

2007 U.S. Banking Issues

FDIC, Fed Disagree on Basel Implementation

As of late September, the federal regulatory agencies in charge of bank supervision seemed to have agreed on how to implement the provisions of the Basel Accord. Yet it seems regulators still have a way to go — and they can't agree on how to get there.

In a pair of speeches Feb. 27 before a meeting of the Global Association of Risk Professionals in New York, representatives of the Federal Deposit Insurance Corp. and the Federal Reserve System — two of the five main U.S. banking regulators — espoused very different views of how Basel II should move forward in the United States. Not two weeks earlier, the General Accountability Office, Congress' investigative body, published a report urging the federal government's banking regulators to forge ahead nonetheless.

Sheila C. Bair, chairman of the FDIC, told the GARP audience that "there is still room for fresh thinking," while Susan Schmidt Bies, a member of the Fed board of governors, said regulators should move forward with the Basel proposals. "We need a more risk-sensitive capital framework," Bies said, "and we believe Basel II is such a framework."

During her speech, Bies also said the Fed is considering a request to delay implementation of the market-risk proposals until January 2009.

Bair, on the other hand, said the Basel II framework, as currently proposed, will lead to a reduction in capital requirements for the larger U.S. banks, which could threaten their stability. "Basel II was supposed to be about improvements in risk management and not about dramatic reductions in capital requirements. This was a sensible guiding principle," Bair said. "If the result of Basel II is much less capital supporting the risks in the banking system, then Basel II may make the banking system more vulnerable

to shock — not safer."

Basel II, officially called the International Convergence of Capital Measurement and Capital Standards — A Revised Framework, is an agreement among the 13 countries that make up the Basel Committee on Banking Supervision. The second revision to the Basel Accord is intended to set consistent international standards for measuring banks' capital adequacy. The Basel II revision has been underway since 2001. In the United States, Basel II has been limited to the 10 largest internationally active banks, with another 10 large banks allowed to "opt in." Banks outside the Basel II framework will adhere to a modified version of the current Basel I framework, called Basel 1A.

Bair also said taking an approach similar to that for Basel 1A, for all banks, instead of just for the smaller ones, may strike a balance between regulatory burdens and making sure banks are adequately capitalized.

"I think everyone would, to the extent possible, like to reduce cost and burdens to Basel II adopters. I suspect some of the costly and prescriptive elements can ultimately be traced to a desire to prevent, or compensate for, unacceptable pillar 1 outcomes," meaning outcomes that stem from an institution's handling credit risk, operational risk, or market risk.

Proposed Capital Rules for Basel 1A

The concept: Make the regulatory framework more sensitive to risk levels.

The outcome: Some banks might face lower capital requirements; some would face higher.

Among the proposals:

- Expand credit risk categories from five to eight, to get finer detail on risk weighting.
- Ease capital requirements for some first mortgages.
- Ease capital requirements for some home-equity loans.
- Raise capital requirements for some off-balance-sheet risks.
- Ease capital requirements on some small-business loans.

What's next: Regulators are accepting comments on their proposals through March 26.

This report was written by Chris Grier, Washington correspondent for A.M. Best Co.



“From the FDIC’s perspective, at least, a framework that provided greater certainty on a bank’s bottom line risk-based capital requirement might well be accompanied by a reduction in other prescriptive or costly elements. More concretely, a standardized or Basel 1A-type of approach to setting regulatory capital ... would be an example of a less burdensome framework that also reduces uncertainties about capital impact,” Bair said.

“I am amenable to other suggestions for ways to simplify and reduce differences between U.S. and overseas implementation, while maintaining strong safeguards against capital reductions,” Bair said, adding that “this process is important enough that we should still be willing to consider fundamental changes in direction. Nothing should be off the table — except for the leverage ratio.”

On Dec. 5, 2006, regulators issued the latest Basel 1A notice of proposed rulemaking or NPR, which would change details on risk weighting and ease some capital requirements for first mortgages. Currently, credit risk is assigned to five risk categories or “buckets” — 0%, 20%, 50%, 100%, and 200% — and the proposal would allow some finer tuning, by adding three more categories: 35%, 75%, and 150%.

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