Roger W Ferguson, Jr: Basel II - a realist's perspective

Speech by Mr Roger W Ferguson, Jr, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the Risk Management Association's Conference on Capital Management, Washington, D.C., 9 April 2003.

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I am grateful to the Risk Management Association (RMA) for inviting me to speak with you today. In recent years, the RMA has been at the forefront of efforts to strengthen risk management within the banking sector and has done excellent work fostering discussions of emerging best practices. The RMA has also provided valuable input to another effort that is intimately connected with improvements in bank risk management--Basel II. Today, I intend to provide you with my candid perspective on the Basel II effort, its current status, and where it is headed. It is important that each of us with a stake in the outcome of Basel II consider it seriously and realistically; I intend to contribute today to such a discussion. I want to first present some of the premises on which I have based my own involvement in the Basel II effort and then turn to the process that we see unfolding in the United States. I will also address some of the concerns that have been raised regarding whether the U.S. approach to Basel II is overly limited in scope.

Starting Points

Let me begin with a now-familiar argument: The need for Basel II arises because our current capital framework, Basel I, is deficient for our larger banks, particularly for our largest, most complex banks. The familiarity of this argument does not lessen its force. As you know, the purpose of a risk-based regulatory regime for capital adequacy is to define a minimum cushion for banks to ensure their safety and soundness and to provide a benchmark by which the financial condition of banks can be measured. The risk-based ratios seek to compare available capital to a measure of the risks taken on. We see today that the largest, most complex banks operate their businesses and conduct risk management in a manner that is substantially different from the method by which they calculate regulatory capital. This difference reduces the usefulness and meaningfulness of regulatory capital ratios and places a burden on banks that must reconcile their risk-management and regulatory capital approaches. In addition, we must consider that material weakness, let alone failure, among the larger, more-complex banks in the United States could pose a significant challenge for our economy and could generate substantial costs. Effective supervision and regulation and other policies that promote a strong banking sector are in the best interests of us all.

For these reasons, policymakers and others with a similar perspective should care deeply that our risk-based capital rules provide a meaningful and comprehensive measure of the risks to which the largest banks in our society are exposed. The significant gap between current capital ratios and the banks' own measures of risk is widening, and in my view, that justifies the need for modifying the capital regime used by our largest, most complex banks. I believe the U.S. regulatory community is in agreement that Basel I as currently applied in the United States is no longer an appropriate system for these banks. Therefore, we have realized that we need to provide our largest banks with a substantially different system for regulatory capital going forward. Frankly, there appears to be no significant disagreement with this premise.

But, of course, the realization that Basel I needs to be overhauled to better address our largest, most complex banks does not itself dictate the form of that restructuring. This is the subject of the second premise, which is that the most promising and, one could argue, only realistic possibility for construction of a Basel II is to use a framework that builds on the modern techniques of corporate finance and risk management and applies them across banks in a broadly similar fashion.

There is not much disagreement with the assertion that Basel II should be built on modern techniques of risk management. Clearly, the incorporation of such techniques at some level seems to be a necessary condition if the goal is a risk-based capital framework that produces a meaningful, comprehensive measure of risk relative to capital. However, not all would agree with the approaches that the Basel Committee has chosen in particular areas or, perhaps more fundamentally, with the nature of the balance between flexibility and comparability that is incorporated into Basel II. For the moment, let me focus on the latter point, the balance between flexibility and comparability.

Some would argue that Basel II should permit banks the flexibility to measure risks precisely as they do internally or that it should allow banks to assess their own minimum capital requirement, subject to various tests and penalties for mis-estimation. While one can perfectly well understand the motivation behind these sentiments, most do not view them as realistic. In a moment, I will talk about the need for us to take seriously the competitive equity issues associated with Basel II. But those competitive equity issues are also relevant here because, given the current and prospective state of technology in banking, a regime that would give the largest banks the flexibility to set their own capital requirements could not satisfy the need for competitive equity. Similarly, a balanced assessment of the state of credit risk modeling and internal ratings approaches leads me to think that a full models regime could not in the near future produce measures of risk sufficiently comparable for a regulatory capital standard.

The tradeoff that is at the heart of Basel II is the tradeoff between flexibility and comparability. Allowing banks to calculate regulatory capital in any manner that they see fit would certainly maximize the flexibility of such calculations, but the results would not be comparable across banks and thus the value of the capital standard would be compromised. On the other hand, to focus too rigidly on comparability would require an approach that made no use whatsoever of internal measures of risk or allowed no differences of technique across banks. Such an approach would not be sufficiently flexible and would prevent us from measuring risk as sensitively as necessary. It would inevitably not be much different than the Basel I standard we have today.

The current Basel II proposals are a balancing act. That is their strength and their vulnerability. In seeking to produce a balance between the virtues of flexibility and comparability, the proposals introduce more complexity than some would prefer to see. Yet, although we could debate at length the optimal proportions of flexibility and comparability in the different areas of the proposals, there is not a realistic alternative to the need to strike some balance between these two extremes. The proposed framework builds on modern corporate finance and risk-management techniques; it gives banks some flexibility to develop their own internal assessments of risk but also constrains their assessments in various ways to ensure a greater degree of comparability. We have not so far been presented with any realistic alternative to this proposed framework that would not in conceptual terms look a great deal like Basel II.

Having elaborated on these two premises--that Basel I is no longer adequate for our largest banks and that the structural concept of Basel II is the only realistic alternative to Basel I--let me now turn to a discussion of the path forward.

Process Going Forward

The Basel Committee is planning to release by early May a third version of its proposals for comment. This third consultative paper--CP3 for short--will contain some modifications resulting from the committee's recent quantitative impact survey, but it will be broadly similar to the proposals that banks in this country and around the world tested in that survey last fall.

The U.S. federal banking agencies are working hard to develop an advance notice of proposed rulemaking, or ANPR, that will explain concretely their vision of how Basel II would be implemented in the United States. The ANPR will be tailored to the U.S. context in a way that particular banks will be able to see whether the proposal applies to them and what it will mean for them if it does. The ANPR will also seek to pose questions in several areas in which the U.S. agencies need specific feedback. We hope to issue the ANPR by the end of June.

The next stage in the process will be the feedback that we receive from you and other interested parties, both on the CP3 and especially on the ANPR in the United States. The federal banking agencies will consider these comments very carefully. I should be very clear about this. Some believe that with the issuance of CP3, the shape of Basel II is essentially set in stone. This is wrong. If the CP3 or ANPR comments show that elements of the proposal need to be modified, the U.S. agencies will seek such modifications.

These views do not conflict at all with those that I elaborated a few minutes ago. As I indicated, there is a well-understood need for a Basel II and any realistic version of it will need to balance flexibility and comparability in the use of modern risk-management techniques. But the members of the Basel Committee need to remain open to the possibility of specific improvements to the proposals.

Let me describe some of the conceptual issues that have been raised regarding the proposals and provide some perspective on them. First and foremost has been the issue of complexity. Concern over this issue appears to have several aspects. The first is a concern over the sheer volume of the proposals. This aspect of the complexity concern is, I think, somewhat misguided because it has typically equated the Basel proposals with the sum total of those background papers that have been released in an effort to explain more transparently not only what the proposals are but why they look the way they do.

Nevertheless, there is no doubt that the Basel II proposals themselves are several times longer than Basel I. One reason for this is that Basel II contains several different versions--it is no longer a one-size-fits-all approach. But in the United States, we are not proposing to implement every flavor of Basel II. The ANPR should therefore present a reasonably streamlined package for U.S. banks to consider. Needless to say, it will also be imperative that the U.S. agencies explain the proposals as clearly as possible in the ANPR itself.

Another aspect of the complexity concern surrounding Basel II is its use of modern risk-management techniques. These techniques inevitably involve complex statistical, and thus mathematical, assessments of risk. To reject such techniques solely because they involve mathematical complexity would be inconsistent with the broader direction that banking and its best-practice risk management have been taking over the past decade. One could not reasonably hope to develop a meaningful or comprehensive assessment of risk at a large, complex bank today without making use of such methods; and, I might add, this view seems to be supported by most of the documents issued on the matter by the RMA.

But some of the concern over complexity is driven by the fact that Basel II makes a number of distinctions between exposures and transactions in an effort to improve the risk sensitivity of the resulting capital ratios. Reasonable people might disagree about these particular tradeoffs between complexity and risk-sensitivity that have been chosen by the Basel Committee. Comments and feedback on these tradeoffs will be particularly important. But such comments will be most effective if they address both sides of the question--not only point out areas in which the proposal may be overly complex but also show how the objective of risk sensitivity could be met in less complex ways or state why it may not be necessary to achieve either flexibility or greater risk sensitivity in this particular instance.

Competitive equity is a second fundamental area that I hope the comment process will address. The question of competitive equity has domestic aspects, international aspects, and bank-nonbank aspects. Let me start with this last aspect, namely whether the Basel II proposals will impose restraints on banks that are not being imposed on their nonbank competitors. It is important that we receive information on the competitive impact of the Basel II proposals relative to nonbank competitors, particularly if it appears that the marketplace allows nonbanks to operate with less capital--or conversely with more leverage--than similarly situated banks would be required to hold.

Clearly, we should not hinder the competitive position of any U.S. banking organization relative to nonbanks and will work to avoid such an outcome. However, bank supervisors also have an obligation to develop the regulations that they feel are appropriate to banks even if similar regulations will not be applied to nonbank competitors. All of you are thoroughly familiar with the elements of the federal safety net--including deposit insurance and access to the discount window and the payment system--that differentiate banks from nonbanks in the United States. The safety net, which is provided at taxpayer expense, obligates supervisors to develop approaches that they believe are prudent for the banks that benefit from that safety net.

A second aspect of the competitive equity issue involves domestic competition among banks--what would be the competitive effect of altering the regulatory capital rules for the largest and most complex banks while keeping the existing framework for most other banks? My perception is that pricing, and thus competition, between large and smaller banks today is relatively little influenced by regulatory capital constraints because banks are operating far above regulatory minimum levels, or because economic capital and not regulatory capital is the binding constraint, or because banks are capable of easily selling or securitizing the exposure, as is the case with the majority of residential mortgage loans. Moreover, the ultimate check on the possibility of competitive distortion is that any bank that makes the investment in risk management technology necessary to meet the Basel II standards will be able to adopt the advanced IRB approach.

I hope that it goes without saying that in proposing to implement Basel II as we have outlined, we are not seeking or expecting to induce material shifts in the competitive banking landscape in the United

States. Nevertheless, if some institutions believe that these proposals will have such an effect, we want them to use the ANPR comment process to enable us to understand and evaluate the rationale for those views and whether modifications to the Basel II proposals, or the way we intend to implement them, are appropriate in response.

Another important aspect of the competitive equity issue is competition among the subset of banks covered by the Basel II approaches, particularly the more advanced approaches. As a result of relying on inputs generated by systems at individual banks, there will inherently be variations across these banks in how such systems treat the same transactions and exposures. A certain amount of such variation is clearly a necessary byproduct of the need to provide the flexibility to make use of internally generated data. But there is also a strong policy interest in ensuring comparability across banks, as I have already discussed. This policy interest is one reason why it is desirable to establish minimum qualifying criteria for the use of approaches that rely on internally generated data, whether they might be the Advanced IRB approach for credit risk or the Advanced Measurement Approach (AMA) for operational risk. On the other hand, we do not want these qualifying criteria to so constrict the development of internal methodologies that we end up stifling their creative evolution. As I noted, the balance between flexibility and comparability is clearly a central issue in the design of a framework such as Basel II.

In considering the issues of competitive equity among banks operating on Basel II, the manner in which U.S. supervisors will evaluate compliance with the minimum qualifying criteria will not place banks in the United States at a disadvantage. We have a track record of listening to banks and applying regulations and supervisory guidance in a manner that is sensible and focuses on priorities. In the coming months, U.S. supervisors will be releasing draft supervisory guidance describing the approach that we envision taking toward the assessment of internal ratings systems for key parts of the loan portfolio. We will of course be greatly interested in industry feedback on this draft guidance.

By including specific qualifying criteria in the Basel II proposals, we help ensure that banks operating in other jurisdictions will develop their internal ratings systems in a broadly similar fashion and thereby advance the achievement of a level international playing field. This seems particularly important if some countries have regimes that rely more on rules and less on on-site supervision. That is, to achieve a level playing field with such rules-oriented regimes, we need to include in the rules for Basel II the elements that we in the United States would be looking for anyway as part of our supervisory oversight process. In the comment process, it will be particularly helpful if banks and others can be explicit in focusing on where concerns about competitive equity across banks are sufficient to warrant a change in the minimum qualifying criteria or in other aspects of the proposals.

Basel II as an International Standard

While on the subject of international competitive equity, let me now digress a bit to discuss some of the concerns that have been raised regarding whether the envisioned U.S. approach to Basel II truly reflects a commitment to an international capital standard. This concern arose after the announcement that the U.S. agencies proposed to formally implement only the most advanced versions of the Basel II proposals and that these will only be mandatory for approximately ten internationally active banks. We anticipate that another ten or so large banks will voluntarily choose to adopt Basel II because of its greater risk sensitivity.

Needless to say, the goal of developing compatible systems of bank capital regulation in different jurisdictions has great merit. The global nature of many banking organizations requires them to consider the rules and regulations of a wide variety of jurisdictions, and so these organizations have a strong interest in common approaches. More importantly, the United States fully supports the role of the Basel Committee in developing capital standards that are appropriate for countries around the world to apply to their banking systems. But as the Basel II process has signaled, one framework can no longer address the needs of all types of banking organizations. To meet this challenge, the Basel II proposals contained in CP3 will include three approaches to the measurement of credit risk as well as three approaches to the measurement of operational risk.

So why is the United States not proposing to implement the full range of these options and apply them to all U.S. banks? In addressing this question, I will first explain why we propose to implement the advanced methods and how we see this working. Then I will address why, for reasons perhaps unique to the United States, we do not believe introducing the other options is necessary here.

In the United States, we concluded that the greatest potential benefit of Basel II was found in the most advanced versions--the Advanced IRB for credit risk and the AMA for operational risk. We concluded that if we as supervisors were going to make the effort required for Basel II, we would like to focus that effort on the most advanced versions. Obviously, concentrating attention on the most advanced approaches could help reduce the complexity of Basel II as it is implemented in the United States.

Clearly, not all banks in the United States can or should use these approaches for the purpose of calculating their capital requirement. So the question naturally arises: Which banks should meet the new requirement? The size, complexity, and international activity of one particular set of U.S. banks makes it imperative that they move to the Basel II advanced approaches as quickly as possible.

It is also clear that there will be a significant number of voluntary adopters of Basel II in the United States. Indeed, I believe that the majority of internationally active U.S. banks will be operating under Basel II soon after the initial implementation date, whether or not they are part of the mandatory set. If, as we expect, about twenty U.S. banks adopt the Basel II approaches at the outset, they will account for approximately two-thirds of all U.S. banking assets. In addition, those U.S. banks account for about 99 percent of all foreign assets held by the top fifty domestic U.S. banking organizations, with the ten mandatory banks themselves accounting for about 95 percent.

This approach to Basel II implementation is a commonsense, step-by-step approach that makes appropriate distinctions between banks on the basis of their size and the scope of their international activities. It will not compromise the international level playing field. But on the other hand, it will allow U.S. supervisors to retain stronger control over the process by which they approve banks for use of the new advanced standards, and will reduce the incentives for banks to "rush" the necessary implementation efforts.

Another aspect of the concerns that have been raised about the focus on advanced approaches relates to the desire for the "mutual recognition" of approaches used in different jurisdictions, so that the differences between home- and host-country capital regimes should be kept to a low level. These home/host issues have already been the focus of discussions within the Basel Committee's Accord Implementation Group, and the discussions will no doubt continue throughout the Basel II implementation period. The United States shares the interests of other countries in trying to ensure that domestic subsidiaries of foreign parents--either U.S. subsidiaries operating abroad or foreign ones operating in the United States--are not required to develop onerous additional procedures to comply with domestic rules. Of course, in the United States and in many other countries, domestic subsidiaries of foreign banks cannot be treated substantially differently from domestic banks.

U.S. and foreign supervisors working together can develop approaches, some of them transitional, that will avoid undue burdens on either U.S. bank subsidiaries of foreign bank parents that are using alternative versions of Basel II in their home countries, in particular other flavors of the operational risk or IRB proposals, or on foreign subsidiaries of U.S. banks. In this regard, we believe it will be necessary for U.S. supervisors to allow, in some cases, for the use of transitional measures where banks--either U.S. or foreign--will not have reliable data for some interval.

The second part of the question is why U.S. supervisors are not proposing to implement other options in the Basel II package such as the standardized approach to credit risk. This does not mean that U.S. supervisors believe these approaches are flawed or inferior to the Basel I approach. Indeed, they contain innovations that should lead to meaningful improvements in other countries where they will be implemented.

For the United States, however, a key factor is that our capital regulations not only embody the Basel I standard but also include various "prompt corrective action" features such as the leverage ratio and the use of well-capitalized thresholds for both the risk-based and the leverage standards. In applying a leverage ratio and a well-capitalized standard, the United States is probably unique. Moreover, virtually all of the U.S. banking system currently meets the well-capitalized standard. This is presumably because of the fact that both market and supervisory attention increases as a U.S. bank falls below the well-capitalized thresholds, which is the essence of prompt corrective action. We are therefore confident that even for those banks not adopting the advanced approaches of Basel II, we will have a capital regime that achieves a standard of prudence as great as Basel II.

In light of these specific U.S. circumstances, the cost-benefit tradeoff associated with implementing the other Basel II options here differs from the tradeoff in other countries. Given the costs involved in adopting new approaches, and given that with our current regime the benefits are lower for our smaller banks, it seems best at this time to retain the current regulatory capital framework for most U.S. banks other than the large, complex internationally-active set I described.

In addition, for many of the same reasons, we believed that it would be inevitable that even if we proposed to implement the Basel II standardized approach, that we would need to retain the current standards for some set of banks. Thus, implementation of the Basel II standardized approach would not involve the replacement of an existing option but would create an entirely new, third approach in the United States. The U.S. supervisors were of the view that this could result in cherry-picking and, thus, that the added complexity would not be worth the additional benefits. More to the point, given the high capital position these banks continue to retain as well as their virtual lack of direct competition with banks in other countries that will be adopting Basel II, it does not seem reasonable to impose the cost of changing systems on most of these banks.

Conclusions

Now I would like to return to the main thread of my remarks and to provide some concluding thoughts on the way forward. I have already stressed the importance of the Basel II ANPR and the associated comment process in the United States. Complexity and competitive equity are two important themes for this comment process. Undoubtedly other issues will also be the subject of significant feedback. The issue of operational risk is by now surely familiar to most of you, so I will not belabor these points here. The calibration of the overall framework as well as of particular subsections of the framework will also inevitably attract a great deal of comment and attention. Such attention can likely improve the Basel II proposals.

My remarks today have tried to lay out what I see as the central policy choices and issues confronting U.S. supervisors as we evaluate the comments we receive on the ANPR. I have tried to be open and candid about the tradeoffs that I believe are involved, some of which are clearly inherent in the nature of the Basel II effort itself. We will surely not be able to please everybody in our attempt to strike the right balance between flexibility and comparability or between complexity and risk sensitivity.

Of course, as supervisors we are not expecting that the banking industry is going to stand up and applaud what remains, after all, a "regulatory requirement." As a sage adviser opined to me recently, if we ever get to the point where all of the banks are too enthusiastic about Basel II, then clearly something must have gone awry from a prudential point of view. But your feedback and comments on the Basel II ANPR will significantly shape the views of U.S. supervisors on how we go forward with these proposals.

In closing, I would like to return to the points I made at the outset. Our most fundamental choice as policymakers is whether we are going to replace the Basel I framework for our largest, most complex banks with a framework that relies significantly on internally generated inputs in an effort to achieve significantly greater risk sensitivity. Against the backdrop of the dynamic changes occurring in banking and risk management, we have little if any choice but to find something that improves substantially on Basel I for the largest and most-complex banks.

Yet the choices involved in developing a viable and realistic alternative to Basel I are manifold, and each one of them gives rise to arguments and counterarguments. We are not going to make the perfect policy choice initially in every one of these detailed instances. In many cases, moreover, the best choice may evolve over time. If we are going to move to a capital standard built substantially around internally generated assessments of risk, we need to focus on the practical realities of that decision and leave behind some of the wishful thinking about what each of us believes a perfect capital framework would look like.

An initiative as important as Basel II is bound to change significantly over time. Basel II contains the promise of a capital framework that will evolve with improvements and advancements in risk-management techniques. As new methods and techniques become more common and well tested, the Basel II framework can and should embrace such advances. The sooner we can gain practical hands-on experience with such a framework, the sooner we can begin to realize its full potential.

The Basel II proposals represent a truly significant step in the evolution of bank regulation. They are important and deserve your most thoughtful consideration as the U.S. bank supervisors evaluate exactly how to proceed with them. I hope that my remarks today will be helpful to you in considering your responses. Thank you for your attention.