FAC comments on the interagency advance notice of proposed rulemaking on possible revisions to the current risk-based capital framework (Basel I) that are designed to enhance its risk sensitivity.

At the meeting of the Federal Advisory Council on December 9, 2005, Thomas A. Renyi, Chairman and Chief Executive Officer, The Bank of New York, New York, New York, presented the Council's views on possible revisions to the current risk-based capital framework (Basel I).

The Council expressed the following views concerning the timing of implementing Basel IA and Basel.

- Members agreed that the timing for implementing Basel IA and Basel II should be consistent to avoid competitive disadvantages.
- Smaller banks, as represented by the Council, are concerned that Basel IA has not been properly vetted while a member representing one large bank worried that further delays in implementing Basel II could create international competitive disadvantages.
- Since members agree that the timing for implementing Basel IA and Basel II should be consistent to avoid competitive disadvantages, the capital floors for both approaches should also be consistent. Consistency can be achieved in two ways: by either allowing Basel IA to serve as the capital floor for banks implementing Basel II, or by applying the same floor used in Basel II to banks implementing Basel IA.

Council members offered the following views on whether the same leverage ratios and prompt corrective action processes should be applied to all banks, regardless of which risk-based capital framework they use.

- Seven out of the nine respondents believe changes need to be made to the leverage ratio and/or the prompt corrective action process.
- Six out of nine banks, as represented by the Council, believe the leverage ratio is in need of further review and adjustment because of the incongruence of capital under the leverage ratio/prompt corrective action process and the Basel II framework's tier 1 capital.
- One way to address FAC members' concerns about the leverage ratio without changing the current leverage ratio framework (3 percent – 5 percent) or Basel II framework is to allow the leverage ratio to adjust depending on a bank's Basel IA or Basel II risk-weighted assets (RWAs). For example, the leverage ratio should be adjusted upwards when a bank's RWAs significantly increase under Basel IA or II; the ratio should be adjusted downwards when a bank's RWAs decrease under the new frameworks. Such changes would allow banks to recognize some of the advantage of the risk management provisions of the New Accord.

The Council presented the following overall views of the proposed revisions to Basel I.

- Overall, member banks, as represented by the Council, agree that the revisions to Basel I (Basel IA) do provide a response to banks concerned with the bifurcated capital adequacy system where one framework (Basel I) is considerably less risk sensitive than the new framework (Basel II).
- However, many of the respondents are concerned that Basel IA has not been properly vetted. They also expressed reservations about some of the details of Basel IA (such as the appropriateness of certain risk weights).
- Some banks, as represented by the Council, cited another drawback of Basel IA is that it does not include operational risk – an area that has concerned the industry and that is addressed in the Basel II framework.
- Also, a few respondents suggested that applying the Standardized and Foundation approaches or a similar framework to Basel II (one that includes the three pillars of capital adequacy) may be more appropriate than the existing Basel IA framework.
- Overall, members felt that the increased risk-weight asset sensitivity afforded by Basel IA is a positive development. Some members would be willing to abide by higher Basel IA capital levels (relative to Basel II) if they are allowed to benefit from the greater sensitivity in risk-weighted assets.