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I have been asked to speak today about the concerns expressed at a recent Congressional hearing on the proposed revisions to the Basel risk-based capital rules. I already knew I had a challenge before me today because Basel II has a lot of math in it, and you're all lawyers – not a good combination! Harder still may be making clear why both the House and Senate have taken an increasingly keen interest in the proposed revisions to the risk-based capital rules governing the world's largest banks. Some commenters – even a few in the U.S. – have recently argued that Congress has no role in this debate. For Congress, the debate is indeed a challenge – lots of members are lawyers and thus don't like math much either. However, the potential competitive impact of the rules and – even more important – their effect on who gets loans where for what price warrant Congressional scrutiny now.

Indeed, I would argue that Congressional involvement is not only appropriate based on the proposal's impact, but also advisable. If regulators don't pay heed now to Congress' concerns, years of hard work could well come to naught as the final Basel Accord crashes on the rocks of Hill opposition to the rule as a whole – opposition that would have been tempered had specific concerns been heeded early on.

Time doesn't permit a discussion of what the revisions to the Basel Accord would do and when Basel and the U.S. regulators plan to do it. Instead, I will focus on some of the key issues of concern on the Hill. The regulators – especially the Fed – are now engaged in a vigorous effort to allay these concerns, so I can't guarantee that they will all be there next time Basel comes up – which should be in hearings shortly after the next Basel proposal is released in May. However, several of the issues of concern to key Members of Congress are fundamental to the Basel rewrite, and they will thus be a major factor as the rules are finalized over the next year or so.

Operational Risk

At the outset, let me say that my firm is directly involved in the operational risk battle. We advise the Financial Guardian Group, an organization for specialized U.S. banks especially concerned with the operational risk-based capital (ORBC) section of Basel II. FGG banks – like many others in the U.S. – believe that operational risk is a serious concern, but that an arbitrary regulatory capital charge is ill-advised. The Basel proposal – even as revised with a new" advanced measurement approach" – could well create perverse incentives to improved risk management, as well as create serious competitiveness concerns for U.S. institutions. A meaningful Pillar 2 supervisory approach to operational risk would be more effective, without the risk of unintended consequences resulting from the current Basel proposal.

The OCC generally concurs with these concerns, favoring a Pillar 2 approach to ORBC. However, EU negotiators in Basel are holding firm to the current proposal, which the Fed also appears to support. During the February 27 hearings in a House Financial Services subcommittee, ORBC was a major focus of attention. This is surprising, given the highly technical nature of the proposal, but Members fear that the rule would undermine, not advance, protection against September 11-type events.

The EU Factor

The Fed's defense of the ORBC proposal is, in part, based on the fact that the EU thinks this is non-negotiable. These days in Washington, that doesn't get one very far on the Hill. In the wake of Iraq, the mood in Congress on the EU is virtually unprintable. After making the necessary obeisance to the benefits of trans-Atlantic trade, Members now will support what the EU opposes or vice versa just for the heck of it. A bumper-sticker I recently saw – "After Iraq, Chiraq" – seems to sum it up.

Who's In, Who's Out

At the February 27 hearing, a major focus of attention was the question of Basel's reach. The Fed and OCC announced that they plan to have Basel II – and then only the advanced models-driven sections of it – apply to the nation's ten largest banks or so. Subsequent speeches by the regulators have suggested that the next ten largest banks would "volunteer" for Basel II. It remains unclear why they would do so unless they see a big drop in regulatory capital attached to the voluntary offer, although the Fed believes "competitive pressure" would force these somewhat smaller banks to belly up to the Basel bar regardless. Given that many Federal Reserve Banks have been telling smaller banks that Basel is in their future, the "voluntary" nature of this offer remains most unclear.

For the moment, the smaller banks are staying out of the Basel II debate. They generally fear the complexity of the proposals and prefer keeping risk-based capital as it is. It remains to be seen, however, if this will be the case as banks – not to mention some of the nation's larger savings associations – take a hard look at Basel and realize that the big banks under it will experience large – sometimes huge – drops in regulatory capital for mortgages, small business loans and other retail assets. Capital is a prime driver of profitability and – even if it weren't, as the Fed sometimes suggests – the new rules require that loan pricing be dictated by regulatory capital models. Thus, banks under the Basel II advanced rules will likely price these retail loans far differently than banks under Basel I can do.

Will smaller institutions sit still for this? I doubt it. Indeed, some are already protesting the potential competitive impact of Basel II, fearful that it will force consolidation of key lines of business into the nation's largest banks. Basel II complexity is indeed so daunting that many banks may think themselves well out of it, but they might reconsider as the strategic impact of the proposal becomes clearer.

Can Basel Fans Make Congress Go Away?

Obviously, the more constituents that like something, the more members of Congress do too. Also obviously, the more these fans are large institutions with a lot of political clout, the more joy gets spread. However, a whole lot of big banks are going to have to love Basel a whole lot before Congress blesses an accord along the lines now under consideration in Basel. The rule clearly has "significant economic impact" and thus comes under congressional scrutiny when the implementing U.S. regulations are issued, whether EU bureaucrats and some international banks like it or not. ❑