A step to Basel 1.5

In October, US banking supervisors released an advance notice of proposed rule-making regarding regulatory capital requirements. While it continues to demonstrate an insistence by the US on going its own way, some aspects of Basel 1.5 would be thoughtful improvements to the standardised approach of Basel II, writes David Rowe

The highly fragmented nature of the US banking system is a reflection of the country's federal political structure and long history of rivalry between rural and urban interests. While a massive banking consolidation has occurred in the past 20 years, there are still many thousands of small local banking and thrift institutions across the country. Moreover, these institutions tend to be well connected with local politicians and thereby exercise significant influence in Washington, especially in the House of Representatives. It was largely in deference to the power of the small bank lobby that the US chose to diverge from the EU's across-the-board application of Basel II.

The central concern of regional and community banks in the US was that larger rivals would be able to reduce their minimum required capital for credit risk through sophisticated internal ratings-based (IRB) models that were beyond the reach of smaller institutions. On top of that, smaller banks using the Basel II standardised approach would have to carry additional capital because of the operational risk provisions of the Accord. It was widely felt that this would leave smaller institutions at a competitive disadvantage to larger money-centre banks.

The initial resolution was to require only large internationally active US banks to implement the most advanced approaches to Basel II. While maintaining their decision not to mandate Basel II below the top-tier banks, US regulators are now proposing a revision to their version of the Basel I rules.[1] This tentative new regime incorporates some provisions of the standardised approach for credit risk, plus some thoughtful extensions of that approach, while still excluding any explicit capital requirement for operational risk.

Among the potential revisions to the current application of Basel I, the agencies propose to increase the number of risk weights from five to nine. Reducing the size of the steps between available risk weights certainly seems like a good idea. It would reduce the tendency to defer reclassifying a deteriorating asset due to a large step-change in the required capital.

The agencies also intend to introduce partial use of external credit ratings into the determination of risk weights, while retaining the existing treatment in selected areas.

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Among the other suggested or proposed innovations are:

- recognition of the risk mitigation from a broader range of collateral than is allowed in Basel I and similar to what is permitted in the standardised approach;
- recognition of an expanded range of guarantors;
- a more risk-sensitive treatment of residential mortgage loans;
- possible introduction of greater risk sensitivity into the treatment of other consumer loans.

Collateral in the form of short- or long-term debt obligations (with appropriate haircuts) of any entity rated investment grade by a nationally recognised statistical rating organisation (NRSRO) would be reflected in the capital calculation. But the agencies caution that such recognition would be contingent on deployment of a collateral management system that can track and value the securities pledged.

Recognition of guarantees would be extended to those of any entity that has long-term senior debt rated investment grade by an NRSRO, regardless of the OECD versus non-OECD distinction. Again, this is similar to the provisions of the standardised approach.

Perhaps the most significant extension is in the treatment of secured one- to four-family residential mortgages that receive a 50% risk weight under the standardised approach. At a minimum, the agencies propose to make the risk weights sensitive to the loan-to-value (LTV) ratio. An even more ambitious proposal would be to incorporate a credit score for the borrower in combination with the loan-to-value ratio. Therefore, a loan to a highly rated borrower would receive a reduced risk weight at a given LTV compared with a poorly rated borrower. While this makes perfect sense from a pure risk standpoint, I suspect it will fail on two counts. First, it introduces significant added complexity and associated cost into the capital calculation – an issue about which the agencies express notable concern. Second, it is likely to have an adverse impact on mortgage availability to working class families – a very sensitive political issue.

A more tentative suggestion is to increase the risk sensitivity of capital requirements for other retail exposures such as consumer loans, credit cards and automobile loans. Obligor credit scores, loan-to-value ratios for secured auto loans and/or the pledge of separate collateral are possible factors put forward for consideration. In this area, such factors may well have a greater chance of inclusion than for home mortgage loans, since they play a more significant role in the loss experience. Moreover, greater recognition of the impact of collateral pledged as security for durable goods (especially auto) loans has been proposed by some in the industry as far back as the responses to the second consultative paper.[2]

This recent proposal by US banking supervisors certainly does not signal an immediate convergence of capital requirements with the EU. It does, however, reflect many common themes and includes some ideas that are worth considering as future enhancements to the standardised approach to credit risk under Basel II. ■

[1] *The full text of the entry in the Federal Register can be obtained at: http://www.occ.treas.gov/ftp/release/2005-103a.pdf*
[2] *See Rowe, D: The future of Basel II, Risk, May 2002, page 69*