

BASEL II – UNSOUND AND UNFAIR

By William M. Isaac*

A recent article in this paper, “A Tale of Two Fed Staffers and a Paper on Basel II,” told of two former staff members of the Federal Reserve, Paul Calem and James Follain, and a study they authored on the competitive effects of Basel II. Their study is a reminder of how complex Basel II is and how little is really known about its potential ramifications.

Messrs. Calem and Follain began work on their paper in 2003 and previewed it recently. They concluded, very much contrary to Fed orthodoxy, that Basel II will have significant adverse competitive effects on some 7,000 U.S. banks and thrifts that are not able to adopt Basel II’s capital rules, which are expected to reduce materially mega-bank capital requirements.

Messrs. Calem and Follain worked at the Fed when they undertook the study. But, according to the article, the Fed decided not to publish their paper and has commenced another study on the same topic.

Basel II is a highly complex set of risk-based capital rules being developed to apply to roughly the ten largest U.S. banks and to other very large banks around the world. Smaller banks will remain subject to the Basel I standards developed in the late 1980s.

Basel I and Basel II have been championed by the Fed. Although the Comptroller of the Currency, Federal Deposit Insurance Corporation and Office of Thrift Supervision participate in the discussions and need to sign off on the product, I am convinced that neither Basel I nor Basel II would exist but for the Fed’s relentless pursuit of them.

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Based on my conversations with regulators, bankers from all sizes of banks, and trade group executives and my review of public comment letters, Basel II is perceived by many as unfair, inordinately complex, and unsound.

Zions Bancorporation is a \$28 billion banking company with over 400 offices in eight western states. Here are a few excerpts from its public comment letter on Basel II:

“While Zions fully supports the concept that capital should properly reflect economic risks . . . we believe [Basel II] will have adverse effects in terms of creating biases that favor large banks, deleterious industry concentration trends, and decreased safety and soundness. . . .

In general, [lower capital requirements for Basel II banks in most loan categories] suggest that [Basel II] banks would have significant competitive advantages. . . . [S]uch advantages would lead to declining market share for community banks and regional banks and would increase the rate of mergers with larger banks. . . .

In the end, the federal government and the taxpayers [will be] forced to cover any adverse risk consequences. . . . We believe that such biases in capital rules would be at odds with the notion of improving bank safety and soundness.”

World Savings, with over \$100 billion in assets, is one of the nation’s 15 largest banking companies. Its recent public comment letter is must reading for everyone involved in the Basel II debate. Here are a few excerpts:

“[W]e continue to oppose Basel II. We have been around long enough, and have survived enough industry crises, to recognize Basel II as bad public policy pretending to be sophisticated risk management.

Capital regulations that affect the stability of our nation’s banking and financial systems should be simple, not complex, and should produce results that are transparent, not obfuscated. We believe it is inherently unsafe and unsound to adopt a capital regime that will be difficult, if not impossible, for regulators, boards, senior management officials, and other market participants to effectively monitor and supervise.

Although certain control and oversight mechanisms will be required of Basel II banks, these controls cannot overcome the fundamental flaw of allowing banks to set their own regulatory capital levels from statistical models the banks themselves create and manage. . . . We have seen time and again that earnings pressures combined with complex rules and models invite mischief. . . .

It is unrealistic to expect that the bank models will not . . . contain [significant] errors. Are we to expect that bank CEOs, CFOs, or audit committee members will detect the flaws in time, or that the regulators will have the time and skills to find the needle in the haystack? Are we prepared to bet the system that they will?

This is not to say there is no role for modern risk management techniques. But they should be used by institutions primarily for internal management purposes rather than for determining what is needed to protect the FDIC insurance fund and, ultimately, the U.S. taxpayer. . . .

[T]here are much sounder ways to modernize the current risk-based capital regulations than what is being proposed. Focused changes to Basel I would probably take care of all legitimate capital issues. . . .

There can be little doubt that the growth in capital levels at U.S. banks . . . has produced a banking system that today is sounder and more competitive than those abroad. Why risk an unproven and unprecedented approach to capital regulation when what we already have has proven to be working?”

I hope someone at the regulatory agencies is listening and will stop the runaway train we know as Basel II. At the very least, reform of Basel I should be given much higher priority than adoption of the highly risky and inequitable Basel II. If not, Congress should intervene before irrevocable damage is done to the world’s best banking system.