FEDERAL RESERVE MAY SHUN GLOBAL RISK RULES BANKS SPENT BILLIONS TO MEET

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(Reuters) Fed officials are concerned that parts of a key tool that regulators have developed to measure banks' riskiness—known as "Basel III capital rules" -- are flawed and can be gamed by the companies.

Under Basel, banks can determine how much debt they can take on by using their own models

and computer systems to calculate how risky their assets are, among other methods. The higher the risk, the less money banks can borrow and lend, in turn cutting income banks can earn. In other words, the Basel rules give banks a chance to monkey with their risk models to boost profit.

In a May speech, Fed Governor Daniel Tarullo condemned the latitude that Basel III gives banks to use their own models. While he was expressing his own views, a source familiar with the matter told Reuters that Tarullo's opinion is held by other governors.

Instead of the Basel rules, Tarullo promoted the use of the Fed's own yardstick of bank health, a test of how bank assets would perform during market turmoil or an economic slump. That process, which the Fed has developed separately from the Basel regulations, is known as the "stress test."

"As a practical matter, it is our binding capital standard," said John Dugan, former U.S. Comptroller of the Currency and now a partner at the law firm of Covington & Burling in Washington.

The Fed's decision to emphasize a different process for evaluating risk is maddening to banks, who complain that the Fed's tests are opaque. The regulator fears that banks would find ways to cheat the tests if they knew too much about the methodology, so it gives them little detail about it. Every year, the Fed can also change the stressful situations it tests for.

Wall Street says it's getting mixed signals about Basel III from the Fed. Tarullo's remarks come less than three months after U.S. regulators gave the green light to eight big U.S. banks to use their own risk models.

One senior bank executive who refused to be named complained that the regulator wants "a private playbook" which it can redesign every year. Another called the stress test process "arbitrary and scary."

The world's biggest banks have probably spent billions of dollars in recent years building computer models, hiring staff and selling assets to comply with Basel III, analysts said. An executive at a major bank told Reuters last year that his firm had spent $500 million on models and systems alone.

Without more detail about the Fed's rules, banks must hold more capital, possibly constraining their lending and global growth, bankers said. Wells Fargo & Co, the fourth-largest U.S. bank, said at a recent conference that it is holding more capital in large part because of the Fed's stress test.

Many regulators have little patience with these complaints. In the run-up to the financial crisis, banks succumbed to the temptation to boost earnings by borrowing more money to fund their assets. If a bank has too much debt, even slight declines in the value of its assets can put it out of business, a lesson that Lehman Brothers Holdings Inc learned the hard way.

The Fed and other regulators are charged with maintaining the health of the financial system, not maximizing bank profits.

Regulators may have reason to be alarmed about the way banks are measuring asset risk. Last year, the Basel Committee, which is refining the current generation of Basel rules, said it found wide variance in how banks assessed the riskiness of hypothetical portfolios of loans and trading assets. A Barclays Capital survey in 2012 found that half of investors distrust banks' assessments of the riskiness of their assets.

Banks rarely confess to changing their risk models to reduce their capital requirements, but evidence of its happening came to light last year, when a U.S. Senate subcommittee released e-mails in which JPMorgan Chase & Co executives discussed how they were changing their models to reduce the apparent riskiness of their assets.

Policing banks' models is labor intensive, and regulators are finding their staff andresources stretched. Even the head of the Basel Committee acknowledged in March that

adjusting assets for risk poses difficulties for regulators.

"The message I would like to leave you with today is that there is one (a problem), and we plan to do something about it," said Basel Committee Chairman Stefan Ingves in a speech in New York.

The Federal Reserve is not inclined to wait to fix rules that global regulators have been discussing and refining for a decade. The central bank has added its own rules to a separate part of the Basel capital requirements, known as the leverage ratios, which do not consider the riskiness of assets.

Tarullo's harsh criticism of the Basel risk measures came in a May 8 speech.

Referring to bank models for calculating asset risk, called the "internal-ratings-based approach," he said, the "combined complexity and opacity of risk weights generated by each banking organization for purposes of its regulatory capital requirement create manifold risks of gaming, mistake, and monitoring difficulty."

Later, he said, "in light of all that has happened in the last decade, I see little reason to maintain the requirements of the IRB approach for our largest banks."

Fed staffers interviewed by Reuters said Tarullo's tone and timing were surprising, given the amount of energy that both U.S. regulators and the banks have put into adopting the third generation of Basel rules, which must be fully implemented by the beginning of 2019.

"They've invested so much time and effort into that process, and it's an international agreed-upon standard, so to say to scrap it – it's a pretty bold statement," said an employee at a regional Federal Reserve bank who did not want to be identified.

Federal Reserve spokeswoman Barbara Hagenbaugh declined to comment.

CRISIS AFTERMATH

Regulators have been working on the third set of Basel rules for a decade, but the effort gained extra momentum after the financial crisis, when investors and depositors feared that banks had too much debt and too little equity, or capital, funding their assets.

Capital represents a cushion that banks have against their assets losing value during times of stress—maintaining enough of a buffer is critical to preventing runs on banks during crises. When investors and depositors lost faith in banks, governments and central banks globally had to pump trillions of dollars into the financial system to bail out lenders.

The Fed developed the stress tests in 2009 in part to restore trust in the financial system. Investors unsure about bank-asset values took comfort that regulators were checking that banks would be solvent during a crisis.

These tests, combined with the Fed's decisions about whether banks can afford to buy back more shares and increase their dividends, have become increasingly important to the regulator, sources said.

The European Central Bank, which will become the continent's bank supervisor before the end of the year, is also developing its own stress tests known as the asset quality review.

Banks including Citigroup Inc and Bank of America Corp have been embarrassed to have had capital plans rejected by the Fed. Their failures have encouraged others to be more cautious managing their capital, analysts said.

John McDonald of Bernstein Research in New York recently estimated that changes in the Fed's grading methods this year canceled out some $60 billion of excess capital at three big banks, Citigroup, Bank of America and JPMorgan Chase & Co.

Changing complexities of the Fed's testing "could have negative implications for the way banks are run," according to McDonald.

Three senior Wall Street executives complained to Reuters about the Fed's shifts towards its own tests, though none would be named for fear of insulting their regulator.

A former Fed staffer who now works in the industry said Tarullo is wrong to be so confident in the Fed's own models, which have been changing year-to-year and haven't been tested in another crisis. In the most recent round of stress tests, the Fed discovered flaws in its models that it said were minor.

It had to adjust its calculations and release revised numbers the next day. Even if one bank's model is not the best, the person said, models from the top 150 banks in aggregate are likely better than a single model from one regulator.

A consequence of banks not knowing how the models will work, the person said, is that banks will be more reluctant to take chances lending and investing. "You are really tamping down potential growth in the economy," the person said.

(Reporting by David Henry in New York and Emily Stephenson, Michael Flaherty and Douwe Miedema in Washington. Additional reporting by Peter Rudegeair in New York. Editing by Dan Wilchins and John Pickering.)