Battling the Basel Babble: Why This Complex Rule Really Matters

Remarks of

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It's a pleasure to be here today to discuss not only reputational risk, but also Basel II. The first topic surely seems like it's right up the general counsel's alley; the second one is a bit tougher, perhaps because of all the math. However easy it is to get lost in the Basel formulas – and it's way easy, I know – this rule has profound franchise and line-of-business impact. Thus, it's important that you add your voice to ensure that your company is doing a "should we" review of Basel II along with the "how to" in which I know you're all deeply engaged.

Today, I'd like to start with a quick review of just what Basel II could do to the competitiveness of a large, diversified bank – pro and con. I'll also take a look at some of the particularly troublesome issues for specialized banks. I think the new capital charge for operational risk is problematic in both cases, in part because of a capital charge for "legal risk" – an issue right up your alley, I know. Big diversified banks think they will get major breaks on the credit risk side to make up for the operational risk hit, but the U.S. banking agencies' plan to keep the leverage and "prompt corrective action" requirements as is make this problematic even if the floors on how much risk-based capital can drop are eliminated. Basel II is a big improvement over Basel I in many respects, but it can and should be significantly improved prior to implementation. If it isn't, some of the banks here today will surely be owned by some of the others, and a few of you could also find yourselves in non-banking firms insulated from the banking rules.

Why Capital Counts

In a series of hearings on Basel over the past two years, both the House Financial Services and Senate Banking Committees asked a lot of hard questions about the impact of the new risk-based capital (RBC) rules on big versus small banks, banks versus non-banks and U.S. banks versus foreign ones. In response, the Federal Reserve is undertaking a series of studies on Basel II competitiveness impact. So far, two have been released – covering overall M&A impact and small-business lending. Perhaps unsurprising in light of strong Fed advocacy for Basel II, both of these studies see little, if any, RBC impact on franchise value. Two others in the works – on mortgages and operational risk – may well reach the same conclusion.

Should this put worries to rest? I don't think so. Regulatory capital isn't the be-all and end-all of competitiveness – little bitty issues like service quality and product design of course make a big difference. But, at the end of the day, regulatory capital drives who ultimately offers what to whom for how much. Holding all else equal, regulatory capital different from economic capital drives big differences in return on equity – in turn, the big driver of shareholder decision-making and, thus, franchise value.

Examples? One obvious one is Fannie and Freddie. One reason – not the only one, but a major factor – that these GSEs dominate the conventional mortgage market is their regulatory capital. This is less than half of what bank regulators require for low-risk

mortgages – meaning that, all else held equal, a GSE makes double the shareholder return for the same mortgage. No wonder their ROEs are still a market wonder (even if much else at them these days is rather the reverse).

Another example? In 1988, Basel I exempted short-term stand-by letters of credit from any regulatory capital requirement – even though there's lots of risk there, as those holding short-term Enron, MCI or similar paper found out. Because bank regulators exempted these risks from RBC, banks quickly wiped non-banks out of a very lucrative line of business.

One final thought: after passage of GLBA, many thought all diversified financial services firms would quickly become financial holding companies. Of course, almost no firm that wasn't already a bank holding company became an FHC. Reason? Some of it lies in the different approach to bank regulation, but a lot – the majority, I think – was the adverse impact of holding company coverage by bank capital rules. Outside an FHC, firms like Merrill Lynch and AIG can pick and choose the regulatory capital regime right for each line of business – a heck of a lot to give up.

Basel II and the Competitive Balance

Time doesn't permit a thorough review of the competitive implications of the complex Accord, which will be implemented in still more complicated rules from the Fed, OCC, FDIC and OTS. As I said at the outset, I do think Basel II on the whole is better than Basel I. Indeed, Basel I has led to numerous distortions that require quick remedy. But, before the agencies finalize Basel II, some serious policy questions need to be answered.

One of these I think of particular relevance to you is the proposed capital charge for "legal risk." The operational risk-based capital charge in Basel II has a specific allocation for the risk of loss resulting from such factors as litigation or compliance failures. Interestingly – indeed, I think, puzzlingly – the ORBC charge doesn't cover reputational risk. As we have already discussed, rep-risk is a major factor; indeed, bank regulators of late have said it's their biggest worry. Legal risk, in sharp contrast, is readily addressed through reserves and is possible to model or calculate in advance. Coming up with a reasonable charge also has serious competitiveness issues due to all the unique rules – against loan discrimination or in favor of class-action litigation, for example – that apply to your institutions and not to foreign competitors.

Additional competitiveness concerns raised by the U.S. version of Basel II include:

- In sharp contrast to the EU and Japan, U.S. regulators can impose the Basel standards only on banks and thrifts, with the plan now to do so only for the very biggest ones. The biggest investment banks now have a new capital rule under the SEC ("consolidated supervised entity" standards) that looks like Basel II, but

eliminates key problems like the leverage capital requirements or banking agency "prompt corrective action" thresholds. Thus, non-banks can either stay outside Basel II altogether or reap all of its benefits without any of the limits proposed for big banks that compete head-on against them.

- This competitiveness problem becomes acute when a bank specializes in a single line of business where non-banks are big competitors. If regulatory capital is lower than economic capital, the bank is a big winner. But, if it's higher, the bank franchise comes under very heavy pressure. The ORBC requirement is perhaps the biggest problem here. No one has come up with an economic capital requirement close in any way to the Basel ORBC requirement. Specialized banks won't get any credit RBC drop to offset the big ORBC add-on. This will adversely affect banks in businesses like asset management, custody and payments processing. However, some diversified banks may find that ORBC has more of a punch than they thought. Big off balance-sheet servicing portfolios will also be subject to a new ORBC charge, with mortgage banks and credit-card ones taking a wallop.

- Outside the U.S., Basel II will apply to all banks, regardless of size. In the U.S., though, the regulators now plan to apply it – and only the most complex sections – to the very biggest banks and thrifts. Others can opt-in, but if they don't, they stay under Basel I. About forty or so banks now think they'll opt-in, but big questions still remain about the competitiveness of those who don't or can't qualify for Basel II. U.S. regulators are thinking about a Basel "1.5," but what it says and who wins and loses if it's finalized are very much up in the air.

Another competitive uncertainty: what's called home/host decisions in Basel-speak. Who judges whether a bank meets Basel II will have profound competitive impact, and separate standards in each nation under the broad Basel rubric will carry major implementation cost. Importantly, regulatory capital in the U.S. is backed up with an array of tough enforcement sanctions, but that's far from true elsewhere. Basel II has a second pillar – supervisory improvements – designed to offset this, but its impact is far from certain. New "Pillar 3" disclosure standards also have big impact for U.S. banks under the SEC.

Tricky Timing Questions

I'll get to how Basel II will be implemented here in a minute, but another, major competitive issue arises because U.S. timing is very different than that in the EU, Canada, Japan and many other nations with big financial services firms that want in here. As I mentioned, the U.S. has decided to impose only the most complex parts of Basel II – the "advanced internal ratings-based approach" for credit risk and the "advanced measurement approach" for operational risk. These are, to put it mildly, hard. As a result, Basel II delays these advanced options until January 1, 2008. However, outside

the U.S., Basel II also includes a far more simple "standardized" approach for credit and operational risk. Banks will be able to use this on January 1, 2007 – and some very big drops in parent bank regulatory capital will be the immediate impact. Importantly, because banks outside the U.S. don't have offsetting leverage and other regulatory capital thresholds, they can get all of Basel II's benefits for low-risk books of business. In certain business lines – mortgages and small-business lending, for example – these drops are big. They'll have immediate competitiveness impact around the world, and some U.S. franchises might look quite nice when their capital requirements are consolidated with those imposed outside the U.S. on the parent holding company.

Basically, Basel II is done everywhere else but here. Domestic rulemaking continues, of course, but banks outside the U.S. know what their new RBC framework entails and – most importantly – whether they win or lose. January 1, 2007 is about here from a strategic planning point of view, so market impact from this certainty is immediate.

In the U.S., the decision-making process is still uncertain, especially when Congress' role is factored in. The banking agencies will do a fourth quantitative impact survey the end of this quarter, with results expected early next year. Only the very biggest, "core" banks must participate, but those planning to opt-in likely will try to complete the survey as well. Based on the results, the agencies will issue a proposed rule that builds not only on this survey, but also on the advance notice of proposed rulemaking issued in mid-2003. A final capital rule isn't likely until year-end 2005, at the earliest. This puts U.S. banks under a lot of pressure to figure out how to implement Basel II, to qualify for the strict eligibility standards, and then to set their strategic course accordingly. The timing becomes still trickier when one remembers that the U.S. agencies are thinking about a Basel I rewrite and want to complete it on precisely the Basel II schedule to limit the adverse big-bank/small-bank issues.

As I said, the regulators' schedule is set, but Congress' role remains to be seen. The comment letters on Basel II from Chairman Oxley and Ranking Member Frank are among the toughest I've ever seen. They have made operational risk a particular concern, in part because they rightly think that a regulatory capital charge detracts from urgent efforts to address post-9/11 contingency-planning and disaster-preparedness needs. Will they allow a problematic rule to go forward? So far, they say no, and the Federal Reserve thus has a big challenge before it.