WHAT DO WE DO NOW, OLLIE?
U.S. Market Developments in the Basel Void

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It is a pleasure today to join a distinguished panel evaluating the impact of the Basel risk-based capital rules on the U.S. financial system. Sen. Hagel has described what he calls an "ideal" Basel rule, but we're a very long way from any rule, ideal or not. I thus could make my remarks very short – saying only that Basel has no impact because no one knows when, if or how the rules will be implemented here. However, that would be to assume the U.S. Basel void rests in a global vacuum, which of course isn't the case. Basel II is final everywhere else but here, with the market impact already being felt.

So, what to do? The response takes two forms: first, what should market participants be doing and, second, what is the appropriate policy response to both the current imbroglio and the pending final rules. Some have suggested we should just keep Basel I as is because it's working well, they argue, and it does not pose the big implementation cost of the other Basel options. I will argue, though, that Basel I is in fact in urgent need of a face-lift, in part because of the M&A impact Basel II is already exerting and because – more worrisome – the current rules encourage undue risk-taking as we've seen in the subprime-mortgage arena.

Real-World Basel

When we all started the Basel debate – it seems like decades ago – our first big fight was over whether the proposals would have any competitiveness impact in the United States. I remember quite a dust-up on this point at the first Congressional hearing on the Basel rules in early 2002, when now-Chairman Barney Frank gave the Fed – what for when they argued this point. Since then, though, I think it has become widely accepted that the Basel rules have profound impact on winners and losers, adding a critical dimension to the factors that drive which bank is taken over by whom. If there were still any remaining doubt on this point, a review of the battle over ABN Amro should settle it. As the Financial Times made clear last week, the new Basel standards are among the fundamental forces driving this deal.

Although the U.S. rules are far from either certain or final, the proposals have also had M&A impact here. They are, for example, a significant factor in the decision by Capital One to get into banking as well as credit cards and why WAMU added subprime credit cards to its mortgage book. One reason U.S. specialized banks are heading overseas in such big numbers is the absence of an operational risk charge at home, giving them a boost – albeit a temporary one – in the ongoing consolidation in the asset-management arena.

The U.S. rules are also – incomplete as they are – driving charter decisions. Basel has had a significant impact on who doesn't do what – one major consumer lender of our acquaintance decided against a bank charter because of the looming cost of Basel to its high-risk business. Investment banks are fighting very hard to be sure the SEC is recognized as a "consolidated" regulator for their industrial loan companies to be sure they stay out of the leverage standard. None of these firms will, we think, make a major bank acquisition unless it's very, very advantageous or they can find a way to plug the new big bank into the old ILC hole and, thus, avoid parent-company capital consolidation and leverage.

In addition to driving takeover and charter decisions, the Basel standards – or lack thereof – have had a big impact on which assets U.S. banks hold and which they securitize or structure. I think the fact that the U.S. version of the Basel rules were an early work in progress throughout the last few years contributed materially to the huge spike in subprime mortgage lending. Had Basel IA or II been imminent or, better, in place, U.S. banks could not have exploited the regulatory-capital arbitrage opportunities afforded high-risk assets under the current rules. For now, U.S. banks capitalize even the most speculative subprime mortgages at the same risk weighting that would apply to a AAA-rated corporate bond (a 100% risk weighting).

The regulators are scurrying to catch up, telling banks now they must hold "appropriate" capital – but that is, I think, too little too late in too vague a form to have much market impact. Further targeting high-risk mortgages still leaves many other areas in which banks take big stakes secure in the knowledge that they are "well capitalized" from a regulatory point of view even though their capital position is miles below an appropriate economic capital allocation.

Next Steps for the Regulators

As I said, all of these forces argue strongly against keeping the U.S. on Basel I as the rest of the world heads into Basel II. However, it's clear our rules are in a quagmire from which they may not emerge and, if they do, several problematic aspects of the current proposal may be finalized. With this in mind, I'd like to suggest a few short-and longer-term action steps.

First, let's get ourselves out of Basel I misery. Many are calling for quick U.S. implementation of the Basel II standardized option. In my view, it's a good start, but numerous aspects of it do not comport well with specific U.S. market conditions – our sophisticated mix of retail-banking products, for example. Adapting the standardized option to U.S. factors isn't, though, hard to do and it would be a good, quick step towards a more rational U.S. regulatory-capital framework. Basel IA is already close to the standardized option – a few tweaks and we're there.

Second – and I know I'm losing on this point –the U.S. regulators should drop the leverage ratio in favor of appropriate prompt-corrective-action standards for the risk-based capital rules.   I know some in the agencies, along with several senior Members of Congress, believe fervently that the leverage rule is a critical safeguard as an untested new capital framework is implemented. In fact, though, the leverage standard encourages – indeed requires – banks to take risks. To align regulatory with economic capital – a critical shareholder imperative in light of all the non-bank competition – banks mix up their book, adding a layer or two of toxic waste – subprime mortgages anyone? – to the portfolio in order to make the leverage ratio at least a reasonable charge. A small amount of high-risk paper can pollute the rest of a bank's book if risk management and disclosures do not match the risk. Better to avoid it by simply having risk match capital without an arbitrary ceiling.

Perhaps even worse, the leverage standard creates an undue incentive to industry consolidation. Again to make the regulatory capital numbers make as much sense as possible, banks will mix up their lines of business. This not only encourages risk-taking, but also entry into new business lines. These could often be better housed in specialized institutions where risk management is up to the demands of the risk, but the leverage standard creates a strong incentive for diversified banks to take out the little guys.

Finally, the U.S. rules should differ from the international Accord and drop the proposed operational risk charge. A capital requirement for this risk makes sense – although there is still absolutely no agreement on what it should be or even how to measure unexpected operational risk. In the U.S., though, major competitors to specialized banks have non-bank charters – as noted, they do this on purpose. In the EU and elsewhere, all companies offering investment advice and similar services come under the Basel rules, but that's not the case here. Thus, the operational charge will encourage fee-based business lines to leave the banking system for investment banks, mutual funds and others outside the Fed's reach. This seems a self-defeating goal for the banking agencies, as well as one with dubious prudential and customer-protection implications.

Conclusion

I can't say that any aspect of the U.S. Basel rules is to anyone's liking at this point. The biggest banks that were Basel's biggest fans now take considerable umbrage at the U.S. proposal. The small banks, once just fearful of Basel II, now positively loathe it, pushing hard to cling to Basel I. To respond to all this, the agencies are now pondering such a mish-mash of Basel options that the prospects for regulatory-capital arbitrage under the new standards would, if anything, be even greater than those achieved under Basel I.

As a result, I suggest a step back from the mammoth Basel proposals to a more measured approach to reforming the U.S. capital rules. Let's start, as I said, with something along the lines of Basel IA – minus the leverage requirement – and require virtually all banks to use it for a while. Then, let's see how that goes as the debate over the advanced options continues and better versions of them are devised.

I know this leaves a lot unanswered – home/host coordination for example – let alone begging the question of all the places Basel IA falls short of sophisticated capital allocation. Still, I think it's better than nothing and absent it, there's a serious risk nothing new will occur in U.S. capital regulation for far too long with far too much systemic and competitiveness risk.