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The New Basel Capital Accord: A Status Report

It's been an extraordinary year since I last spoke to the Institute in this forum -- a year that saw both unspeakable tragedy and awe-inspiring heroism. And it saw something else that I think few people expected in the wake of September 11: extraordinary solidarity in the international community. To date, no fewer than 147 nations have frozen assets linked to terrorist organizations. International cooperation in the anti-money laundering campaign has been exemplary. Dozens of nations are cooperating in the effort to root out terrorist cells. Others have contributed combat and logistical support to the war in Afghanistan and are now contributing significantly to the international effort to rebuild that country's shattered infrastructure.

I believe this experience may have some relevance for those of us who are engaged in the effort to bring about greater harmonization in the supervision of internationally active financial organizations, in particular for the Basel Committee on Banking Supervision. 2001 began auspiciously with the release of the second consultative draft of the Committee's proposal for a new capital accord -- a 500-plus page set of documents. The Committee also announced an ambitious schedule for moving ahead with that proposal: a four-month comment period; final publication of a new accord by year-end 2001; and full implementation in 2004.

As spelled out in the consultative package, the new framework for regulatory capital -- which I shall refer to as "Basel II" -- aimed to address many of the distortions that have resulted from Basel I, the original 1988 capital accord. Although it represented a breakthrough in many ways, the 1988 accord was found to be seriously deficient in others, and these deficiencies have become more conspicuous with each passing year. It is now widely acknowledged that Basel I inadequately differentiates among institutions of varying risks and risk management capabilities. In some respects, the Basel rules have even proved counterproductive, having encouraged some institutions to move high quality assets off the balance sheet, thus reducing the average quality of bank loan portfolios.

Despite the good that has come from it -- and the good has been substantial -- there's now a general and understandable sense that time has overtaken the 1988 accord.

The proposal for a new accord that was rolled out last January is designed to provide a framework that's as sophisticated as the industry itself is today -- and yet one that also accommodates the industry's extraordinary diversity, both among and within its home countries.

Before it commenced work in earnest on the proposed new accord, the Basel Committee laid out five objectives to guide its efforts.

- First, any new capital rule should at least maintain the current overall level of capital in the banking system.
- Second, it should promote competitive equality and a level playing field for international banks.
- Third, it should take a comprehensive approach to addressing risks.

- Fourth, its approach to capital adequacy should be appropriately sensitive to the degree of risk inherent in a bank's positions and activities.
- And, finally, a new capital rule should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication.

Those were the guidelines that the Committee set for its own work. I would add the following as important principles that should also guide the Committee.

- First, I strongly believe that whatever rule we adopt must work in practice as well as in theory. A rule that is intellectually elegant but overly complex and difficult to comprehend and implement may create more problems than it solves.
- Second, the rule has to provide supervisors with sufficient flexibility to accommodate differences among financial institutions. Institutions should not be forced to modify practices that raise no safety and soundness concerns, and settled, well-functioning markets should not be disrupted, simply in the name of compelling adherence to a common rule.
- Finally, I believe it's exceedingly important from a domestic perspective that we avoid impairing the competitive vitality of U.S. banks, and from an international perspective that we avoid placing banks generally at a competitive disadvantage compared to other financial service providers. To be sure, banks play a special role in the economy of every country, and thus frequently warrant special treatment. But the line between banking and other financial services is becoming increasingly blurred, and we must recognize

that investment banks, insurance companies, and other non-bank institutions are major competitors of banks.

So -- how well did we do? Did the document released in January of last year meet these standards or did it fall short? If the latter, what steps should we now take to correct any deficiencies and to produce an accord that will genuinely contribute to a safer and more competitive global financial system?

To answer those questions, a more detailed review of Basel II -- and of the reaction to it from its various constituencies -- is in order.

The new accord, as I'm sure you know, is built on three pillars: minimum capital, supervisory review, and market discipline. It would reward banks that have developed the most advanced internal risk rating systems by allowing them to use those systems in the calculation of their capital requirements -- the so-called "internal risk ratings-based approach," or IRB. Banks with less developed capabilities would have a somewhat less advantageous methodology, while banks with more rudimentary risk management systems would utilize risk weights and capital charges established by the Committee under a standardized approach.

But even banks adopting the IRB approach would not be unconstrained in calculating their own capital requirements. The primary regulator would still be responsible for evaluating and validating each institution's models and risk rating system and for assuring that they are applied with consistency and integrity. Banks' internal processes would be subject to regular supervisory testing -- and intervention, if necessary. And all internationally active banks, regardless of their complexity, would be required to make a capital allocation for operational risk.

Moreover, the Basel Committee envisions an important role for the financial markets as a barometer of the financial condition and risk profile of regulated institutions -- as well as a reality check on the job we do as regulators. Thus, the third pillar of Basel II would require that financial institutions improve the quality and quantity of the information they make public, so that financial markets have the ability to make accurate and informed judgments on the health of each institution.

The transparency pillar has an important additional function that should not be overlooked. It will provide both banks and supervisors with information that will enable them to assess how the requirements of the accord are being observed and applied in other countries. In this respect it will facilitate a kind of "self-policing" of compliance by banks subject to the accord and their supervisors.

A brief summary obviously cannot do justice to a dense document of 500 pages, but there you have the highlights, at least, of Basel II -- the product of months of consultation among the principals and extraordinary effort by the Committee secretariat and the staffs of the various Committee members. That we have been able to come as far as we have is a tribute to the strong and skillful leadership of Bill McDonough, who brought to bear not only his standing as one of the world's leading central bankers, but his extensive practical background as a banker. By not underestimating the difficulties that stood in its way, Bill has kept the highly collegial but occasionally fractious Committee on point and headed in the right direction. Indeed, it is not taking anything away from the great service our members have rendered to say that our proceedings have been marked by spirited exchanges of viewpoints that reflect the wide differences in legal, supervisory, and accounting practice in our respective nations. The Committee's proceedings underscored the importance of developing rules that make sense, at least in terms of their broad principles, not only for the G-10 but also for all nations expecting to operate under the Basel framework.

We expected that the reaction to the proposed accord issued in January 2001 would reflect the wide divergence in financial practice around the world, and in this regard we were not disappointed. Some stakeholders urged us to simplify; others asked that it be made even more risk sensitive -- and, at the same time, more complex. Smaller, noncomplex institutions in the United States went on the record as expressing a preference for the status quo; the gains promised under the new accord, they said, seemed not worth the trouble and expense of shifting to a new system. Many institutions particularly objected to the capital charge for operational risk, disagreeing both with the definition of operational risk and with the amount of capital they would be expected to set aside for that purpose. Even the risk rating agencies, which might have been expected to applaud a system that would utilize their services for banks without reliable in-house risk-rating capabilities, worried publicly about conflicts of interest and the possibility that they would be perceived as unduly influenced by the regulators.

The Committee's initial cut at Pillar 3 raised very substantial objections, and knowledgeable observers were quick to point out that market discipline, as contemplated in Basel II, can be an elusive concept -- difficult to standardize and potentially burdensome in terms of the disclosures the industry would be required to produce. Indeed, just days before last January's release, a Federal Reserve-sponsored working group issued a report that cast doubt on the value of disclosures for regulators given the different risk management methodologies in use among financial institutions. And a day after the release of that report, the Treasury Department and the Federal Reserve released a joint study concluding that what some industry analysts had viewed as among the most promising tools for market discipline -- the use of subordinated debt -- was actually of questionable value.

What we had at the end of the day, then, was strong support for the Basel principles and equally strong opposition to many of the details of the proposed Basel II rules. To the Committee's credit, it has devoted a tremendous amount of time and energy in an effort to meet these and other concerns and to continuing the dialogue with the industry. It has already revised downward the proposed charge for operational risk from 20 percent of total regulatory capital to 12 percent in the standardized method, and it has laid the groundwork for a non-formulaic approach to operational risk in the other method -- the Advanced Measurement Approach, or AMA -- that would look more to a bank's internal assessments, much as the IRB-based approach does with credit risk -- although the attractiveness of this approach may be appreciably lessened by the prospect that a "floor" might be imposed. It has also cut back significantly on the volume of disclosure that would be required under Pillar 3. And in the area of retail credit, the Committee has issued a working paper on the capital treatment of expected losses and future margin income that is still open for comment.

Throughout this difficult process, the Committee has rightly maintained that it would do whatever it took to get the new accord right. Thus, when it became clear that it would be impossible to fairly evaluate the concerns of market participants and still meet our own implementation deadlines, we extended the deadlines. There will now be a third consultative package, although that document will not be released until Committee staff has completed an additional review aimed at assessing the overall quantitative impact of a new accord on banks and the banking system. In this "quality assurance" phase, the Basel Committee will focus especially on the highly controversial question of appropriate capital treatment of credits to SMEs, the small- and medium-sized enterprises that are so vital to economic growth and job creation.

The Committee is also finalizing calibration of the minimum capital requirement in order to achieve a level of capital that, on average, is approximately equal to the amount of capital produced by the present accord, while still providing incentives to banks to use internal ratings systems.

Merely stating these objectives helps to convey the difficulty of the Committee's challenges. How do you satisfy the political imperative of avoiding a reduction in the overall capital of the banking system, while at the same time holding out to the largest and most sophisticated banks that a set of rules better tuned to risk may enable them to enjoy lower capital -- unless, of course, the new rules will result in an increase in the capital of other more risky banks?

In this connection, a comment may be appropriate as to just which banks will be subject to the new accord. The intent is that it will be applied to "internationally active" banks. U.S. regulators have made clear that they do not intend to apply the new accord to the many thousands of community banks that serve local markets in this country.

At the same time, many of us have real questions about how many of our larger banks will be in a position to adopt the IRB approach. I think it is a fair guess that only a very small handful of our largest, most sophisticated banks -- perhaps no more than 6 or 8

-- will qualify, at least initially, for the advanced IRB approach, and even the foundation IRB approach may not be suitable for many large banks.

There are, of course, a number of thorny issues that remain to be worked out. I have been quite concerned, for example, about the approach to operational risk, and have voiced those concerns consistently in Committee meetings. I view operational risk as the risk that inheres in the quality of a bank's internal controls. Thus, two banks engaged in an identical line of business may present vastly different quantities of operational risk when the internal control systems of one are significantly better than those of the other. A one-size-fits-all approach to operational risk -- such as a formulaic capital charge based on some percentage of gross revenues or a percentage of the charge for credit risk -- while simple to apply, would disadvantage the best managed banks and provide undeserved advantage to the worst managed. Worst of all, it would provide no incentive to improve internal control systems. For this reason I have repeatedly argued that operational risk is particularly well suited for a Pillar 2 approach. But there are many on the Committee who are very cautious about such a use of Pillar 2, believing it would be used for supervisors to provide competitive advantages to their banks. Those holding this view find strong comfort in highly detailed prescriptive rules. While I find the AMA concept quite appealing, I am concerned that it not be so constricted as to diminish its attractiveness to banks.

I have also been concerned about the approach to securitizations. U.S. bank regulators are keenly aware -- increasingly so -- of the various risks involved in securitization, and we have seen numerous instances in recent times in which badly managed securitizations have caused serious problems for banks. On the other hand, securitization has been an important risk management and funding technique for many of our best-managed banks, which have developed securitization markets to a high level of efficiency.

While we must address the real risks here, we need to do so with care, so that we don't needlessly or unintentionally disrupt an important market. We must also avoid a "beggar-thy-neighbor" approach. The volume of securitization activity among U.S. banks vastly exceeds that of all of the other G-10 countries combined. While the popularity of securitization is certainly spreading, we must resist the temptation to embrace new rules uncritically when their burden will fall most heavily on countries other than our own.

Finally, I am concerned about the enormous complexity of the proposal. With great respect for the various task forces and working groups that have conscientiously produced extremely thoughtful papers, I would be amazed if every member of the Committee has been able to plow through the details of every paper. I'm frank to say that I have not. I suppose it's a character flaw of mine that as soon as I see the symbol for an indefinite integral on a page, my attention starts to flag. Unfortunately there are many pages of complex formulas in the Committee's recent work.

I believe it is essential for a number of reasons that we make a very strong effort to simplify the articulation of the basic rules. Bankers, examiners, legislators, and policy makers need to be able to comprehend the structure and content of the new accord without having to plow through reams of mathematical minutiae. We need a reasonably concise set of black-letter rules that lay out the structure of a new accord, with such elaborating detail as is absolutely necessary left to annexes. And we should not attempt to draft language addressing every possible contingency or detail that might arise, to chase every rabbit down every hole. Again, I believe we should put more reliance on Pillar 2 to fill in the interstices. We in the U.S. have to keep in mind that before the new accord can become effective for our banks, we will have to go through a formal rulemaking proceeding, and while an agency head probably can't be sent to jail for violating the "plain language" requirement we are supposed to observe, we should at least make a stab of it.

The Committee has demonstrated that it is not unresponsive to the views and interests of the industry, and I believe that banks that have provided input to the process have contributed immeasurably to our joint effort. I have urged all of our large banks to analyze the Basel proposals and to let us and the Committee know their views, and I have personally met with a number of the more engaged banks to discuss the issues. The dialogue in which we have been engaged together -- as supervisors and bankers -- offers an excellent case study in cooperation, which bodes well for our ability to develop the inevitably complex rules that are so necessary to help us address increasingly complex risks in the global banking system.

But I also believe that we must continuously ask ourselves what "getting it right" really means. While competitive equity and uniformity of application are important objectives of the Committee, we need to consider the difficulty of delivering a comprehensive framework that encompasses all the different ways that institutions are operated and supervised across the G-10 and around the world. In the U.S., for example, we have a highly developed system of bank supervision. The OCC has full-time teams of resident examiners on site at our largest banks. In other countries, the task of supervisory oversight may be quite different, with an important role being left to the outside auditors. Given such disparities, what can we expect in the way of uniform application of highly complex and prescriptive rules? Would we be less well served if the Basel process aimed instead at seeking agreement on broad principles and modes of behavior? Should we consider emulating the less prescriptive approach adopted by today's international coalition against terrorism -- or by the International Accounting Standards Board, which promulgates global standards and principles, and leaves implementation and enforcement to national authorities?

More than anything else, the Committee needs to work with and understand the dynamics and operational incentives of the banking industry. We need to make certain that the new capital framework reflects and reinforces the best contemporary practice. We must be very careful to avoid micromanaging the institutions that we supervise. And above all we must be cautious not to disrupt or destroy settled markets by adopting new approaches that could have serious unintended consequences.

In light of everything that has occurred over the past year, I believe it is impossible to predict exactly what the Basel Committee's final product will look like -- or when we will come to closure. Although we recognize that there are costs associated with further delay, a process that involves such complexity and such a potential for causing unintended consequences should not be rushed. We need to take the required time not only to complete the testing and calibration of the IRB approach, but also to assure that our approach to such issues as operational risk makes good sense.

Over its distinguished history, the Basel Committee has functioned best when it has focused on developing and articulating basic principles. The "Core Principles for

Effective Banking Supervision," which the Committee adopted in 1997, have made a tremendous contribution to the improvement of supervisory practice worldwide. Basel has been an invaluable forum for supervisors to use for sharing experiences and insights and learning from them. We have done less well when we have tried to make our vastly diverse and complex global banking system -- and the variety of our supervisory arrangements -- conform to a single model.

The Basel Committee is unalterably committed to the goals of financial stability and effective international bank supervision. But as we continue to learn, it is both necessary and possible to come up with mutually agreeable standards of international conduct without dictating how those standards are to be achieved or enforced.

In the world of international politics, sovereign differences can be a source of strength. I believe that's just as true for international bank supervision. As the Basel Committee continues its important work, we must respect those differences -- and build on them -- in order to achieve a truly prosperous global economy.