of any G-10 country, U.S. banks will likely be required to set aside far more capital for OR than their foreign competitors. They will be forced to do this despite the fact that U.S. securities laws already require holding reserves for material legal risks and there is no evidence that these have ever adversely affected the safety and soundness of any U.S. bank. As Credit Suisse notes, "Firms with significant activities in the United States could be put at a competitive disadvantage due to the increased litigation risk resulting from the U.S. judicial system."[31]

International competitiveness issues are not the only concerns raised by the ORBC requirement. Although Basel II outside the U.S. covers all major financial institutions, within the U.S. it can only be applied to insured depositories and certain of their holding companies. Thus, bank/non-bank competitiveness is an additional and very significant problem – or, perhaps, an opportunity if viewed from the non-bank perspective.

Non-banks are major competitors in key business lines covered by ORBC. For example:

- 37 of the top 50 asset managers, 74%, are non-banks;
- 5 of the top 10 wealth managers, 50%, are non-banks;
- 4 of the top 9 transfer agents, 44%, are non-banks
- 7 of the top 10 defined contribution plan service providers, 70%, are non-banks; and
- 9 of the top 10 401(k) plan administrators, 90%, are – yet again – non-banks.

How to Handle Operational Risk

As noted, the proposed RBC charge for operational risk is problematic from a methodological and competitiveness perspective, as well as raising the serious risk of becoming a perverse incentive to effective OR management. OR management is in fact critical to safe and sound banking – and it has become even more so in these post-9/11 days when threats to critical financial infrastructure have come from frightening new sources.

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[30] *A Diverse Industry Struggles with Op Risk,* Rob Garver, American Banker, May 3, 2005.
[31] *Basel II Implications for Banks and Banking Markets*, Credit Suisse Economic & Policy Consulting, July 29, 2003.

The first and most important way to ensure effective OR management is a sound set of supervisory standards ("Pillar 2" in the Basel framework). These can and should include an economic capital allocation for those forms of operational risk for which such a charge is meaningful, and disclosures can provide useful information to investors on this allocation and on overall OR management (adding "Pillar 3" market discipline to the mix).

Advocates of the current Basel rules have argued that the AMA is, in effect, a "Pillar 1.8." However, the fact that the AMA excludes most risk mitigation and is based on untested, debatable data belies the certainty that must underlie a regulatory capital charge. The more flexible framework finally included in the Basel rules also poses serious problems given the U.S. system of tough enforcement for institutions that do not pass muster as "well capitalized." Importantly, no such standard applies elsewhere, with supervisors providing considerable latitude in the way RBC is measured and in what happens when totals fall below required amounts. Supervisors should get considerably more experience with ORBC and ensure that international standards are comparable before U.S. banks are subject to a charge that – even while still at variance with economic capital – can carry a serious wallop.

Basel Basics

The Basel Accord is an international agreement governing the capital adequacy of banks operating globally. The Switzerland-based Bank for International Settlements (BIS) first established these international capital standards, generally referred to as "Basel I," in 1988. Due to certain inadequacies in the first Accord, namely that it did not accurately reflect the diverse risks taken by banks, the BIS's Basel Committee in 1998 decided to undertake a comprehensive rewrite. The new Basel Capital Accord, "Basel II," uses a new three-Pillar architecture to achieve this goal. It includes:

- Pillar 1: minimum regulatory capital requirements;
- Pillar 2: enhanced supervisory review of an institution's capital adequacy and internal assessment process; and
- Pillar 3: market discipline through public disclosure of various financial and risk indicators.

Last summer, the Basel Committee released the final version of this new framework, now the blueprint for implementation in individual countries.[32] The framework significantly revises the capital requirements for various risks, potentially increasing or decreasing them significantly for individual institutions. The Basel Committee, however, has calibrated the overall Basel II framework in hopes of keeping the current 8% risk-based capital (RBC) ratio in place for the banking industry as a whole. A series of quantitative impact surveys (QIS) have occurred to test if the RBC rules will in fact keep this 8% number intact for the industry as a whole, with wide variability expected for individual institutions. The results of the fourth QIS caused the banking agencies to delay U.S. implementation plans. A fifth QIS, to be undertaken by international banks, is expected early next year.

For the first time, the Basel RBC standards will apply not only to banks, but also to bank parent companies. In addition, the new rules will, for the first time, impose regulatory capital charges for operational risk (Basel I only covers credit and market risk). Interestingly, Basel II continues to count interest-rate risk under Pillar 2 rather than impose a capital charge, even though it is far easier to measure than operational risk. As shown in the U.S. S&L disaster as well as in the isolated failure of a number of banks, interest-rate risk – in sharp contrast to operational risk – is a proven cause of major banking crises.

Under Basel II, institutions are allowed three approaches to assessing credit risk and three for assessing operational risk. However, the Accord is only a framework, and national supervisors may diverge from it, in some cases significantly. For example, the U.S. regulators (the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation) are only allowing institutions to use the most advanced approaches to operational and credit risk.

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[32] *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, Bank for International Settlements, Basel Committee, June 26, 2004.

Timeline

The Basel Committee intends its new framework to be implemented at year-end 2006.[33] However, the more complex advanced approaches will be delayed for an additional year. U.S. regulators initially pushed for the delay to ensure that the final U.S. rules can reflect any changes warranted by their studies of the Accord's impact. Banks using the advanced options will need to run them parallel with Basel I for one year and then apply floors on the amounts of capital that must be held. These floors are expressed as a percentage of the capital that would be required under Basel I. The following chart details how this will work:

	From year-end 2005	**From year-end 2006**	**From year-end 2007**	**From year-end 2008**
Less Advanced Approaches	Parallel Calculation	95% floor on capital reductions	90% floor	80% floor
Advanced approaches for credit and/or operational risk	Parallel calculation or impact studies	Parallel calculation	90% floor	80% floor

U.S. regulators are moving on a different timetable than other countries. Already moving more slowly than other regulators, the U.S. agencies had planned to release a Basel II proposed rule in June along with the planned Basel I rewrite (possibly issued as an advance notice of proposed rulemaking). However, on April 29, 2005, the agencies announced that this schedule has had to be revised. The U.S. QIS4 found wide variations in regulatory capital, leading agencies to question whether their information on the rules is correct and/or if the rules will permit too much of an RBC reduction.

The agencies now plan to have Basel rules in place by January 1, 2007, which is consistent with the Basel schedule for the advanced options, but they also note that this could well change if ongoing studies and negotiations lead to a significant delay in the Basel II proposed rule.

[33] The EU is pushing their start dates back one day to January 1, 2007 and January 1, 2008 rather than December 31, 2006 and December 31, 2007 to avoid extra costs for banks whose financial years end on December 31.