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Statement of the Shadow Financial Regulatory Committee

On

The Latest Revisions to Basel II and Implementation Plans in the United States

May 5, 2003

Over the years since the first proposed revision of the Basel Accord on Capital Adequacy (Basel II), the Shadow Financial Regulatory Committee has criticized the Basel Committee's proposals (Statements 154, 156, 168, 169, and 179) and developed an alternative approach to capital regulation that emphasizes market discipline and the mandatory issuance of subordinated debt (Statement 160). The Committee has expressed concern over the complexity of the Basel Committee proposal, the lack of attention to improving the definition of regulatory capital, the lack of rationale for the minimum 8 percent ratio, the lack of attention to market-value accounting, and inadequate emphasis on market discipline. More specifically, among other issues, the Committee has questioned the arbitrary nature of the risk weights and the rationale for a capital charge for operational risk as well as limits on the use of insurance to mitigate the capital requirement for operational risk.

At the end of April 2003, the Basel Committee published a new Consultative Document, "The New Basel Capital Accord." It is a 226-page restatement of the original document, which was more than twice as long, containing several revisions based on prior comments and the results of quantitative impact studies. These changes involve minor tinkering with the risk weights and the provision of greater flexibility in the application of the Advanced Measurement Approach to operational risk. This restatement retains the fundamental shortcomings noted by the Shadow Committee.

The US regulatory authorities have recently informed Congress about how they intend to implement Basel II. They stated that approximately ten internationally active banks, which account for almost 95 percent of the foreign assets of US banks, will be required to implement Basel II. These banks will be required to adopt the most advanced approaches contained in Basel II for the computation of capital charges: the Advanced Internal Ratings Approach for credit risk and the Advanced Measurement Approach for operational risk. Subject to regulatory approval, some other US banks may voluntarily adopt these approaches. (The regulators expect another ten banks to do so.) All other US banks will continue to be subject to the original Basel Accord (Basel I).

In view of our criticisms of Basel II, we applaud the decision of the US authorities to limit its application to *a few* internationally active banks. In addition, we believe that the advanced approaches may be less distortive than the more elementary approaches. We are concerned, however, that the Basel Committee has calibrated the risk weights to reduce banks' capital charges for credit risk in order to provide an incentive for all banks to adopt the Advanced Internal Ratings Approach. Although the charge for operational risk is also calibrated to leave the overall capital requirement unaltered on average, the overall capital charge for any particular bank depends very much on its mix of business. Thus, the new approach will reduce capital requirements for some large internationally active banks and, in the absence of greater emphasis on credible market discipline, can reduce the capital strength of some banks.

Although we are pleased that the US regulatory authorities have chosen a limited implementation of Basel II, some of the arguments in support of this position highlight certain fundamental defects of the Basel II approach. For example, levying a capital charge on operational risk, rather than dealing with operational risk under banking supervision (Pillar 2 in the Basel II approach), is rationalized on the basis that capital charges under Pillar 1 are disclosed while those under Pillar 2 are not. But the more important point is that all capital charges should be disclosed individually. If the regulatory authorities are serious about market discipline, capital charges should be disclosed whether under Pillar 1 or Pillar 2.

The U.S. authorities justify the operation of Basel II alongside Basel I by arguing that the banks' current capital ratios as well as loan pricing and origination decisions are driven more by market forces than regulatory requirements. But this throws into question the entire rationale for the whole, complex Basel II enterprise.

The Shadow Financial Regulatory Committee continues to believe that it would be far preferable to replace the complicated Basel capital adequacy framework with a much simpler capital requirement that includes the mandatory issuance of subordinated debt.