

President's Message



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William Poole

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Basel II: Good for Banks, Good for Financial Stability

In June 2004, bank supervisory authorities in the Group of Ten countries endorsed the new capital-adequacy framework known as the New Basel Capital Accord, or Basel II. U.S. supervisory agencies will implement it in 2008 for the largest banking organizations. Banks making the switch will be able to operate more cost-effectively than before; for everyone else, the benefits will come from a stronger and safer banking system.

The Federal Reserve and other supervisors of international banks began planning in the late 1990s to update the 1988 risk-based, or Basel I, capital framework. To keep pace with developments in large banks' risk-management practices, bank supervisors recognized that capital requirements needed to be aligned more closely with banks' actual risks than had been true under Basel I. We at the Fed had even more reason to press for the more finely tuned Basel II framework: Not only are we the umbrella supervisor over all financial holding companies but, as the nation's central bank, we are responsible for maintaining the nation's financial stability. The best way to ensure financial stability is to promote safe and sound financial institutions.

The new accord is organized around three pillars—capital requirements, supervisory oversight and market discipline. As for the first pillar, earlier international agreements to enforce standardized bank capital requirements for credit and market risks will be supplemented with capital requirements for operational risks. These risks encom-

pass banks' exposure to problems such as internal reporting or control breakdowns, employee fraud, computer crashes and natural disasters. In addition, the measurement of credit risk—i.e., the risk of a customer defaulting—will be improved substantially.

Why is it so important to quantify a bank's exposures to these risks and allocate sufficient capital to absorb the resulting losses? One lesson we have learned from financial instability around the world is that financially and operationally weak financial institutions have been a key contributing factor to nearly every crisis. Minimum capital requirements based on advanced risk-measurement techniques should reduce greatly an economy's vulnerability to financial instability.

The second pillar of Basel II is supervisory review of the setting of minimum capital requirements. Basel II provides incentives to financial institutions to implement sound risk-measurement systems in order to align their regulatory capital more closely to their economic need for capital. This difficult process requires a great deal of judgment. Financial supervisors will need to be involved in two ways. Supervisors will assess the adequacy of a bank's risk-measurement and risk-management processes, and they will decide whether Basel II's minimum 8 percent capital requirement for risk-weighted assets is adequate for the particular institution's risk profile.

The third pillar of Basel II is market discipline. Market forces ought to supplement government supervisors' over-

sight of financial institutions. Private investors with money at stake are highly motivated to price the risk of banks' debt and equity accurately. Not only do the banks themselves learn from investors how their risks are perceived, but supervisors learn from the market as well.

Despite its limited scope of application, Basel II presents significant challenges to banks of all sizes. One outcome of the new accord will be capital requirements that differ among banks. Banks applying Basel II's most advanced credit-risk measurement approach will be able to hold less capital than other banks against certain types of historically low-risk loans, such as residential mortgages. Therefore, they may be able to offer more competitive lending rates than other banks can. Banks not operating under Basel II, then, may have to look for loan opportunities that are not affected as much by the new approach.

Basel II also introduces challenges to bank supervisors. Calculating capital requirements under the accord requires advanced economic and statistical methods.

Like most significant changes, Basel II brings with it opportunities and challenges. I have no doubt that the banking system will adjust to this new era in a way that enhances financial stability.

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