RISK-BASED CAPITAL

Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework

What GAO Found

Rapid innovation in financial markets and advances in risk management have revealed limitations in the existing Basel I risk-based capital framework, especially for large, complex banks. U.S. banking regulators have proposed a revised regulatory capital framework that differs from the international Basel II accord in several ways, including (1) requiring adoption of the most advanced Basel II approaches and by only the largest and most internationally active banks; (2) proposing Basel IA, a simpler revision of Basel I, and retaining Basel I as options for all other banks; and (3) retaining the leverage requirement and prompt corrective action measures that exist under the current regulatory capital framework.

While the new capital framework could improve banks’ risk management and make regulatory capital more sensitive to underlying risks, its impact on minimum capital requirements and the actual amount of capital held by banks is uncertain. The approaches allowed under Basel II are not without risks, and realizing the benefits of these approaches while managing the related risks will depend on the adequacy of both internal and supervisory reviews. The move to Basel II has also raised competitiveness concerns between large and small U.S. banks domestically and large U.S. and foreign banks internationally. The impact of Basel II on the level of required capital is uncertain, but in response to quantitative impact study results showing large reductions in minimum required capital, U.S. regulators have proposed safeguards, such as transitional floors, that along with the existing leverage ratio would limit regulatory capital reductions during a multiyear transition period. Finally, the impact on actual capital held by banks is uncertain because banks hold capital above required minimums for both internal risk management purposes as well as to address the expectations of the market.

What GAO Recommends

With safeguards, it is appropriate for U.S. banking regulators to proceed with finalizing Basel II and begin the transition period. GAO recommends that they (1) clarify some aspects of the Notice of Proposed Rulemaking (NPR); (2) issue a new NPR if material differences from the current NPR, or a U.S. standardized approach option, are planned for the final rule; (3) issue periodic public reports on progress, results, and any needed adjustments; and (4) at the end of the transition period, reevaluate the appropriateness of Basel II as a long-term framework for setting regulatory capital. The Federal Reserve said it agreed with our recommendations and the other banking agencies said they will consider them as part of the rule-making process.


To view the full product, including the scope and methodology, click on the link above. For more information, contact Orice Williams at williams0@gao.gov or Tom McCool at mccoolt@gao.gov.