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Basel II Risk-Based Capital Standards: Challenges of Maintaining a Level Playing Field

In the press release issued by the Office of the Comptroller of the Currency early last November announcing approval of the final rule implementing advanced approaches of the Basel II Capital Accord, OCC head John Dugan reaffirmed the significance of the proposed standardized option under Basel II for smaller, “non-core” financial institutions: “The development of the standardized approach is an important enhancement of our regulatory capital program for banks not adopting the advanced approaches.” Community banks, in particular, may wish to employ the standardized approach when determining their risk-based capital requirements as larger, “core,” or “opt-in” banks implement the advanced approaches aimed at making the determination of regulatory capital more sensitive to risk. Otherwise, smaller, “opt-out” banks may find that they must hold higher levels of risk-based capital as per the existing Basel I standard which may result in competitive disadvantages with respect to pricing and performance for certain balance sheet categories and lines of business.

It is instructive to examine potential competitiveness issues between (larger) banks opting to implement the advanced approaches of Basel II versus (smaller) banks opting to remain subject to Basel I requirements or implement the forthcoming standardized option. An assumption is made that the yet-to-be-issued final rule for the standardized option will not contradict or contravene existing standards included in the final rule issued for advanced approaches under Basel II.

First, let us review what has not changed between the existing Basel I capital rules and still evolving Basel II framework. As pertains to the calculation of minimum capital requirements (Pillar One), the definition of (regulatory) capital has not changed nor has the minimum ratio of capital to risk-weighted assets (RWA). Current definitions of Tier 1 and Tier 2 capital remain the same between Basel I and advanced approaches of Basel II. Also, definitions of well-capitalized and adequately capitalized under risk-based capital ratios and the leverage ratio remain unchanged. U.S. regulatory requirements under Basel I and Basel II still stipulate 10%, 6% and 5% respectively as well-capitalized [8%, 4%, and 4% for adequately capitalized] for total capital to risk-weighted assets (RWA), Tier 1 capital to RWA, and Tier 1 capital to total average assets. Lastly, the Prompt Corrective Action (PCA) enforcement framework remains intact for all U.S. banking institutions, regardless of size or balance sheet complexity. Regulatory sanctions and enforcement actions will still occur should the Tier 1 risk-based capital (RBC) ratio drop below 4%, the total RBC ratio drop below 8%, or the leverage ratio fall below 4%. In other words, and not without controversy, regulatory capital levels effectively remain floored for all banking institutions regardless of balance sheet size, complexity or how

much risk (credit, market and operational) is incorporated into to the calculation of minimum capital requirements.

The most significant changes implemented between the Basel I and Basel II frameworks relate to how risk-weighted assets are calculated for capital required to cover credit risk. In addition, the advanced approaches under Basel II permit the explicit inclusion of operational risk (defined as the “risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events”¹) in the calculation of regulatory capital. Furthermore, under Pillar 2 of the Basel II framework, regulatory agencies have the discretion to require additional amounts of capital given an institution’s overall risk profile. The combination of these changes will result in varying levels of minimum required capital above the well-capitalized and adequately-capitalized thresholds now in place. While the full effect of such risk sensitivity on the calculation of required capital for banks using the advanced approaches as compared with banks who opt-out remains unclear, U.S. regulatory agencies hope that the availability of the standardized option will mitigate such potential imbalances in minimum capital requirements and thereby ensure as much as possible the maintenance of a level playing field for banks regardless of asset size.

Several studies have been completed in recent years examining the competitive effects of RBC requirements under Basel II, including so-called quantitative impact studies (QIS) completed under the auspices of the Basel Committee for Banking Supervision and U.S. regulatory agencies.² As part of a BCBS-sanctioned National Impact Study, U.S. regulatory agencies completed a fourth quantitative impact study (QIS-4) during 2004-2005. The results of this QIS indicated a substantial decline in minimum risk-based capital requirements for banks operating under the Basel II framework. This raised concerns that core banks and larger banks more able to opt-in and absorb the higher costs associated with implementing the complex requirements of the advanced approach would see a significant decline in risk-based capital. As a result, such opt-in institutions would gain a significant competitive edge in loan pricing and market performance due to substantially lower regulatory capital requirements.

While the results of other studies largely have been inconclusive, given the greater sensitivity to (credit and operational) risk in the determination of minimum required capital available under the Basel II framework, it is clear that banks exposed to higher risk will be required to hold higher levels of regulatory capital.

Example: under the advanced approaches, certain kinds of historically low risk loans such as conforming, prime-based residential mortgages would require potentially less regulatory capital. As a result, banks using advanced approaches may be able to offer more competitive lending rates for these loans. Alternatively, banks using existing guidelines or asset risk weights based upon external credit assessments as per the standardized option may have an advantage in the pricing for commercial loans given

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that banks using advanced approaches under Basel II would face higher capital requirements for these generally riskier loans. Moreover, banks implementing the advanced approaches under Basel II would have to include a regulatory capital charge for operational risk whereas opt-out banks would not [it not yet clear at what level and to what degree the standardized option will incorporate operational risk]. Overall, differing approaches for calculating minimum required capital under Basel I and Basel II (advanced or standardized options) will result in varying levels of regulatory capital explicitly based upon risk exposures and implicitly based upon balance sheet size and complexity.

In order to minimize the extent to which smaller, community banks are disadvantaged by core or opt-in banks implementing the advanced approaches of Basel II when setting their regulatory capital levels, the standardized option indeed may support the maintenance of a level playing field of RBC standards among banks both large and small. Community banks should consider carefully whether making their calculation of risk-based capital more risk sensitive employing the standardized option, once promulgated, makes good economic sense. Completion of the final rule implementing the standardized approach is expected before 2009.

*-James L. Glueck, CFA
Risiko Advisory Services*

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¹ *Key Aspects of the Final Rule on Risk-Based Capital Standards: Advance Capital Adequacy Framework – Basel II*, page 10, Financial Institution Letter (FIL) 107-2007, Federal Deposit Insurance Corporation.

² See Hancock, Lehnert, Passmore, and Sherlund, *The Competitive Effects of Risk-Based Bank Capital Regulation: An Example from U.S. Mortgage Markets*, Federal Reserve Board, August 2006, and Berger, *Potential Competitive Effects of Basel II on Banks in SME Credit Markets in the United States*, Federal Reserve Board, February 2004. For more information regarding Quantitative Impact Studies, visit Bank for International Settlements website, www.bis.org. For *Summary Findings of the Fourth Quantitative Impact Study*, visit FRB website, <http://www.federalreserve.gov/newsevents/press/bcreg/20060224aa.htm>.