Standardized Basel II: A Primer

The "Basel II" Accord, so-named for the Swiss home of the Bank of International Settlements that authored the agreement, represents the efforts of global bank regulators to update bank capital regulation. Basel II comes in two distinct flavors; the largest dozen US banks (those with more than $250B total assets or $10B foreign assets) must use the complex "Advanced" approach while all other banks and thrifts can use the simpler "Standardized" version to calculate their regulatory capital requirements. Here we focus on Standardized Basel II as all but the largest banks will likely choose this approach. The final Standardized Basel II rule will be published in the first quarter of 2009, after which all US banks and thrifts can elect to apply for treatment.

The first part or "pillar" of Basel II revises existing asset risk-weights to more accurately reflect balance sheet risk. Whereas existing rules apply a 50 percent risk-weight to all first-lien mortgages, for example, the new Basel II rules apply a variety of risk-weights, from 20 percent to 150 percent, depending upon loan-to-value ratios. Standardized Basel II risk-weights are lower than existing weights for most banks; these institutions will enjoy higher capital ratios under the new rules. Of the 7,500 US banks not required to follow the Advanced rule, our public data model suggests that 78 percent will save capital under Basel II. The median bank saves 4.5 percent of their existing capital base, a quarter save 8.6 percent and the top 1000 save 11.6 percent capital or more. All told, community, regional, and super-regional banks stand to save as much as $31B in capital by complying with Standardized Basel II.

These capital savings have material implications for bank operations and strategy. Consider Mercantile Bancorp of Quincy, IL, a $1.7B bank with roughly median capital savings under Standardized Basel II. Were they to comply with the new regulation, their 1Q2008 total risk-based capital ratio would increase from 10.3 percent to 10.8 percent. Alternatively, Mercantile could issue a $6.2mm special dividend or buyback 365,000 shares of stock, increasing EPS five cents to $1.20, without lowering their capital ratio from its current level. Finally, Mercantile could maintain its existing capital ratio while adding $71mm of additional assets without raising additional equity. These are all tantalizing options in today's economic environment.

So what, you might ask, is the catch? US bank regulators are certainly in no mood to give away capital, and the second "pillar" of Basel II provides the mechanism for corroborating, slowing, or even reversing any capital benefit realized under pillar one. Pillar two empowers regulators to review pillar one calculations and any other pertinent institutional information in setting a final capital requirement. The centerpiece of pillar two is the Internal Capital Adequacy Assessment Process, or ICAAP. Banks that wish to comply with Standardized Basel II must produce a comprehensive document of 50 or more pages that demonstrates the quality of risk management, reliability of internal controls, and adequacy of the bank capital position. Economic capital modeling, stress testing, peer benchmarking, and scenario analysis are among the tools that regulators expect to find in the ICAAP.

Pillar Two brings a richness to capital regulation that Standardized Basel II might otherwise lack. Unlike the Advanced version, Standardized capital calculations are technically simple, perhaps no more difficult than under Basel I. Pillar Two is where the regulators seek evidence of a genuine commitment to thoughtful capital management. Pillar One opens the door to capital savings for many, but only those demonstrating strong risk management philosophy and capability will be allowed through. The ICAAP requirement will prevent Standardized Basel II from becoming a capital bonanza for banks unable to wisely manage an efficient capital position.

Second Pillar Consulting is ready to help with the ICAAP and other compliance requirements that stand between your institution and the valuable capital benefits of Basel II compliance. Please contact us at www.secondpillar.com for additional information on Basel II and a free estimate of your bank's prospective Basel II capital savings