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 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

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<tr>
<th>Proposed Accord</th>
<th>1988 Accord</th>
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<td>- Capital is the first of three pillars</td>
<td>- Entire Accord focused on capital</td>
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<td>- Flexible capital model for all sizes and complexity</td>
<td>- Structured capital model was designed for large banks</td>
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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.
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.