

## **WHAT IS THE RATIONALE FOR BASEL II?**

**By William M. Isaac\***

Basel II is an inordinately complex set of risk-based capital rules being developed by international bank regulators to apply to the largest U.S. and foreign banks. The more I try to understand the rationale for Basel II the less persuaded I am that there is one.

International regulators developed risk-based capital rules, dubbed Basel I, in the late 1980s to apply to banks of all sizes. They offered two primary justifications for Basel I: i) capital rules should apply uniformly to banks throughout the world in order to level the playing field, and ii) capital requirements should correspond to the level of risk in individual banks. One could hardly quarrel with either objective, although it was far from clear that Basel I was the most appropriate way to achieve them.

For example, Basel I has not come close to fostering parity in worldwide capital standards. At year-end 2004, the twenty largest banking companies outside the U.S. had a median capital-to-assets ratio of 3% compared to the 6% median ratio (deleting goodwill) of the twenty largest U.S. banking companies.

The capital level at these foreign banks was below where the capital of large U.S. banks was in the late 1970s before U.S. regulators began a major push to increase large bank capital levels. Only two of the twenty foreign banks met minimum U.S. standards.

Despite this overwhelming use of leverage by large foreign banks, their median return on equity was virtually the same as the median return of major U.S. banks. In short, large U.S. banks are much better capitalized and far more profitable.

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The Federal Deposit Insurance Corporation – before, during and after my tenure as Chairman – was highly skeptical of model-driven regulatory capital standards. Its view was that regulators should set a minimum equity-to-assets standard (leverage ratio) for all banks, irrespective of their size or risk profile.

Banks that were determined during the supervisory process to be higher risk would be required, on a case-by-case basis, to maintain more capital. The FDIC believed that no risk-based model for capital could be developed that could not be “gamed” by banks and that models were no substitute for effective, on-site supervision.

Compromises were reached that allowed Basel I to move forward despite these concerns. The regulators agreed to keep Basel I simple by delineating only a handful of risk categories. Importantly, the leverage ratio remained in place in the U.S. as a “fail-safe” mechanism to protect against “gaming” by the banks, potential flaws in risk models, and the unknown. Moreover, U.S. regulators retained the ability to override the Basel I standards and demand more capital when warranted.

With these safeguards in place, Basel I had limited capacity to do harm. Indeed, the presence of these safeguards in the U.S. – and their absence in most other countries – contributes to the fact that the U.S. banking system is the strongest in the world.

Almost as soon as Basel I was put in place, some began to complain that it was too simplistic. It needed more risk classifications. It needed to take into account “operating” and other forms of “off-balance sheet” risks. It required sophisticated models – models so complex that only bankers and their consultants, not regulators, would have the capability of developing them.

By 1998 work had begun at the Bank for International Settlements in Basel, Switzerland on what has become known as Basel II. Basel II is scheduled to go into effect on a test basis in 2007 and for real in 2008.

To say that Basel II is controversial in the U.S. is a gross understatement. Many believe it is much too complex and places too much faith in models. Smaller banks worry that the large

banks will use Basel II to reduce their capital significantly and thereby gain a competitive advantage. Their concerns are well founded.

A recent Quantitative Impact Study (known as QIS4) conducted by the regulators indicates that Basel II would allow capital levels to drop by at least 26% at half of the big banks, some dropping by as much as 50%. The QIS4 results caused bankers, legislators, and most regulators to call for an end to the rush to implement Basel II.

I have discussed Basel II with a good number of senior career bank supervisors at various agencies. All of them believe that banks should be encouraged strongly to develop more sophisticated tools and systems to identify and quantify their risks.

But I have found not a single career bank supervisor who favors adoption of Basel II. Moreover, if Basel II is adopted, to a person they favor retention of the leverage ratio at or near its current level.

I keep coming back to the same question: “What is the rationale for Basel II?” If it is to make U.S. banks more competitive on the world stage, they don’t need the help. U.S. banks are the strongest banks in the world by all measures – capital, asset size, profitability, and corporate governance.

Adoption of Basel II runs a serious risk of weakening the U.S. banking system. Some large banks and regulators have urged that once Basel II is firmly in place, the leverage ratio should be abandoned. This would almost certainly lead to a substantial decline in the capital ratios of the largest U.S. banks. That, in turn, would create inexorable political pressure to reduce capital requirements for all U.S. banks and thrifts.

Is the rationale behind Basel II to reduce reliance on on-site supervision in favor of significantly greater reliance on complex risk models? If so, the mission is foolhardy.

Models are good tools to aide in risk identification and enable regulators and bankers to better focus their attention and resources. They are also necessary tools for the management of at least mid-to-large size banks to use in evaluating and pricing risks.

But models have severe limitations. They are only as good as the data and assumptions entered into them, and they do not exercise judgment. They can create a false sense of security as people tend to place too much faith in them.

Few, if any, banks have detailed loss information dating back more than ten years – the best decade in banking history. Are data from the past decade the foundation on which we want models built that will determine how much capital will be held in our banking system?

The single most important tool for regulating capital in the banking system is the leverage ratio. If it is in place and enforced, there are any number of ways of measuring risk and allocating capital to cover that risk. On-site regulatory supervision can and should play a big role.

An updated Basel I (which some are calling Basel 1.5) could work well in large and small banks alike. I believe strongly that regulators should set aside Basel II and instead strive for incremental improvements in Basel I.

We cannot afford to put at risk the best banking system in the world by relying on incomprehensible models developed by mathematicians with scant input from professional bank supervisors. And we should not allow the Basel Committee or anyone else to reduce the U.S. banking system to international standards.