

BASEL II – DOWN THE STRETCH
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Basel II – a new capital regime first proposed by regulators a decade ago for the largest banks in the world – is the single most important policy issue in front of the banking regulators today. U.S. regulators are finally coming down the stretch toward finalizing their approach. If the regulators don't get it right, our banking system and country will likely pay a very big price down the road.

Federal Deposit Insurance Corporation Chairman Sheila Bair summed up the stakes in a speech this past February:

Our decisions will determine whether the effort becomes a compliance exercise, or truly improves risk management. Our decisions could affect the severity of the business cycle and allocation of credit across economic sectors. We risk accelerating the contraction of our community banking sector, and our large banks have expressed concerns about international competitive imbalances. Most fundamentally for any regulator, our decisions will affect the capital strength of the U.S. banking system and its ability to absorb losses without imposing costs on the federal safety net.

The original premise behind Basel II was that risk management at the largest, most complex banks could be improved by developing sophisticated mathematical capital models, while broadly maintaining the overall level of capital. The models would measure the risks in these institutions and assign capital to cover those risks.

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If Basel II had remained true to its original premise, it would have engendered little controversy. No one disputes that mathematical models can be a useful tool to be used by bank management in identifying, pricing, and controlling risks and by bank examiners in testing management's competence and performance.

Somewhere along the path we took a wrong turn. The original purpose of encouraging the development of better risk management tools and processes was transformed into an expectation that large banks would earn the carrot of reduced regulatory capital requirements in exchange for developing models.

Nearly all of the controversy (not to mention the complexity) involved with Basel II stems from this unfortunate detour. No one who lived through the banking crisis from 1978 through 1992 is comfortable with the notion that the largest banks in the world have too much capital and ought to be allowed to reduce it materially if their mathematical models support the reductions.

We believe that the largest banks in the U.S. have satisfactory but not excessive capital. Moreover, the U.S. has the strongest and most profitable banks in the world that do a great job of meeting the credit needs of businesses and individuals. The system in the U.S. is clearly not broken and does not need a radical fix.

What does require attention are the capital ratios of the largest banks outside the U.S. These banks generally operate with about half of the capital of the largest U.S. banks and achieve about half the return on assets. It doesn't require a bank stock analyst or a professional bank supervisor to know that a bank with half the capital and half the profit margin is less vibrant and healthy than a bank that has twice the capital and twice the profit margin.

The most contentious issue before the regulators involves the use of the “Advanced Modeling” approach vs. the “Standardized Approach” in setting capital. The Advanced Modeling approach relies on extremely complex mathematical models to measure and assign capital to specific risks, while the Standardized Approach puts categories of risks into buckets, which are assigned capital requirements.

Should U.S. banks be limited to using the “Advanced Modeling” approach under Basel II or should they be offered the alternative of using the “Standardized Approach” that is available to large banks in most other countries? For those banks that use the Advanced Modeling approach, should it be underpinned with safeguards to prevent a significant decline in large bank capital ratios no matter what the models indicate?

As two chairmen who spent a combined 14 years at the FDIC during the worst banking crisis since the Great Depression, we believe that the answer to the second question is open and shut. It has taken our nation and its largest banks nearly two decades to rebuild a strong capital base accompanied by strong profitability. It would be the height of folly to backtrack on these efforts in reliance on unproven mathematical models that very few bank executives, analysts, board members, or bank examiners are capable of understanding.

A year ago four major U.S. banks (JP Morgan/Chase, CitiGroup, Wachovia, and Washington Mutual) sent a letter to the regulators requesting that U.S. banks, like their foreign counterparts, be allowed the alternative of using the Standardized Approach to Basel II. We support this position, as we believe the Standardized Approach is superior to the Advanced Modeling approach in several important respects:

- **The Standardized Approach is more transparent and much easier for all of the important users of the information to understand, including boards of directors,**

bank executives, customers, investors, analysts, the media, and bank regulators.

Indeed, in objecting to a proposed requirement in Basel II that boards of directors review the Advanced Models on a regular basis, some of the large banks made the point that it would be a waste of time because their boards are not capable of understanding the models.

- **The Standardized Approach is less intrusive than the Advanced Modeling approach and will allow banks more flexibility to manage themselves.** Models are important to large banks in managing and pricing risks. They are a management tool and are very poorly suited for use in setting regulatory capital standards. Banks need the flexibility to make continuous adjustments in their models and cannot wait for a regulatory committee to decide what changes are appropriate.
- **The Standardized Approach is much less expensive to implement and maintain.** We understand that Basel II banks have spent between \$100 million and \$300 million each in an attempt to build models under Basel II. Despite the enormous expenditure of time and money, the Basel II banks we have spoken with believe their current systems for identifying, managing, and pricing risks are superior to the Advanced Approach.
- **The Standardized Approach will produce a smaller disparity in capital requirements between large and small banks.**
- **The Standardized Approach will allow Basel II banks in the U.S. to be treated in the same fashion as Basel II banks in other countries, which are not required to use the Advanced Modeling approach.**

We believe it is very important that the four federal banking agencies adopt a common approach toward Basel II as soon as possible. We believe that approach should have safeguards

to prevent a significant diminution of capital ratios among major U.S. banks. Moreover, we believe that Basel II banks in the U.S. should be afforded the opportunity to utilize the Standardized Approach, which is available to most banks throughout the world.