Opinion

Trailing in the wake of US banks over new capital standard

In a personal view, guest contributor *Christoper Whalen* says the US is much better prepared than Europe to handle the reality of implementing Basel II

A recent survey by professional services firm Accenture claims that "European banks are still much further along the Basel II implementation cycle than those in North America".

The survey*, published in July, repeats a view expressed previously by Accenture and other organisations that European Union banks and their regulators are ahead of rest of the world when it comes to risk management generally and the risk-based international Basel II bank safety rules in particular.

While EU banks may indeed believe that they are exemplars in the world of risk management and banking supervision, objective observers may debate the findings of the Accenture survey. In particular, if you take a close look at the lack of transparency and public disclosure in the European supervisory process, the assertion of EU leadership starts to unravel.

Each of the three pillars of Basel II - minimum capital requirements, supervisory review and market discipline - requires a high degree of analytical precision and, most significantly, validation to achieve the Basel regime's aims, namely enhanced risk management and capital adequacy. And in each of these areas the 25-nation EU bloc is arguably well behind the US.

There is no reporting regime in existence or in prospect in Europe which even begins to approach the level of regulatory disclosure and transparency already adopted by US banks.

It can be argued that there are no consistent, uniform and verifiable capital requirements in Europe today for pillar 1 minimum capital rules. While all EU banks come under their respective national supervisors, who to one degree or another subscribe to the original Basel capital accord, the reality is that the EU is a patchwork of different jurisdictions with disparate rules, reporting regimes and accounting standards.

The unfolding scandal involving Bank of Italy governor Antonio Fazio, who is defending himself against allegations that he favoured the successful local bidder Banca Popolare Italiano over the Dutch ABN Amro group in the controversial takeover battle for Italy's Banca Antonveneta, illustrates the insular, sometimes chauvinistic tendencies of the European monetary and finance authorities. There is as yet no political authority within the shaky EU structure which has the power to challenge this fragmented status quo much less compel improvements.

To its credit, the EU bureaucracy has begun to address this situation via the creation of the Committee of European Bank Supervisors (CEBS), which comprises top banking supervisors from the 25 EU nations, and the proposed Capital Requirements Directive (CRD), which will be the mechanism for transposing Basel II into law in the EU. But to say that EU banking supervision and specifically minimum capital requirements are anything more than work in progress seems overly optimistic, particularly given the current political crisis sparked by the rejection of the new EU constitution in French and Dutch referendums.

By contrast US state and federal regula-

Opinion

Performance and new capital standard metrics of US banks

Figures for March 31, 2005 *Source: FDIC/IRA Bank Monitor*	Total assets of lead bank (000s)	Return on assets (%)	Return on equity (%)	Loss experience benchmark rating	Observed default experience rate (basis points)	Loss Given Default (%)	Weighted Average Maturity (years)	Exposure At Default, (%)
JPMorgan Chase Bank	$983,049,000	0.61	7.31	BBB	14.8	70.7	3.42	69.27
Bank of America	$838,258,244	1.70	24.71	A	6	55.1	7.74	64.05
Citibank	$684,592,000	1.32	16.69	BBB	40.7	73.7	1.69	166.54
Wachovia Bank	$454,751,000	1.35	13.05	A	4	52.1	5.16	77.05
Wells Fargo Bank	$367,427,000	1.70	18.38	A	8.7	65.6	2.88	47.53
Washington Mutual Bank	$305,721,973	1.18	15.21	AA	2	82.4	NA	29.97
Fleet National Bank	$213,056,075	1.58	7.54	A	8.5	12.7	6.6	55.57
U.S. Bank	$197,847,178	2.00	20.51	BBB	17.3	74	3.66	85.26
HSBC Bank USA	$138,568,614	0.92	11.21	BBB	23.2	61.2	3.75	55.78
SunTrust Bank	$136,163,072	1.26	16.56	A	5.1	47.7	4.29	72.46
World Savings Bank	$111,802,382	1.29	18.64	AAA	0.1	50.9	NA	3.24
Citibank (West)	$105,047,177	1.37	12.03	A	5	92.8	NA	12.87

Explanation: Loss Experience Benchmark = actual default rate expressed as bond rating equivalent using industry break points. Defaults = Observed loan and lease defaults in basis points. Loss Given Default ("LGD") = percent loss after default per dollar lent. Exposure at Default ("EAD") = amount obligor could borrow immediately prior to default expressed as percentage of existing credit available.

tors have been directly supervising banks for more than a century. For instance, the Federal Reserve, the US Treasury's Office of the Comptroller of the Currency and Office of Thrift Supervision, and the Federal Deposit Insurance Corporation (FDIC) and state agencies, cooperate to examine banks using their own personnel to conduct inspections, scrutinise bank operations and monitor monthly bank financial reports.

Legal authority

Most significantly, US regulators have the legal authority to set financial and management standards and when a bank's solvency is threatened the FDIC, the federal agency that insures customer deposits at US banks, is legally empowered to step in as receiver – without the approval of politicians in Washington. While the concept of "too big to fail" was used to justify the rescue of the largest US banks during the early 1990s real estate debacle, the US regulators largely allows the marketplace to resolve troubled institutions and starting new banks is reasonably easy.

In the EU, by contrast, banks are rarely allowed to fail and it is virtually impossible for an investor to establish a new bank. European regulators often rely on private auditors to inspect banks and provide information on their operations. Whereas US regulators are preparing to make Basel II effective via a rule-making proceeding later this year, the EU is still in the proposal stage in setting basic standards for solvency – an issue the US addressed in the early 1930s.

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Another basic issue facing the EU in achieving Basel II compliance is public bank data. How can claims that the EU is ahead of the rest of the world in terms of Basel II standards be confirmed when there is no common template for gathering financial data on European banks or even credit statistics for many EU consumers? Financial analysts and risk professionals cannot even obtain basic financial data regarding EU banks without going through enormous trouble and expense. All of these issues are part of the CEBS mandate for building, to paraphrase CEBS chairman José María Roldán, a "European supervisory culture" but none of these basic building blocks for regulating banks exists today.

Benchmarking US Banks

But in the US data available to regulators make it possible to benchmark all US banks against the new credit risk factors included in Basel II: probability of default (PD); loss given default (LGD); exposure at default (EAD) and aggregate portfolio maturity (M). Because of the excellent structured financial data reported quarterly by US banks, and validated and maintained by the FDIC, US regulators may measure and compare the financial compliance of every bank in the US under the Basel II schema - whether the bank elects to participate in Basel II or not. The table above shows basic performance and Basel II metrics for the top US banks using data from the FDIC.

The US is the only banking market where

Opinion

it is possible to readily test banking companies, unit by unit, for compliance with Basel II's pillar 3 – market discipline – and validate claims of compliance made by banks or their national regulators. These reports provide a performance benchmark to compare with the more detailed internal ratings generated by banks for regulators, who will use them as a tool to validate compliance or discipline banks whose models deviate excessively from actual experience.

Indeed, US bank regulatory data is so granular and its history so complete that with proper analytics tools one can accomplish the next stage in regulatory surveillance and compliance, namely the quantitative assessment of bank solvency, stability and strategy – the elusive "managerial intent" aspect of operational risk. And this information is freely available on the FDIC's web site (www.fdic.gov) or in structured format for a small fee.

Adopting XBRL

CEBS is working to create a data reporting framework using a version of eXtensible Markup Language ("XML") known as XBRL, or eXtensible Business Reporting Language, but in the US bank reporting is already embedded in the supervisory culture. It will be years before the EU is even ready to begin gathering bank data using the new template, and there are no plans to aggregate historical data in it.

Meanwhile, the US is moving ahead with significant enhancements to its already superlative data reporting regime. As ***Global Risk Regulator*** has reported extensively (see July/August issue, page 18), in October the FDIC begins accepting data from US banks coded in XBRL. While this marks an important advance, such is the strength of the reporting template put in place two decades ago that, for production purposes, the FDIC will simply map the new XBRL accounting taxonomy onto the existing regulatory template of historical data.

Real time reporting

The new electronic data interface between the FDIC and member banks will eventually allow real time reporting of financial data that could lead to monthly or even weekly disclosure cycles to support the pillar 2 supervisory review process of Basel II. There is no reporting regime in existence or in prospect in Europe which even begins to approach the level of regulatory disclosure and transparency already adopted by US banks.

The availability of bank data in the EU is important for several reasons. First and foremost, without timely disclosure of financial information, there can be no effective market discipline under pillar 3. At present, most EU banks release annual reports and semi-annual updates, but the information is provided as much as six months after the period close and is not in a consistent format that allows for objective comparisons.

While EU regulators receive extensive confidential financial information from their constituent banks, none of this is available to the public, including investors, other banks, and regulators around the world. How then will EU banks prepare the internal credit ratings required for the advanced Basel II approaches, the level where bank are permitted to model their economic capital?

When nations such as China, Korea and Vietnam look for examples of how to construct the regulatory culture and, equally important, the infrastructure required to supervise their infant private banking and investment sectors, there may be a temptation to look to the EU for guidance. However, the better model in terms of current capability may be found on the other side of the Atlantic, where the FDIC and other US regulators have created the regulatory and informational foundation that makes ensuring the safety and soundness of banks, the ultimate goal of Basel II, a practical reality. GRR

* *Key findings from Accenture's Basel II research* – Accenture.

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