Two Tracks to Basel II:
The Fate of the Capital Accord in the U.S.

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

Before the
American Bar Association

Tampa, Florida
April 6, 2006

We meet today in this lovely spot one week after the Federal Reserve Board unanimously approved the next proposal in the round to implement the risk-based capital rewrite generally known as Basel II. The U.S. has slowed the rule down, leading to a delay generally called the "gap year." However, I think we have more of a "gasp here" – the U.S. approach to this critical regulation is so different than the international one that banks here are facing a very, very different competitive and regulatory future.

My guess is that all of you have finished reading the 500 or so pages released last Thursday by the Federal Reserve. And, as lawyers, you've also parsed all the equations for your banks or clients. Okay, maybe not. So, first, I'd like to run through the key features of the new proposal and then I'll try to focus on its strategic impact.

Before I do, though, I'd like to address a major issue that has long dogged the entire Basel rulemaking here and in other financial markets. The complexity of the rule has all too often consigned its review to implementers. Put simply, any 500-page rule – and the current one is shorter than its predecessors – tends to bounce down the corporate decision-making tree to the poor person who hasn't someone else to whom to send it. These folks are in the "how-to" department, not the "should-we" one. As one looks at Basel II, one is struck by how much work has gone into the "k" into the securitization equation or the variables that drive LGD – loss given default. Indeed, even "default" is a tricky question and a lot of negotiations lie behind how this seemingly-simple fact is defined.

All of this is important and, indeed, it's critical to a functioning regulatory capital framework. But, it's wholly insulated from the larger real world, where many critical competitors are exempt from this complex risk-based capital (RBC) framework. It's also a debate that sometimes drills down to tiny details, leaving for another day the core question of how this new RBC regime works at the consolidated parent-company level.

Let's step back and remember that shareholders often ask a very simple question: if I give you equity – that is, if I invest in your shares – what return can I expect? Is it more or less than if I invest in a comparable venture that isn't subject to your regulatory-capital requirements? If regulatory capital diverges too far from economic capital allocation as determined by acknowledged market forces – especially if it's too high – then shareholder dollars will go elsewhere. That's the core, key strategic reality that must drive consideration of the Basel II rule.

What Is It?

First, though, let me quickly summarize the proposal the Fed released last week. Key features – and my views on them – include:

- The rule will be a work in progress even after it is finalized. Thus, for all its pages and every little detail, a bank can spend millions to comply and still not know if the Basel II standards apply. Even then, it can't expect much capital relief from the current, anachronistic standards because of all the floors and caveats in the new rule. Almost none of these applies outside the U.S., which means that foreign institutions – let alone non-bank competitors -- will have a big regulatory-capital advantage.

- The agencies are proposing to keep the current leverage standard intact. This applies a flat capital charge for all on-balance sheet assets regardless of risk. In short, even if you drop risk and should get a risk-based capital advantage, you won't. So much for all the risk-management incentives the rule is supposed to provide. The proposal does drop current prompt corrective action (PCA) standards for holding companies, but I think that all this will do is drive assets off the balance sheet to arbitrage the remaining leverage rule – raising again the core question of what's the point.

- The proposal retains a new capital charge for operational risk – including legal risk. Please, all of you here, tell me how to measure this. Okay, you're right – no one yet has been able to do so. Banks can, of course, mitigate this risk through effective controls and insurance, but the proposal still doesn't permit much of an offset for this risk mitigation – precisely the reverse of the risk-management incentive it's supposed to create.

- All very large U.S. banks and savings associations will be subject to Basel II. However, only bank holding companies will also come under it. The agencies hope that the rule will address regulatory arbitrage – choosing charters for capital advantage – but the proposal may well exacerbate this problem.

Are there good things in Basel II? To be sure, especially when one considers how far out of date Basel I has become since it was finalized in 1988. However, I think the proposal's complexity is unnecessary and the delay unwise – we should move quickly to finalize the simpler parts of Basel II – doing so for all insured depositories – test it and, then and only then, move on to the more complex parts of the rule that make the model-builders so happy.

What to do?

First, of course, come the comment letters. Each of you will soon be involved in deciding what should be in them and then drafting the views due to the agencies 120 days after the proposal is finally published in the *Federal Register* later this year. It's easy, I know, for counsel in this case to turn the comment letters over to the quants – the sheer size and complexity in the proposal makes this all too tempting. This, though, would leave consideration of the proposal on only one track: the how-to one I mentioned earlier. The "should-we" question must be answered as the complex proposal is considered. To make this call, one must step away from the details of the proposal to consider how it effects each of your banks as a whole and each of the business lines that are most important within it. To be sure, this is a quantitative determination to some degree, but it's also a critical policy one in which each of you plays a major part. If your banks or clients decide its views on Basel II only after all of the models are run and the final numbers are in, the rules will be final and it will be too late.

Already, I hear institutions saying that this or that provision won't effect them because they aren't in this or that business. But, what if they want down the road to get into it? How close to the bank's strategic plan now is that business? More important, are competitors in it that could find an acquisition – not sought by management – a far better bet under Basel II?

I haven't yet mentioned the Basel IA rules. This is an advance proposal issued late last year by the agencies to address the competitive challenge of Basel II. Many institutions rightly thought through the strategic challenge and said, "Whow." If my big-bank competitors get a big RBC break, I'm duck soup. The agencies initially resisted this, but finally offered a regulatory-capital option for mid-size institutions not required to come under Basel II. This proposal also requires careful examination and, as it advances, the same strategic think-through as the new Basel II one.

What Will Happen?

I started this talk by suggesting there are two tracks in the Basel rulemaking. I'd like to turn now to the two tracks I think critical in the resulting strategic planning.

The first track is the one I have briefly discussed: understanding this latest proposal and commenting on it. Associated with this, if desired, is advocacy to get the critical "should-we" parts of the rule as right as possible. We're facing the unprecedented situation of a rule fraught with uncounted caveats that, at the same time, will be in place for years. Thus, getting it as right as possible is a major challenge.

It isn't, though, the only one. Throughout all of the years it will take the agencies to finalize Basel II and let your banks use it, the markets will be moving and critical M&A decisions await. It is, thus, I think an urgent priority to review this proposal, along with the IA one, in light of current and prospective market trends to decide whether your bank is a winner or loser and what you want to do in either case. Some institutions haven't let time go by – there have already been a few U.S. deals done with Basel in mind and the rest of the world is moving still more swiftly.

There is, thus, the "how-to" and "should-we" factors to be considered throughout the coming comment period. Atop this, though, is the "we must" set of decisions based on the fact that – like it or not, change it or not – the rule is settled everywhere else and inevitable here.