FAC comments on proposed revisions to the Basel II Capital Accord by the federal bank and thrift regulatory agencies and whether banking organizations subject to the proposed rule should be permitted to use other credit and operational risk approaches similar to those provided under the Basel II 2004 mid-year text.

At the meeting of the Federal Advisory Council on December 1, 2006, Thomas A. Renyi, Chairman and Chief Executive Officer, The Bank of New York, New York, New York, presented the Council's views on whether banking organizations subject to the proposed revisions to the Basel II Capital Accord should be permitted to use other credit and operational risk approaches similar to those provided under the Basel II 2004 mid-year text.

If such options were provided, what would be the appropriate length of time for those options to be available?

- The alternate approaches are viewed by some as stepping stones to the more advanced approaches. Inasmuch as the regulatory capital for a given exposure can be materially greater under the standardized approach relative to Basel II's advanced approach, banks will be motivated to progress to the advanced approach as soon as possible. This assumes, however, that the U.S. version of the advanced approach allows banks to recognize the capital benefit. Therefore, if other approaches are provided, they should remain available at least until the leverage ratio and/or the A-IRB capital floors imposed by U.S. regulators for credit risk no longer apply. In that way, assuming no modifications are made to the other approaches, the U.S. banks would be in the position to comply with the Basel II Accord in line with banks throughout the rest of the world.
- Others argue that the rationale for options is not about transitioning to another approach, but that the various approaches were designed and calibrated so that the capital levels will vary inversely with the level of sophistication applied, and that the methodology chosen should be matched to the cost and benefit that can be derived from the chosen approach, given the risk characteristics of the bank. For well-capitalized, medium-sized banks without sophisticated capital markets businesses, there is no conceivable scenario under which compliance with the advanced measurement approach for operational risk under Basel II will result in a return on the investment required to comply. If a bank opts for a particular approach because it makes more sense to do so, there should be no time restriction on that selection.
- Even some of the smaller banks that are not subject to Basel II in the U.S. see a benefit for their institutions from larger banks having the standardized option. They believe that the trickle-down effect will lead to the eventual adoption of the standardized approach by smaller banks, after some evolution.

What modifications to the standardized option in the Basel II 2004 mid-year text would make it more appropriate for use by large, complex banking organizations?

- If a standardized approach is provided for credit risk, we recommend that there be no modifications. It was designed as a simpler improvement to Basel I than the advanced approach. It balances less sophistication with generally higher capital requirements, and any piecemeal changes that alter its relative calibration are inappropriate. As it exists, the standardized approach is a more conservative method of calculating Pillar I regulatory capital, relative to the other approaches. Therefore, there is no need to make the measure of capital more conservative, and although some would argue that there should be less conservatism regarding derivatives, other capital markets transactions, unsettled trades, equity exposures, etc., the potential capital benefits do not justify the time delay and cost of opening up this discussion. The standardized approach is well defined and, because of the less demanding regulatory validation expectations, already cheaper than the advanced approach.

Besides a standardized approach, what other actions should be considered to encourage large, internationally active banking organizations to enhance their risk-management practices and their public disclosures?

- The standardized approach applies specifically to the measurement of regulatory capital (Pillar I), and therefore would not result in a sacrifice of supervision (Pillar II). In the last decade, the risk-management practices at large, internationally active banking organizations have evolved considerably, and regardless of the Basel II approach selected, each such institution will continue to be subject to the influence of regulatory bodies and will be required to meet the qualification expectations put forth in Pillar II.
- The most effective incentives to enhance risk-management practices and public disclosures are to allow banks to recognize the capital benefits that can be the result of such enhancements. In the United States, the regulatory uncertainty and the high cost of implementing advanced approaches serve to deter banks from committing to additional investment in risk infrastructure. A concern is that the excessively detailed prescriptions found in the U.S. proposal will have the consequence of diverting finite resources away from improving risk-management systems to maintaining compliance systems.
- With respect to public disclosure by these institutions, Pillar III will apply, regardless of approach, albeit at a less granular level. If, through public disclosure, a competitive advantage is revealed via the more efficient use of economic and regulatory capital, market forces will drive banks to enhance their risk-management systems and practices to meet market expectations. Any measurement, such as the leverage ratio, that in effect nullifies regulatory risk sensitivity will discourage these initiatives.

- Although the question's focus is an implementation of Basel II, and in particular the options under Pillar I, the Council's discussion continues to be dominated by the issue of competitiveness in light of the inconsistency of capital requirements between the U.S. banks and their offshore competitors. Given the continuation of the leverage ratio and A-IRB minimums, the U.S. banks are at a competitive disadvantage given the capital ratios allowed by the host regimes of their competitors.
- A discussion of the second issue of mandatory disclosure under Pillar II ensued, with some Council members commenting that it is not in the Federal Reserve's purview to require disclosures given that other agencies (*e.g.*, the SEC and FASB) dictate disclosure requirements.