

Basel II Policy and Implementation Issues*

George French
Federal Deposit Insurance Corporation

** The views expressed are those of the presenter and not necessarily those of the FDIC*

This presentation covers unanswered questions and concerns about Basel II's advanced approach:

- level of capital requirements
- dispersion of capital requirements
- potential competitive effects

Context for concern about capital requirements

- Substantially reducing capital requirements could harm the safety and soundness of our banking system
- Avoiding substantial reductions in capital requirements was part of the Basel II agreement

QIS-4 estimates show large reductions in risk-based capital requirements

Percentage Change in:	Weighted Average	Median
Total Capital Requirement	-15.5%	-26.3%
Tier 1 Capital Requirement	-21.8%	-30.8%

Source: *Summary Findings of the Fourth Quantitative Impact Study.*

Lower capital requirements for complex risks:

Exposure type	% change in capital requirement	Source
Securitizations	-18%	QIS-4
All off-balance sheet exposures, excluding OTC derivatives	-19%*	QIS-4
Counterparty credit risk charge (for OTC derivatives and securities financing transactions)	large reduction	recent evidence

* Source: FDIC calculations based on QIS-4 workbooks.

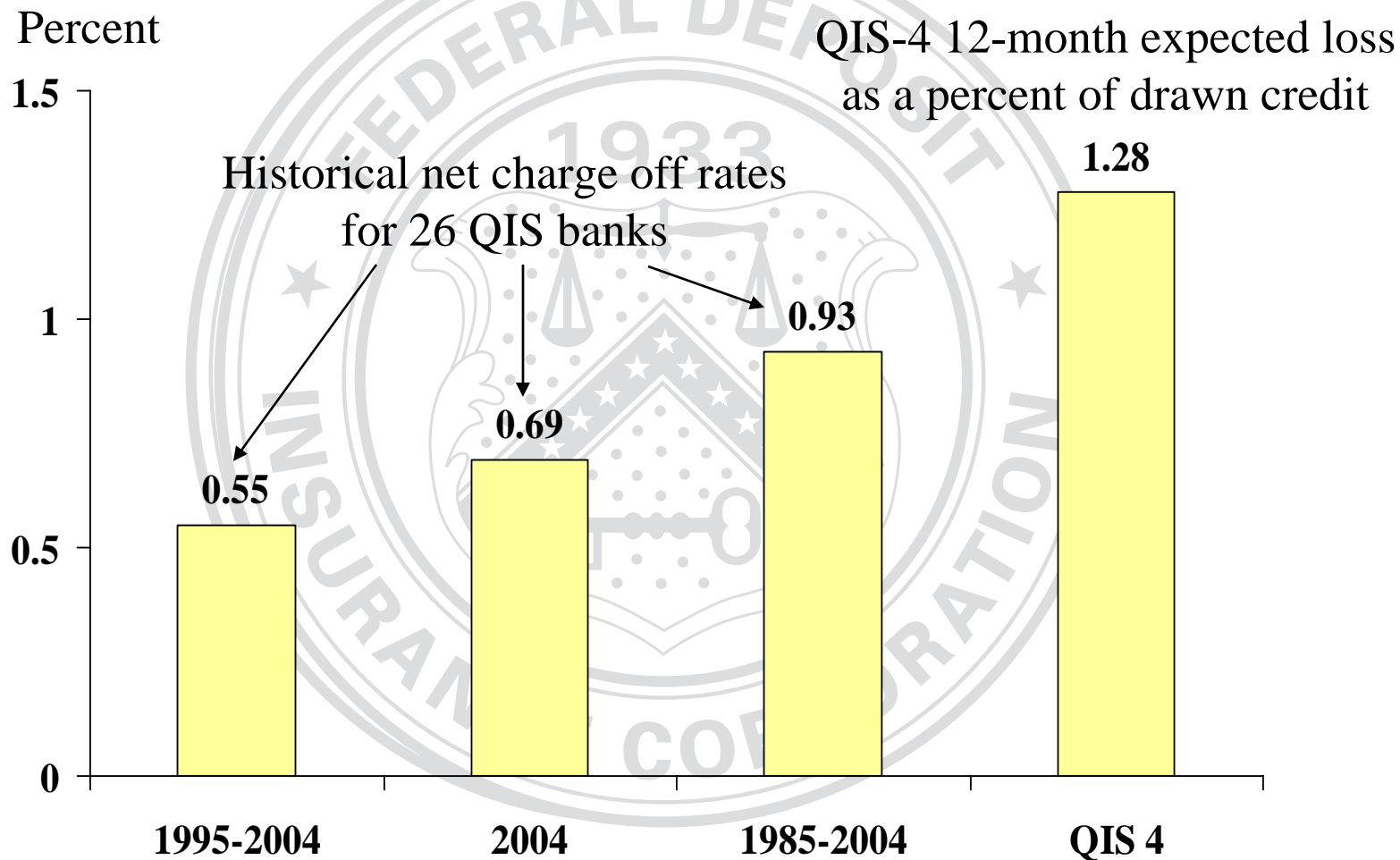
QIS-4 capital requirements were well below leverage based requirements

Minimum Tier 1 Requirements as a Percentage of On-Balance Sheet Assets

Ratio	Number of companies in range
< 2 percent	10
2 -3 percent	10
3-4 percent	4
4-5 percent	0
> 5 percent	2
Total QIS-4 banks:	26

Source: FDIC calculations based on QIS-4 workbooks. The calculations assume that the minimum tier 1 capital requirement is 4 percent of risk-weighted assets, as it is internationally.

Will the advanced approach reduce capital requirements more than QIS-4 suggests?



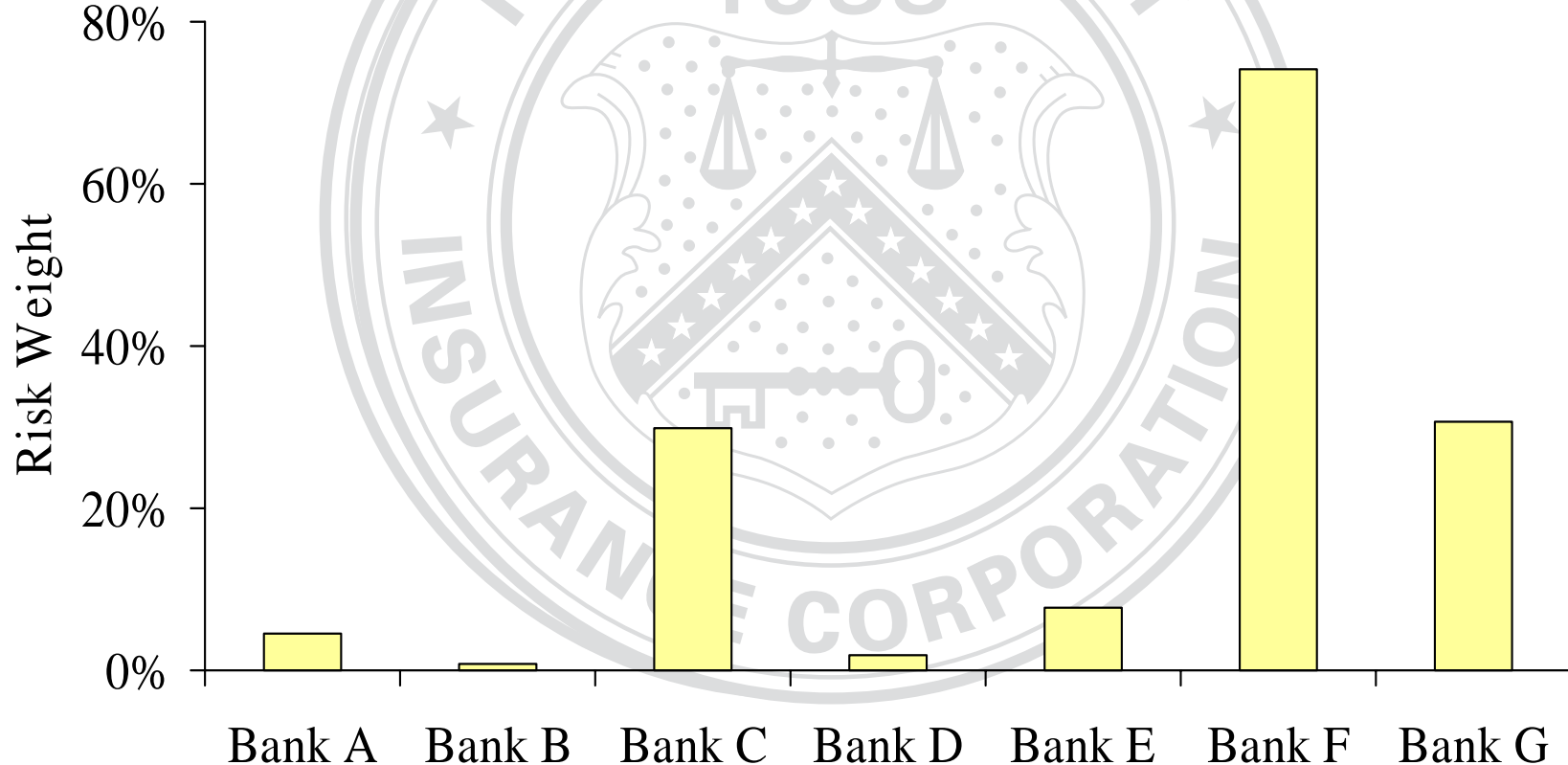
Source: FDIC calculations based on QIS-4 workbooks and Quarterly Reports of Condition and Income. Net charge off rates do not include some economic losses that should be included in expected losses, and may not reflect stress elements.

Context for concern about capital dispersion

- Is there a correct measure of risk?
- How can regulatory consistency be achieved?
- Will market disclosures be useful?

QIS-4 showed substantial differences in capital requirements for similar exposures

Risk weights for 5/1 hybrid ARMs originated within last 90 days: 80% LTV / 660 credit score



Source: QIS-4 results.

Context for concern about competitive impact

- No precedent for large differences in regulatory capital requirements across U.S. banks
- Would such differences accelerate consolidation?
- Would such differences threaten the dual banking system?

Credit risk weights: Basel IA vs. Basel II

Exposure Type	Basel IA ANPR	Basel II Advanced QIS-4 (median)
Small business loans:		
Retail	100%	61%
Other	100%	74%
Commercial real estate:		
High volatility	100%	70%
Other	100%	48%
Other commercial loans	100%	47%

Source: *Summary Findings of the Fourth Quantitative Impact Study.*

Credit risk weights: Basel IA vs. Basel II

Exposure Type	Basel IA ANPR	Basel II Advanced QIS-4 (median)
Typical 1-4 residential mortgage	35%	16%
Typical home equity loan	100%	19%
Credit cards	100%	117%
Other retail loans	100%	56%
AAA-rated Fannie or Freddie MBS	20%	7%

Notes: Advanced Approaches median risk weights come from *Summary Findings of the Fourth Quantitative Impact Study*. The 7 percent risk weight on Fannie Mae and Freddie Mac mortgage backed securities is based on the Basel II NPR proposals. Advanced Approaches capital requirements for credit cards are likely understated in this table because of the large importance of capital requirements for undrawn lines, requirements that are not present in Basel IA. Basel IA risk weights for residential mortgages refer to a loan with a current loan-to-value ratio of 80%, after including the effects of loan-level private mortgage insurance.