Consumer Risk and the Basel II Proposal

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The Authority of Basel

- Whether “Basle” or “Basel”, the Committee is the Webster of best practices in bank capital regulation
- The Basel Accord, while sweeping in its scope, is a like a skeleton without flesh
- Nations individually flesh out the framework to reflect the unique structure of their banks

Retail Bankers' Concerns

- Clarification on the fundamental aspects of the proposed Basel Accord
- Analysis of the proposed Accord's affects on consumer portfolios
- Analysis of the proposed Accord's affects on specific retail banking segments

A Brief History of Basel

- The Committee was established in 1974 by central bank governors of "Group of Ten" countries to foster cooperation and understanding among regulators
- Basel possesses no formal authority and has no legal force
- Basel recommendations carry the weight of global consensus

Basel I - The 1980s

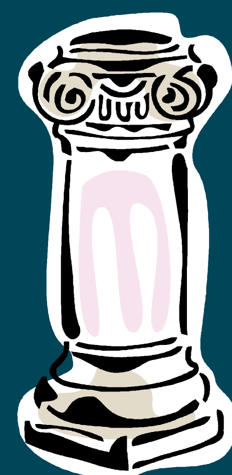
- Basel concluded that many large banks needed to hold additional capital and international standards were needed
  - Capital requirements of many nations were not sensitive to risk
  - Differences in capital requirements placed some banks at a competitive disadvantage
  - Technology and innovation were creating a single global marketplace

The 1988 Basel Accord

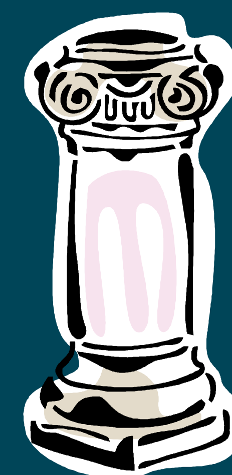
- Featured broad weighting bands to reflect the riskiness of assets
- Recommended an 8 percent international standard for risk-weighted minimum capital for large banks
- Became a world standard for measuring and regulating bank risk

The Proposed Basel Accord

Capitalization Standards



Methods of Supervision



Market Discipline

Pillar I - A Comparison

Proposed Accord

- Capital is the first of three pillars
- Flexible capital model for all sizes and complexity

1988 Accord

- Entire Accord focused on capital
- Structured capital model was designed for large banks

Pillar I - Not Just IRB

- Internal Ratings Based (IRB) approach
  - Requires advanced, complex capital and risk management systems
  - Appropriate for more complex institutions
- Revised Standardized Approach
  - Similar to Basel I, but with better methods of determining risk weights
  - Probably the choice of most banks

The IRB Approach

- Capital assessments based on bank's assessment of borrower credit quality
- Key measures:
  - Probability of default
  - Loss expected given default
  - Expected exposure at default
- Standards are tailored to specific asset classes

IRB Asset Categories

- Assets segmented into six categories: corporate, project finance, sovereign, bank, retail, and equity
- Banks further segment categories into groups with similar characteristics and similar exposures

Two IRB Alternatives

- Foundation IRB Approach
  - Banks able to determine default probabilities but not to estimate loss given default or exposure at default
  - Regulators set standards for loss rates and exposures
- Advanced IRB Approach
  - Banks with sophisticated modeling techniques

The Goals of Pillar I

- Provide incentive for banks to upgrade risk management systems
- Enhance bank management's sensitivity to risk
- Recognize the potential affects of operational risk

Pillar II - Supervision

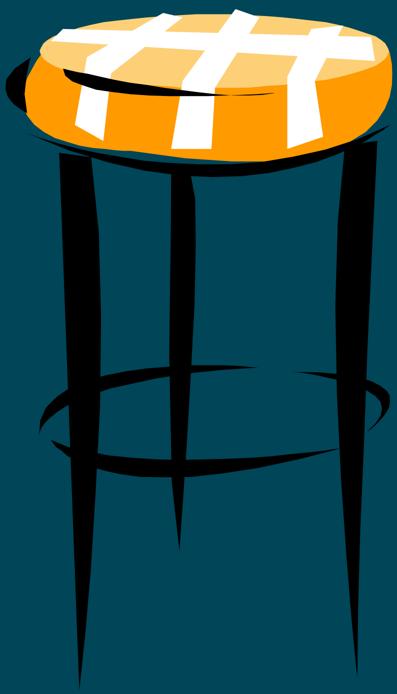
- Expands on current trend toward strong internal controls, self-policing, and joint Board and management oversight
- Enhances communication between bank management and supervisors
- Supervisors review each bank's assessment of its capital adequacy and internal controls

Pillar III - Market Discipline

- Goal is to improve transparency and make more information - both qualitative and quantitative - publicly available
- Amount of additional disclosures required or recommended to be disclosed would be proportionate to the degree the IRB approach is used

The Three Pillars Together

Provide a Sound, Risk-Based Capital Foundation



Profile of Consumer Credit

- U.S. retail debt reached $1.6 trillion in 2000
- New risk management techniques encourage banks to accept more risk
- Debt service has grown to 14.3% of personal income
- Current economic slowdown has stretched consumer finances

Basel and Consumer Credit

- Pillar I : Current practices such as segmenting consumer portfolios and credit scoring are integral elements
- Pillar II : Regulators work closely with bankers on capital and internal controls
- Pillar III : Retail banks have detailed information on portfolio composition, performance, and credit risk

Consumer Credit 'Best Practices'

- Increased competition has spawned new risk-management practices
  - Using information-based support when extending consumer credit
  - Classifying consumer loans by risk, with explicit capital charges to profit centers
  - Integrating formal measurement and quantification of risk into consumer lending processes

Applying IRB to Retail Credit

- Minimum qualifying criteria
  - Exposure to individual person(s)
  - Certain loan types automatically qualify
  - Exposures must be part of homogenous pools of type, risk, delinquency, and vintage
- Risk management system must differentiate default risks and use a segmentation approach

Applying IRB to Retail Credit

1. Bank estimates exposure at default

2.a. Bank determines the asset class' average probability of default and average loss given default, *or*

2.b. Banks could assess the expected loss associated with a segment rather than estimating PD and LGD

3. Bank back tests its assumptions

4. Supervisors review IRB models

Other Retail Credit Provisions

- Small business loans may be retail if the bank's internal processes consistently regard them as retail
- Collateral will be reflected in banks' LGD estimates
- Risks on uncommitted retail lines of credit will be captured
- Risks inherent in asset securitization will be captured

Consistency of Recent Supervisory Guidance

- SR 01-4 Subprime Lending
  - Institutions are responsible for quantifying the amount of capital needed to support the additional risks in subprime lending
  - Institutions are responsible for documenting the methodology and analysis
  - Examiners take a more active and ongoing interest in the activities of subprime lenders

Challenges for the Industry

- Stress testing and validating internal models
- Quantifying the affects of risk mitigation techniques
- Providing additional detail on past due and nonperforming retail loans
- Publicly releasing additional information

The Industry's Early Response

- General support for underlying concepts
- The devil is in the details
  - Proposal captures consumer portfolio risk but ignores margin profiles that mitigate risk
  - Proprietary information might be published
  - Quantifying operational risk is a wild card
  - Banks not using IRB will be disadvantaged
  - Time to implementation

The Regulators' Challenge

- Balancing credit risk management supervision with economic cyclicality
- Determining the appropriate risk weight formulae for different product types
- Enhancing skill sets and retaining supervisory staff to oversee the new IRB models

A Final Thought

**Making Basel II work
is a joint mission:
regulators and bankers must be
on the same page and
reach mutual agreement
for the Accord to be a success.**