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Competitive effects of Basel II on US bank credit card lending [☆]

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Abstract

We analyze the potential competitive effects of the proposed Basel II capital regulations on US bank credit card lending. We find that bank issuers operating under Basel II will face higher regulatory capital minimums than Basel I banks, with differences due to the way the two regulations treat reserves and gain-on-sale of securitized assets. During periods of normal economic conditions, this is not likely to have a competitive effect; however, during periods of substantial stress in credit card portfolios, Basel II banks could face a significant competitive disadvantage relative to Basel I banks and nonbank issuers.
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1. Introduction

This paper analyzes the potential competitive effects of the proposed Basel II capital regulations on US bank credit card lending. Under Basel II, a small number of large US banking organizations would be required to use the advanced internal ratings-based (A-IRB) approach for credit risk and the advanced measurement approach (AMA) for operational risk. In addition to these "mandatory banks," it is expected that a relatively small number of mostly large US banks are likely to "opt-in" to Basel II and use the A-IRB and AMA. However, the vast majority of other US banks would continue to operate under the current Basel I capital rules.[1] The Basel I rules require the same minimum capital charge for all credit card exposures regardless of credit quality. In contrast, the Basel II rules are more risk sensitive with minimum capital requirements based on banks' internal estimates of the probability of default (PD), loss given default (LGD), and exposure at default (EAD).

The Basel II proposal raises questions about the competitive positions of banks adopting Basel II relative to banks remaining under the current capital regime and relative to nonbank rivals. Some bankers, particularly community bankers, have expressed concern that Basel II banks would face lower capital requirements for various products (including credit cards) and therefore have a competitive advantage.[2]

Basel II will generate competitive effects only if the regulatory capital constraint is *binding* (i.e., for a given portfolio, minimum regulatory capital requirements cause banks to hold more capital than they would hold in the absence of the requirement). A central component of our analysis will be to determine whether regulatory capital requirements for credit card portfolios are currently binding or are expected to be binding under the proposed Basel II regime.

Three caveats to our analysis are noteworthy. First, the analysis is based on the *current* Basel II proposal, which has not yet been written into US rules and is subject to revision as well as to changes in interpretation. Second, the analysis is based on the *current* Basel I rules, which may be modified before the effective date of Basel II. Third, our analysis focuses solely on the domestic US credit card market. We do not consider the potential competitive effects on international credit card operations.

The remainder of the paper is organized as follows: Section 2 provides descriptive background on the most important features of the credit card industry. Section 3 describes the current and proposed regulatory capital framework. Section 4 lays out our analytical framework for assessing changes in regulatory capital standards. Section 5 analyzes whether regulatory capital requirements are currently binding or are expected to be binding under Basel II. Section 6 concludes and presents several likely reactions to the Basel II A-IRB framework that banks could have in response to the bifurcated capital regime.

[1] This paper considers the Basel II regulations as stated in the June 2004 Basel Committee Framework Agreement. The US banking agencies have proposed modifications to the current capital standards that would increase the risk sensitivity of those standards. For the purposes of this paper, we assume that banks not adopting Basel II will operate under the current Basel I rules, and we will use the term "Basel II bank" to designate a bank operating under the A-IRB rules of Basel II, and "Basel I bank" to designate a bank not operating under A-IRB.

[2] See "Smaller US Banks Say Basel Accord Unfair," *Reuters News*, June 22, 2004. This study uses the term "community bank" for banking organizations with assets of less than $1 billion. We use "regional bank" to refer to banking organizations with assets over $1 billion that operate in regions of the US and not nationally or globally. Unless otherwise noted, the term "bank" will mean depository institution more generally.