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Basel II and QIS 4: Where Do We Go From Here?

U.S. federal banking agencies recently announced results of the fourth in a series of quantitative impact studies (QIS-4) designed to simulate implementation of the Basel Accord and measure the resultant impact on U.S. financial institutions' capital levels. The results of the study suggested that capital levels would drop dramatically, with significant dispersion of results across institutions and portfolio types.

Accordingly, the regulators announced that the Notice of Proposed Rulemaking, long expected to be released in June 2005, would be delayed, along with promised supervisory guidance around advanced management programs for operational risk and proposed revisions to the original Accord for banks not opting-in to Basel II. The delay is said to be designed to give regulators more time to study the results, discover the root causes of the variances, and recalibrate the rules as necessary to ensure that capital levels do not fall too much in the final analysis.

So how should U.S. financial institutions react to this news? Is the U.S. implementation timetable consisting of a parallel year run in 2007 and a"go-live" date beginning in 2008 in jeopardy? And what about the Basel framework itself as we know it?

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Given the significant investments being made in technological infrastructure, personnel, and process reengineering, perhaps the prudent approach would be to pause in the wake of this news and await clarity and futher direction from the regulators. To be sure, anecdotal, as well as documentedevidence exists that more than a few institutions have suspended at least some aspects of Basel II preparations in light of the current uncertainty surrounding U.S. rulemaking.

However, close review of corresponding testimony of regulatory officials, as well as reexamination of the underlying spirit of Basel II itself, suggests a different response. To the contrary, institutions should continue, if not accelerate, their preprations for Basel II, not solely for purposes of regulatory compliance, but to improve their risk management capabilities, enhance their ability to communicate timely, effectively, and transparently with the marketplace, and build competitive and financial advantages.

Automated Financial Systems, Inc.

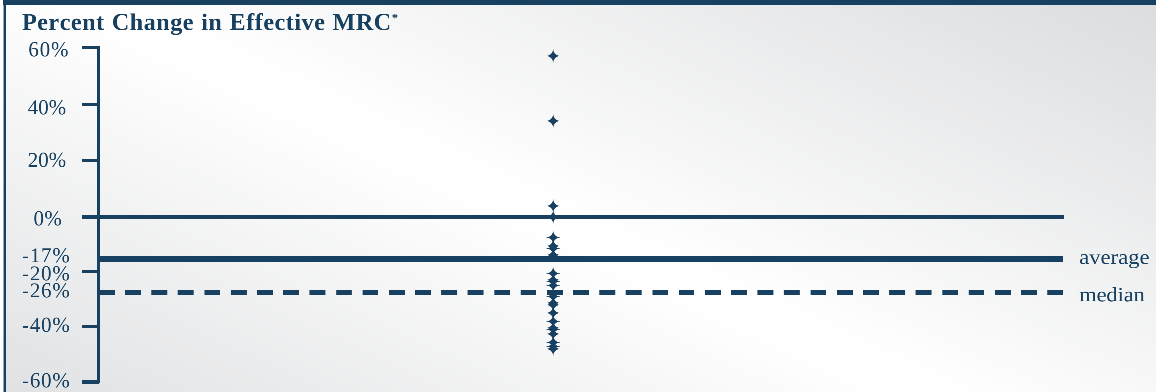
Corporate Office:
123 Summit Drive
Exton, PA 19341
Phone: 610-524-9300
Fax: 610-524-7977
afsvision.com

European Subsidiary/ EMEA Head Office:
Seidlgasse 22, Top 4
1030 Vienna, Austria
Phone: + 43 (1) 714 1009
Fax: + 43 (1) 714 1009 99

The Results

While few industry participants were shocked that U.S. capital levels were found to drop with modeled implementation of Basel II, the sheer levels and variance of results startled nearly everyone. The preliminary results found that capital levels would drop by at least 26% for 13 of the 26 banks participating in the study, with a high-end drop of 47%. The average change in minimum capital requirements for participating financial institutions in changing from Basel I to Basel II was 17%.

QIS-4 Preliminary Change in Minimum Capital Requirements of Participating Institutions: Basel I to Basel II



*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note: This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions, and caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.

Chart from: www.fdic.gov, *Statement of Thomas J. Curry Director Federal Deposit Insurance Corporation on Basel II*, May 11, 2005, Room 2128, Rayburn House Office Building

On a portfolio basis, the results were even more dramatic. For example, capital levels would drop 74% and 62% on average for home equity and residential mortgage loans, respectively. Even capital requirements for highly volatile commercial real estate, long a nemesis for bankers during periods of economic stress, would drop by an average of 33%. Considering that the participants of the impact study were the largest, most complex banks in the country, it is understandable that the results caused the regulators to pause and reevaluate their plans.

QIS-4 Preliminary Change in Minimum Capital Requirements of Participating Institutions: Basel I to Basel II

Portfolio	% Change in Portfolio MRC	Median % change in Port. MRC	Share of BaselI MRC	Share of BaselI II MRC
Wholesale Credit	(25%)	(24%)	44.3%	38.8%
Corporate, Bank, Sovereign	(22%)	(30%)	33.9%	30.7%
Small Business	(26%)	(27%)	4.6%	4.0%
High Volatility CRE	(33%)	(23%)	1.8%	1.4%
Incoming Producing RE	(41%)	(52%)	4.0%	2.7%
Retail Credit	(26%)	(50%)	30.5%	26.3%
Home Equity (HELOC)	(74%)	(79%)	6.1%	1.8%
Residential Mortgage	(62%)	(73%)	11.1%	4.9%
Credit Card (QRE)	66%	63%	6.1%	11.7%
Other Consumer	(1%)	(35%)	6.0%	6.5%
Retail Business Exposures	(6%)	(29%)	1.2%	1.3%
Equity	11%	(9)%	1.3%	1.6%
Other assets	(12%)	(3%)	10.1%	10.4%
Securitization	(20%)	(40%)	7.9%	7.7%
Operational Risk				
Trading Book	(0%)	(0%)	0.0%	9.0%
Portfolio Total	(14%)	(24%)	5.2%	6.0%
Change in Effective MRC*	(17%)	(26%)	100.0%	100.0%

*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

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Possible Causes

So what caused these results, and how could their significance and disparity have caught so many off guard? Policymakers reviewing the study are not ruling anything out, from simple mistakes in the questionnaires to more complex issues such as problems with fundamental formulas designed to derive the capital charges themselves. But certain excerpts of the regulators' testimony, combined with some simple macro-analysis of the economic environment from which the data set was drawn, gives some insight into explaining the results.

The first and most obvious cause is the so-called cycle effect. Participating QIS-4 institutions reported data as of the end of the second or third quarter of 2004, which just happened to be a period of pristine credit quality for the vast majority of U.S. financial institutions. For whatever the reason, regulators failed to point out this important point in their congressional testimony on the results of QIS-4. Considering that most reporting institutions' data histories only encompassed one or two years, certain Basel parameters such as loss given default (LGD) did not appropriately factor in the effects of a downturn in the credit cycle.

Equally important are the differing stages of institutions' implementation efforts. The regulators have acknowledged that not a single U.S. organization is ready for Basel II today. None of the participating banks have completed their databases and models for all of their risk areas. Models have not been tested internally nor validated by supervisory authorities.

Another possible explanation is the fact that banking institutions commonly employ vastly different types of internal rating systems or philosophies, such as those looking "through the cycle" versus "point in time" or some hybrid approach, which can all lead to materially different results.

The list of possible causes is wide-ranging, and yet institutions would be making a strategic mistake in postponing implementation efforts at this critical stage.

Next Steps for the Regulatory Community and Lawmakers

To date, the regulatory community has been far from unanimous regarding where to go from here. The FDIC, OTS, and OCC seem to want to study the results in greater detail, and remain somewhat noncommittal regarding the short-term outlook for further rulemaking and associated supervisory guidance. The Fed has been the most outspoken in terms of pressing forward, preferring instead to get the Notice of Proposed Rulemaking into the hands of the industry, as the blueprint banks will use to continue to develop and flesh out the systems, models, and databases that will be needed to implement Basel II.

Surely congressional lawmakers want to proceed with caution, especially in light of the alarming results of QIS-4. In fact, a "Basel bill" had been introduced in the House of Representatives as early as last year. The bill would appoint a committee to oversee the Accord's implementation in the U.S., ensure the U.S. regulators present a united position prior to negotiating at the Basel Committee, and authorize the Secretary of the Treasury to settle disagreements between the regulators. While the regulators are all lobbying hard against the need for legislative action and further congressional oversight, certainly the results of QIS-4 and the regulators' apparent inability to present a united front have done little to lessen whatever chance the bill has.

Moving Forward

Despite this great theatre regarding the future of Basel II, leading institutions are pressing forward with Basel preparations—not for the singular purpose of regulatory compliance, but because they view this process as improving their ability to quantify, manage, control, and report risk positions on multiple levels throughout the organization.

Let's examine some of the arguments for pressing forward toward Basel II.

Issues surrounding data persist.

As of this writing, the regulators have not publicly commented on the underlying cause of these results. But a few things they have been clear on. One, not a single participating bank has completed its databases and models for all required risk areas. Second, most banks participating in the study reported expected losses based only on a one or two year period. In other words, the strong credit performance of U.S. portfolios over the last couple of years would not have been appropriately balanced out by the higher losses we would expect to see at other stages of the credit cycle. Recalling that Basel II ultimately requires banks to capture historical information going back three, five, and, in some cases, seven years in order to generate appropriately stress-tested model inputs, it is apparent that most, if not all, institutions continue to lack the depth and breadth of data needed for basic compliance, to say nothing of enhanced capital allocation and asset pricing.

Considering that the ultimate success of Basel II will depend on the quantity and quality of data that banks have to use as inputs into the framework, much work surrounding data remains.

Best practices, and any resultant competitive advantages, evolve from the marketplace.

Institutions waiting for national (or global, for that matter) consensus on regulatory matters as complex as Basel II will only fall further behind. In fact, U.S. supervisors have been applying and advocating the principals of the three pillars for years, and will continue to do so regardless of the timetable and final effective date of the new Accord, as illustrated below.

Supervisory Advocacy of the Three Pillars

- The basic concept of Pillar 1 was the foundation of the original 1988 Accord, which was to more closely align minimum capital requirements with banks' actual underlying risks. U.S. regulators have been advocating risk-based concepts and practices for at least a decade, such as its application to pricing, capital allocation, reserving, staffing, general managerial oversight and governance, and so on.
- A quick sampling of relevant regulatory pronouncements and enforcement directives uncovers a consistent stream of supervisory rhetoric reminding institutions of their responsibility to develop their own processes for evaluating their capital needs and a strategy for maintaining those levels (Pillar 2).
- Finally, regulators have long stressed the importance and benefits of market discipline (Pillar 3). In this age of absolute transparency, comprehensive data systems are the sources of record that will generate detailed, real-time disclosures to market participants. To be sure, the Sarbanes-Oxley Act of 2002 seized on the concept of market discipline and transparency and raised the bar even further through Sections 404 and 409.

The expectations of the market are dynamic and growing.

Another compelling aspect of the argument to move forward is the expectation of the market. Given some of the perceived benefits of Basel II, it may be that the timetable set by the markets for banks and countries to evolve to Basel II will be more demanding than the soft transition that the supervisory community has been proposing. In short, the market may not allow certain institutions to postpone their implementation plans, and may in fact penalize those organizations that slow down their efforts. Even the threat of congressional action in the form of the so-called Basel bill will not deter the market's expectations for advances in risk management and refinement of capital allocation methodologies.

Basel II is more than just a compliance exercise.

Banks looking at the requirements of Basel II as a costly compliance exercise are clearly missing the point. At its core Basel II seeks to encourage improvements in the measurement and management of risk, and, in fact, provides explicit incentives for those banks that do so. Basel II seeks to promote an infrastructure that is well anchored by a solid corporate governance structure and sound risk culture. Finally, Basel II seeks to promote innovation in risk management and build global consensus around sound practice and governance standards.

In short, institutions with foresight and appropriate strategic planning and tactical thinking are looking to make it a competitive differentiator.

Conclusion

Basel II represents a tremendous opportunity for banks by stimulating organizations to upgrade their data collection and warehousing systems, risk models, and reporting capabilities. Those institutions that recognize and capitalize on this transformation will achieve greater operational efficiencies, better capital allocation, and greater shareholder value, while lessening the effects credit cycles have on earnings.

Banks that dwell too long on the results of QIS-4 or on the current ambiguity surrounding U.S. rulemaking are missing not just the competitive potential, but the underlying spirit of the new Accord. The essential strength and spirit of Basel II is the dynamic way in which it will promote strong risk management practices across banks and reinforce the importance of market discipline. At least in its early stages of adoption, Basel II may not turn out to be the galvanizing force that drives a globally-accepted way to define, measure, and control risk, but it does come at a time when financial institutions can benefit from and leverage the most advanced techniques and technologies the industry has ever known.

afs™
Automated Financial Systems, Inc.

Corporate Office:
123 Summit Drive
Exton, PA 19341
Phone: 610-524-9300
Fax: 610-524-7977
afsvision.com

European Subsidiary/ EMEA Head Office:
Seidlgasse 22, Top 4
1030 Vienna, Austria
Phone: + 43 (1) 714 1009
Fax: + 43 (1) 714 1009 99