THE NEW BASEL ACCORD: IN SEARCH OF A UNIFIED U.S. POSITION

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

JUNE 19, 2003

Printed for the use of the Committee on Financial Services

Serial No. 108–40

U.S. GOVERNMENT PRINTING OFFICE

91–770 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

MICHAEL G. OXLEY, Ohio, *Chairman*

JAMES A. LEACH, Iowa
DOUG BEREUTER, Nebraska
RICHARD H. BAKER, Louisiana
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
ROBERT W. NEY, Ohio
SUE W. KELLY, New York, *Vice Chair*
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
JIM RYUN, Kansas
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
DOUG OSE, California
JUDY BIGGERT, Illinois
MARK GREEN, Wisconsin
PATRICK J. TOOMEY, Pennsylvania
CHRISTOPHER SHAYS, Connecticut
JOHN B. SHADEGG, Arizona
VITO FOSSELLA, New York
GARY G. MILLER, California
MELISSA A. HART, Pennsylvania
SHELLEY MOORE CAPITO, West Virginia
PATRICK J. TIBERI, Ohio
MARK R. KENNEDY, Minnesota
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
TIM MURPHY, Pennsylvania
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
KATHERINE HARRIS, Florida
RICK RENZI, Arizona

BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
BARBARA LEE, California
JAY INSLEE, Washington
DENNIS MOORE, Kansas
CHARLES A. GONZALEZ, Texas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
JOSEPH CROWLEY, New York
WM. LACY CLAY, Missouri
STEVE ISRAEL, New York
MIKE ROSS, Arkansas
CAROLYN MCCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
ARTUR DAVIS, Alabama
RAHM EMANUEL, Illinois
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia

BERNARD SANDERS, Vermont

Robert U. Foster, III, *Staff Director*

Page

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

SPENCER BACHUS, Alabama, *Chairman*

STEVEN C. LATOURETTE, Ohio, *Vice Chairman*
DOUG BEREUTER, Nebraska
RICHARD H. BAKER, Louisiana
MICHAEL N. CASTLE, Delaware
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
SUE W. KELLY, New York
PAUL E. GILLMOR, Ohio
JIM RYUN, Kansas
WALTER B. JONES, JR, North Carolina
JUDY BIGGERT, Illinois
PATRICK J. TOOMEY, Pennsylvania
VITO FOSSELLA, New York
MELISSA A. HART, Pennsylvania
SHELLEY MOORE CAPITO, West Virginia
PATRICK J. TIBERI, Ohio
MARK R. KENNEDY, Minnesota
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
TIM MURPHY, Pennsylvania
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
RICK RENZI, Arizona

BERNARD SANDERS, Vermont
CAROLYN B. MALONEY, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
LUIS V. GUTIERREZ, Illinois
DENNIS MOORE, Kansas
CHARLES A. GONZALEZ, Texas
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
JOSEPH CROWLEY, New York
STEVE ISRAEL, New York
MIKE ROSS, Arkansas
CAROLYN MCCARTHY, New York
ARTUR DAVIS, Alabama

CONTENTS

THE NEW BASEL ACCORD: IN SEARCH OF A UNIFIED U.S. POSITION

Thursday, June 19, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:06 a.m., in Room 2128, Rayburn House Office Building, Hon. Spencer Bachus [Chairman of the Subcommittee] presiding.

Present: Representatives Bachus, Kelly, Toomey, Hart, Capito, Tiberi, Hensarling, Murphy, Brown-Waite, Oxley (ex officio), Sanders, Maloney, Watt, Sherman, Velazquez, Davis and Frank (ex officio).

Chairman BACHUS. [Presiding.] Good morning. The Subcommittee on Financial Institutions and Consumer Credit is convened. The Subcommittee meets to examine the proposed Basel II Capital Accord and its potential effects on the domestic and international banking systems.

The goal of Basel II is to develop a more flexible and forward-looking capital adequate framework that better reflects the risks facing banks and encourages them to make ongoing improvements to their risk assessment capabilities. The Subcommittee on Domestic and International Monetary Policy, Trade and Technology held a hearing in February to examine the proposal, where we heard from a distinguished panel of regulators, including Federal Reserve Vice Chairman Ferguson, Comptroller Hawke, Chairman Powell and a panel of private sector witnesses.

This hearing revealed that the federal regulators did not have a unified position on the scope and merits of Basel II. Following this hearing, I along with Congresswoman Maloney, Chairman Oxley, Ranking Member Frank, introduced H.R. 2043, the United States Financial Policy Committee for Fair Capital Standards Act.

H.R. 2043 requires the federal banking regulators to develop a unified position on issues under consideration and the Basel Committee on Banking Supervision. Today, we will hear from the Federal Reserve, OCC and FDIC, along with OTS Director James Gilleran.

Our second panel of private sector witnesses includes representatives of a large bank, a financial services trade association and university professor. I look forward to hearing from today's witnesses and thank them for taking time from their busy schedules to join us.

I applaud the intent and the objectives of Basel II agreement: to ensure solvency of our banking institutions and protect against substantial losses; to create international standards to better manage risk; and align regulatory capital to economic risk.

The distinguished witnesses on our first panel are to be commended for the work they have already accomplished on this agreement. Nonetheless, I have concerns regarding Basel II on several grounds.

First, I believe it is unnecessarily complex and costly, with inflexible formulas replacing current rules and supervisory examinations. In addition, I believe that the current draft would create an uneven playing field, one that unfairly penalizes many banks in this country, particularly our regional banks.

But my main concern is about the transparency of the Basel process as a whole and specifically, how the U.S. position at the Basel Committee is determined. I know that there has been an extensive comment period. And representatives of the Federal Reserve Board assure me that the banks that would be subject to Basel II approve of it.

Nonetheless, some of the banks have indicated to me, through their representatives, that they are in fact tremendously concerned about Basel. I understand that banks that have reservations about the U.S. position are hesitant to object openly to a regulatory agency that exercises power over them.

This concern seems reasonable to me. I believe we must arrange for a full airing of the views of all interested parties, without institutional constraint.

In addition, it has become clear to me that the bank regulators are not in agreement on the desirability of the accord as currently drafted. I am hesitant about this Congress supporting fundamental changes to our banking system in the face of a lack of consensus among thoughtful regulators.

And I note at this time that the Senate testimony yesterday by banking representatives did describe Basel II as a fundamental change in banking supervision and regulation. H.R. 2043 would require the regulators to reach agreement by establishing a procedural framework for further deliberations on Basel.

Our bill would create an interagency Committee, chaired by the Treasury Department, and include federal banking regulators. If the members cannot reach consensus on a position, the position of the Treasury would prevail.

It is important that the secretary, as part of the elected administration, set U.S. policy. Yesterday, I announced at the Exchequer Club, that the Subcommittee plans to mark up this legislation in July.

In closing, I want to thank Chairman Oxley, Ranking Member Frank and Mrs. Maloney for working with me to develop this legislation. I look forward to working with them and other members of this Subcommittee on this important issue. I also look forward to the testimony of our regulators this morning because, as I have said on two or three occasions, we are concerned that there are different opinions on Basel II and its effect on the banking institutions and our financial system as a whole.

I now am pleased to recognize Mrs. Maloney for an opening statement. Or Mr. Frank—I am sorry. Mr. Frank has come in.

[The prepared statement of Hon. Spencer Bachus can be found on page 62 in the appendix.]

Mrs. MALONEY. I defer to the ranking member of the Committee and appreciate so much his intelligent concern on this issue and so many others. Thank you, Barney.

Chairman BACHUS. I just simply did not see that you had come in. So I apologize.

Mr. FRANK. I try to be as unobtrusive as possible, Mr. Chairman. [Laughter.]

I appreciate your acknowledging that. I want to comment—and I appreciate your diligence in giving us a chance to be involved in this. I must say, I do get the feeling from the Federal Reserve that our interest is not entirely welcome. But that is one of the things that concerns me.

I have procedural concerns here as much as substantive. And I was pleased to hear that you plan to move on this legislation because I think we have a very big problem in the way in which we formulate policy here.

Globalization is a fact. It is probably as important in the financial markets, given the nature of money and its fungability in finance. Globalization is as powerful a force there as anywhere else.

So formulating American policy to deal with these global issues is very important. And I think we do not have a coherent process in place for formulating these.

And we began these conversations. And some financial institutions had substantive concerns, called them to my attention and the attention of some others.

We began these discussions based on those. But my concern broadened to include the procedures because we were initially told that there was a Committee of U.S. regulators that had come up with this common position.

But it now is clear that two of the three federal agencies disagree with the position to some extent. And frankly, we were told, to some extent, by the Federal Reserve it seemed to me, that everybody was in agreement.

And then we heard from the Comptroller of the Currency and the head of the FDIC that there was not agreement. And to adapt the line from Chico Marx when he was caught at something he had denied, the question became, “Who are we going to believe, them or our own ears?”

And I am going with my ears. And I think what we need to do is to create a structure here.

I also continue to believe that while I, along with everybody else, have not just respect but gratitude for the great work that the New York Federal Reserve Bank does in helping us manage our financial institutions, it ought never to be considered to be on a par with those institutions of the federal government which have a Presidential appointee at the head who was confirmed by the Senate.

So when we are told that there is a four-member Committee and it is the Federal Reserve Board, the New York Fed and the Comptroller of the Currency and the FDIC, I think that is not an appropriate structure. I should add that I have been concerned about some of the substance. And I will ask some questions specifically about that.

But I also believe that, given the lack of coherence in the procedures and given the disagreements that evidently exist—and they are legitimate disagreements. These are not easy questions to answer.

There is nothing wrong at all with there being legitimate differences of opinion among regulators. To some extent, they have different regulatory functions. But they also have inarturial perspectives. And these are the things that we ought to have discussed.

But given the obvious differences that continue to exist among the responsible regulators, it seems to me an error for us to go forward with what purports to be an American government position, which does not represent not just some of the important regulators, but frankly does not seem to have a lot of support in Congress.

And as much as I respect the work that the Federal Reserve does, it is not, I think, empowered to speak for the U.S. government by itself to the extent that it seems to me to be doing in this situation. I do think that there needs to be some better working together.

Now I would assume the Fed would have a major role here, a lead role in some ways. But I think that we have gotten ahead of ourselves in purporting to have a unified position from which there is significant dissent among the relevant regulators and within the Congress and the relevant Committees.

So I appreciate this further chance to address that. And I thank you very much, Mr. Chairman, for your very diligent work in this regard.

Chairman BACHUS. Thank you. Are there other members wishing to make—Chairman Oxley? Would you like to make an opening statement?

Mr. OXLEY. Thank you, Mr. Chairman. And thank you for calling this hearing.

I think the presence of the Chairman and the ranking member of the full Committee indicate how concerned we are about the whole process and that this rarely occurs. And I do think it does point out some concerns that we have, particularly because it does appear that the regulators have different opinions on this.

Certainly, the last hearing reflected that. And subsequent events have also indicated a fissure within the regulating community here. And obviously, there are some concerns on this side of the dais as well.

I am going to ask unanimous consent that my formal statement be made a part of the record, Mr. Chairman.

Chairman BACHUS. Without objection.

Mr. OXLEY. But only to say that I echo some of the concerns that the gentleman from Massachusetts brought up in regard to the substance, as well as the process going forward. This is a big deal. And the decisions ultimately will reflect and affect the financial system in this country for a long, long time.

And it is critical that we get it right, not just from the banking perspective, but a number of non-banking perspectives as well. I notice we have, on the second panel, some testimony from the Bond

Market Association, which would indicate that there are some folks that have, perhaps, some opinions as well that are not technically in the banking community.

So this has a broad reach and a long effect, a long-term effect on our markets and our banking system. And that is why I applaud the Chairman for his diligence in this.

We thank him for scheduling a markup on the Oxley-Frank legislation. And I think it does reflect some of the very sincere concerns that many of us have.

We have a great deal of respect for Mr. Ferguson and for the Fed and for their distinguished leadership. It does appear that there is a difference of opinion on this issue. And we need to make certain that, at the end of the day, we have a unified position from this side before going forward.

And with that, I yield back the balance of my time.

[The prepared statement of Hon. Michael G. Oxley can be found on page 60 in the appendix.]

Chairman BACHUS. Thank you.

Mrs. Maloney?

Mrs. MALONEY. I thank the Chairman for holding this second hearing on the Basel II Capital Accord. For more than a year now, I have been closely following the progress of Basel II.

I participated in the earlier hearing. And I have met with regulators and bankers. After all this discussion, I still believe there are significant issues appropriate for congressional review. As early as last August 14, I wrote the regulators about this issue. And I believe that many of my concerns expressed then are still relevant. I remain concerned about the inclusion of operational risk in Pillar 1. And most importantly, I want to know more about what the ultimate impact of the accord will be on U.S. competitiveness.

As a New Yorker, I am very aware of the contingency planning effort that financial institutions are taking for physical attacks. I want to be reassured that investments and business continuity planning, backup systems and insurance will not be reduced because institutions have to devote resources to capital charges for operational risk.

From an international competitiveness standpoint, the U.S. is fortunate that we have the opportunity today to receive testimony from probably the most sophisticated and most professional group of financial service regulators in the world. In each country where Basel II is applied, the domestic regulators will ultimately be responsible for the compliance of the in-country institutions.

Not every country has as distinguished a group of regulators as the U.S. And I fear that differing levels of application by various international regulators of such an enormously complex proposal could affect the competitiveness of our industry and have an impact on all of our constituents and our economy.

For these reasons, I am pleased to have joined Chairman Bachus, Chairman Oxley and Ranking Member Frank in introducing H.R. 2043, the United States Financial Policy Committee for Fair Capital Standards Act. This legislation takes a balanced approach to ensuring a unified U.S. position at Basel and a full study of the effects of the accord on our domestic industry.

I look forward to the markup in July. And I look forward to working with the Chairman on this proposal. And I thank him again for making it a priority of this Subcommittee.

And as I said, I am highly, highly concerned about the impact of Basel on the competitiveness of our financial institutions, our financial system. We should not do anything that would place the United States at a disadvantage by having a higher capital standard for U.S. institutions.

I yield back.

Chairman BACHUS. Gentleman from Pennsylvania is recognized.

Mr. TOOMEY. Thank you, Mr. Chairman. I just want to briefly second the comments generally that the gentlelady from New York just made. One of my concerns is that we have the most robust, in some ways most aggressive and most effective regulatory framework for financial institutions arguably in the entire world.

We also have some of the most competitive and most successful financial institutions in the world. And I am a little bit concerned about one specific aspect of the proposed capital requirements.

And that would be that we would use a Pillar 1 approach for operational risk, which strikes me in many ways more appropriately dealt with under the Pillar 2 approach. And I am concerned that if we go with the Pillar 1 specific capital requirement, we would in fact be placing our financial institutions, extremely well regulated, extremely successful in a variety of ways, at a competitive disadvantage to other financial institutions.

So I hope we get a chance to explore that issue at this hearing today. And I thank you for conducting this hearing, Mr. Chairman.

Chairman BACHUS. Mr. Davis, do you have an opening statement? All right. Thank you.

Ms. Kelly or Mr. Hensarling? All right.

If there are no further opening statements, at this time I want to welcome our first panel of distinguished witnesses. From my left to right, they are: the Honorable Roger W. Ferguson, Jr., Vice Chairman, Board of Governors of the Federal Reserve System; the Honorable John D. Hawke, Jr., Comptroller, Office of Comptroller of the Currency; the Honorable Donald Powell, Chairman of the Federal Deposit Insurance Corporation; and the Honorable James E. Gilleran, Director, Office of Thrift Supervision.

I would like to commend you gentlemen on your work to date on the Basel Agreement, Basel II, and for the attention you have paid to this issue. I think there have already been positive changes in the U.S. position. We applaud those.

I note from your testimony today, Vice Chairman, that you indicated further movement on the real estate issue, and I commend you for that.

At this time, we will start with Vice Chairman Ferguson. We welcome your testimony. You will not be limited by the 5-minute rule. And I am sorry that some of you may not have received that message earlier. I apologize for that.

STATEMENT OF HON. ROGER W. FERGUSON, JR., VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. FERGUSON. Chairman Bachus, members of the Subcommittee on Financial Institutions and Consumer Credit, Chairman Oxley, Ranking Member Frank, thank you for inviting me to testify on behalf of the Federal Reserve Board on Basel II and H.R. 2043.

I will be brief. But I ask that my entire statement be included in the record.

The development of Basel II over the past 5 years has been transparent and has been supported by a large number of public papers and documents on the concepts, framework and options, as well as by a large number of meetings with bankers. Over the past 18 months, I have chaired a series of meetings with bankers, often jointly with Comptroller Hawke.

The banking agencies last month held three regional meetings with banks that would not, under the U.S. proposal, be required to adopt Basel II, but may have an interest in choosing to do so. The comment period for the third Basel consultative paper, sometimes called CP-3, is now in progress.

And in about a month, the banking agencies in this country hope to release an advance notice of proposed rulemaking, so-called ANPR, that will outline and seek comment on specific proposals for the application of Basel II in this country. We continue to be open-minded about new suggestions, backed by evidence and analysis, and approaches that simplify the proposal, but still attain its objectives.

When the comments on CP-3 and ANPR have been received, the agencies will review them and meet to discuss whether change are required in the Basel II proposal. In November, we have scheduled to meet in Basel to negotiate our remaining differences.

Realistically, this part of the schedule may be too tight because it may not provide U.S. negotiators with sufficient time to digest the comments on the ANPR and develop a national position to present to our negotiating partners. Some slippage in the schedule will no doubt occur.

Implementation in this country of any final agreement on Basel II would require a notice of proposed rulemaking, an NPR, in this country in 2004 and, of course, a review of comments from that notice of proposed rulemaking. Additional quantitative impact studies starting in 2004, and probably conducted for the next 2 years, will also be necessary so we can be more certain of the impact of the proposed changes on individual banks and the banking system.

As it stands now, by the fall of 2004, core and opt-in banks will be asked to develop an action plan leading up to final implementation. Whenever a final rule is developed, in 2004 or in 2005, there would be at least a 2-year lag before implementation.

Within that implementation interval, the large banks to which Basel II will be applied in this country will be developing their individual bank implementation work plans in conjunction with their supervisor. As you know, most of the banks in this country will remain under the current capital rules. No bank that will be required or chooses to adopt the new capital accord would be forced into a regime for which it is not ready.

To be sure, supervisors will expect a formal plan with a reasonable implementation date from the latter banks once a final rule is developed. But no bank will be required to adopt Basel II if it has not yet built the required infrastructure.

At any time during that period, we can slow down the schedule or revise the rules if there is a good reason to do so.

Mr. Chairman, you have asked for the Board's views on H.R. 2043. We understand and support the bill's objective, to ensure that the people sitting at this table work together cooperatively and that all of us shape our positions, especially at Basel, with a full understanding of the likely effects of any decisions on our economy.

With respect, however, the Board believes that the current process achieves those goals and that legislation is not necessary.

Moreover, H.R. 2043 could be counterproductive. In the Board's view, the agencies have demonstrated their ability to work together, one must admit sometimes not as smoothly as perhaps others would like.

But also, we have demonstrated our ability to change our minds on the basis of evidence and persuasion, as you have indicated, Mr. Chairman, in your opening remarks. The bill would reduce our ability to negotiate with our foreign counterparts, eliminate the room for us to disagree and work out our differences and involve Congress in technical supervisory and regulatory issues that are probably better left to the supervisors.

Obviously, of course, we recognize the appropriate interest and role of Congress in aggressive oversight. And in that regard, I am obviously pleased to be here.

Let me now turn to three other issues that have been raised about the current Basel II proposal. The first is competitive equity.

While this concern takes several forms, the most frequently voiced is the view that competitive imbalances might result from what is called a bifurcated set of rules, requiring Basel II for large banks, while applying the current capital rules for all other U.S. banks.

The fear is that the banks that remain under the current capital rules, with capital charges that are not as risk sensitive, might be at a competitive disadvantage compared to Basel II banks that would get lower capital charges on less risky assets.

We take this concern seriously and will be exploring it through the ANPR. But without prejudging the issue, there are reasons to believe that little, if any, competitive disadvantage would be brought to those banks remaining under the current capital regime.

The basic question is the role of minimum regulatory capital requirements in the determination of the price and availability of credit. Our understanding of bank pricing is that it starts with the capital allocations that the banks themselves make internally, within their own organizations, then factors in explicit recognition of the riskiness of the credit and is then further adjusted on the basis of market conditions and local competition from bank and non-bank sources.

In some markets, some banks will be relatively passive price takers. In either case, regulatory capital is mostly irrelevant in the pricing decision and therefore, unlikely to cause competitive disparities.

Moreover, most banks—and especially the smaller ones—hold capital far in excess of regulatory minimums for various reasons. Thus, changes in their own or others' minimum regulatory capital, as might occur under Basel II, probably would not have much effect on the level of capital they choose to hold and would therefore not necessarily affect either internal capital allocations or the resulting pricing.

Finally, the banks that most frequently express a fear of being disadvantaged by a bifurcated regulatory regime have for years faced capital arbitrage from larger rivals, who are able to reduce their capital charges by securitizing loans, for which the regulatory charge was too high relative to the market or economic capital charge.

The advanced versions of Basel II to be adopted here would provide, in effect, risk-sensitive capital charges for lower-risk assets that are similar to what the larger banks have, for years, already obtained through capital arbitrage. In short, competitive realities between banks might not change in many markets in which minimum regulatory capital charges would become more explicitly risk sensitive.

Now I do not mean to dismiss competitive equity concerns. Indeed, I hope that the comments on the ANPR bring forth insights and analyses that respond directly to the issues, particularly the observations that I have just made.

But to take a different view, we need to see reasoned analysis, and not just assertions.

The second area of concern that I would like to focus on is the proposed Pillar 1 treatment of operational risk. Operational risk refers to losses from failures of systems, controls or people.

Capital charges for such risks have been implicit under Basel I for the last 15 years. These risks will, for the first time, be explicitly subject to capital charges under the Basel II proposal. Operational disruptions have caused banks to suffer huge losses and, in some cases, failures—both here and abroad. My written testimony provides some recent and familiar examples.

In an increasingly technologically-driven banking system, operational risks have become an even larger share of total risk. At some banks, they are indeed the dominant risk.

To avoid addressing them would be imprudent and would leave a considerable gap in our regulatory system. The Advanced Measurement Approach—or the so-called AMA approach—which I am sure we will discuss further, for determining capital charges and operational risk, is a principles-based approach that would obligate banks to evaluate their own operational risks in a structured but flexible way.

Importantly, a bank could reduce its operational risk charge by adopting procedures, systems and controls that reduce its risk or by shifting the risk to others through measures such as insurance. Some banks, for which operational risk is the dominant risk, oppose an explicit capital charge and would prefer the operational risk be handled case by case through the supervisory review of buffer capital under Pillar 2 of the Basel II proposal, rather than being subject to an explicit regulatory capital charge under Pillar 1.

The Federal Reserve believes that would be a mistake because it would greatly reduce the transparency of risk and capital that is such an important part of Basel II. It would lessen potential market discipline and would make it very difficult to treat risk comparably across banks because Pillar 2 is judgmentally based.

The third concern I would like to discuss is the fear that the combination of credit and operational risk capital charges for those U.S. banks that are under Basel II would decline too much for prudent supervisory purposes. Speaking for the Federal Reserve Board, let me undermine that we could not support a final Basel II that caused capital to decline to unsafe and unsound levels at the largest banks.

There will be several stages before final implementation, at which resulting capital levels can and will be evaluated. At any of those stages, if the evidence suggests that the capital were declining too much, the Federal Reserve would insist that Basel II be adjusted or recalibrated, regardless of the difficulties with bankers here and abroad, or with supervisors in other countries.

But let us keep this in mind: supervisors can achieve their objective of maintaining the same level of average capital in the banking industry either by requiring that each bank maintain its Basel I capital levels or by recognizing that there will be some divergence levels of capital among banks because they will be dictated by different risk profiles of the banks.

To go through the process of devising a more risk-sensitive capital framework, just to end with the Basel I result in each bank, is pointless. Greater dispersion in required capital ratios, if reflective of underlying risk, is an objective, not a problem to be overcome.

Of course, one must also recognize that capital ratios are not the sole consideration. The improved risk measurement and management and its integration into the supervisory system under Basel II are also critical to ensuring the safety and soundness of the banking system.

Let me just say, by way of conclusion, that the Basel II framework is the product of an extensive, multi year dialogue with the banking industry, regarding evolving best practice risk management techniques in every significant area of banking activity. Accordingly, by aligning supervision and regulation with these techniques, it provides a great step forward in protecting our financial system and those of other nations to the benefit of our own citizens.

We now face three choices. We can reject Basel II or we can delay Basel II as an indirect way of sidetracking it. Or we can continue the domestic and international process, using the public comment and implementation process to make whatever changes are necessary to make Basel II work effectively and efficiently.

The first two options require staying on Basel I, which is not a viable option for our largest banks. The third option recognizes that an international capital framework is in our self interest, since our institutions are the major beneficiaries of a sound international financial system.

The Fed strongly supports the third option.

I will be happy to respond to questions. Thank you, Mr. Chairman.

[The prepared statement of Hon. Roger W. Ferguson can be found on page 82 in the appendix.]

Chairman BACHUS. I appreciate that.

Comptroller Hawke?

STATEMENT OF JOHN D. HAWKE, JR., COMPTROLLER, OFFICE OF THE COMPTROLLER OF CURRENCY

Mr. HAWKE. Thank you, Chairman Bachus, members of the——

Chairman BACHUS. Is the microphone on?

Mr. HAWKE. It is the job of the Fed to help the OCC.

[Laughter.]

Chairman BACHUS. That was the Vice Chairman that turned your microphone on.

Mr. HAWKE. Again, I think it reflects on the fact that they have an unlimited budget and they can study things like this.

[Laughter.]

Chairman Bachus, thank you, Chairman Oxley, Ranking Member Frank and members of the Subcommittee. We appreciate the opportunity to participate in this hearing. And I very much welcome the interest and involvement of the Subcommittee in these important issues.

I want to assure the Subcommittee that the OCC, which has the sole statutory responsibility for promulgating capital regulations for national banks, will not endorse a final Basel II framework for U.S. banks until we have determined, through our domestic rulemaking process, that any changes to our capital regulations are practical, effective and in the best interests of the U.S. public and our banking system.

In response to a point that Ranking Member Frank made in his introductory remarks about who is in charge here, I think it is important to recognize that Congress has clearly allocated to each of the federal banking agencies responsibility for overseeing the capital of banks within their jurisdiction and for adopting capital regulations. The Fed has authority over bank holding companies and state member banks; the FDIC over state non-member banks; and the OCC over national banks. So it is up to each of us, in the final analysis, to make our own decision. But the need for achieving agreement among the agencies, I think, is recognized by us all.

My written testimony provides a detailed discussion of the background and content of Basel II and the important issues with which this Subcommittee is properly concerned. I would like to use this time to make several important points that may help to put today's testimony into proper focus.

First, all of the U.S. banking agencies share a concern about the potential effect of Basel II on the capital levels of large U.S. banks. Our banking system has performed remarkably well in the difficult economic conditions in recent years, and I believe that is due, in significant part, to the strong capital position our banks have maintained. While a more risk-sensitive system of capital calculation might be expected to have the effect of reducing the capital of some banks, we would not be comfortable if the consequence of

Basel II were to bring about very large decreases in required minimum capital levels.

By the same token, if Basel II were to threaten significant increases in the capital of some banks, it could undermine support for the proposal itself and might threaten the competitiveness of those banks. As things stand today, we simply do not have sufficiently reliable information on the effect of these proposals on individual institutions or on the banking industry as a whole.

Before we can make a valid assessment of whether the results are appropriate and acceptable, we have to know, to a much greater degree of reliability than we now have, just what the results of Basel II will be.

The OCC believes that significant additional quantitative impact analysis will be necessary. Even if the Basel Committee does not itself undertake such a study—and I think that would be the preferred approach—I believe it is absolutely essential that the U.S. agencies make such an assessment prior to the adoption of final implementing regulations. I strongly believe that we cannot responsibly adopt final rules implementing Basel II until we have not only determined with a high degree of reliability what the impact will be on the capital of our banks, but have made the judgment that that impact is acceptable and conducive to the maintenance of a safe and sound banking system in the United States.

Second, a number of Subcommittee members have commented on differences among the U.S. banking agencies and are of the view that a new interagency coordinating mechanism is needed. Mr. Chairman, you and some of your colleagues have introduced H.R. 2043, a bill that would establish an interagency Committee whose purpose would be to resolve such differences. While I am sympathetic to the concerns that underlie this legislation, with great respect, I suggest that it is not necessary at this time.

There have, indeed, been some differences among the agencies during this process. But I believe the agencies have generally worked exceedingly well together on the Basel II project for the past 4 years, and I am confident that we will continue to do so. To be sure, we have not always agreed on every one of the multitude of complex issues that Basel II has presented, but that is no more than one would expect when a group of experts have brought their individual perspectives to bear on difficult and complex issues. Where there have been differences, we have worked our way through them in a highly professional and collaborative manner. In a few weeks, we will be jointly issuing an Advance Notice of Proposed Rulemaking, seeking broad comment on the Basel II structure, together with draft supervisory guidance for those of our banks that will be subject to Basel II. Both the ANPR and the guidance have been developed in a collaborative process in which each of the agencies has had substantial input.

I believe we agree on the need for further quantitative impact study before Basel II is finally put in concrete although I do not want to speak for Governor Ferguson on that.

I think it is probably correct to say that we at the OCC have had some reservations that the Fed does not share about the overall approach to Basel. For example, I commented in my earlier testimony about the complexity of Basel II. I have a concern about complexity because it seems to me that complexity could work toward competitive inequalities across countries, given the difference in the nature of supervision from country to country. Governor Ferguson, I think at the last hearing, pointed out that we live in a complex world and we are dealing with complex subjects, and complexity is a necessary consequence of this process.

We may have some difference of perspective on time schedule. I think the Fed wants—and I do not mean to speak for the Fed—but I think the Fed wants to adhere to the current time schedule. We certainly would like to, if it is possible. But I think we may have the view, more so than others, that achieving the present time schedule is a daunting challenge.

While we had differed on operational risk at earlier stages of this process, I want to make clear that we are completely comfortable and supportive of the treatment of operational risk under the AMA approach in Pillar 1. And I would like to expand on that just for a moment because this is such an important issue for the Subcommittee.

As the Subcommittee knows, I had argued earlier in the Basel Committee that operational risk should be treated under Pillar 2 because it involved qualitative judgments about the adequacy of internal control systems. Nobody else on the Committee agreed with that. And it was very clear to me that that view would not be accepted by the Committee.

As a result, we and the Fed worked very closely together developing the Advanced Measurement Approach to operational risk. The product of that collaboration, I think, has been very productive. We are completely comfortable that the AMA approach to operational risk imports a degree of supervisory discretion and judgment of exactly the sort that would come to bear if this had been a Pillar 2 issue. Indeed, I think that if operational risk were to be treated under Pillar 2, it would be essential for us to have a framework for the consideration of operational risk that would probably look very much like what we presently have under the AMA approach. So I do not think the Pillar 1 versus Pillar 2 issue should any longer be a matter of significant concern.

Third, as I said earlier, I think we are all committed to a process that has real integrity to it. The current Basel Committee timeline presents, as I said, a daunting challenge to both the U.S. banking agencies and the banking industry. And while it is clearly necessary to address the acknowledged deficiencies in the current Basel Capital Accord, the banking agencies must better understand the full range and scale of likely consequences before finalizing any proposal.

We have identified in our written testimony a lengthy and formidable list of critical milestones that the agencies must meet under the current Basel II timeline. They include: first, consideration by the Basel Committee itself of the comments that have been received on CP-3, its latest consultative paper. Next, the preparation and issuance by the U.S. agencies of the Advanced Notice of Proposed Rulemaking and draft supervisory guidance that goes with it, with a 90-day period for comments. At the end of that comment period, we will jointly consider those comments, analyze them, and make a judgment about the implications of those comments for the final iteration of the Basel document.

The Basel Committee is presently scheduled to meet in December, which will give us the opportunity to feed back into the Committee the results of that ANPR process. We are also going to be requesting comment in the ANPR process on the economic impact of Basel II.

Executive Order 12866 requires that we make an economic impact analysis in the case of any significant regulatory action, which is defined to mean an action that will have an annual effect on the economy of $100 million or more. We are soliciting information to enable us to determine whether that executive order will be triggered by the Basel proposal. If it is, we will conduct that economic analysis as part of this process.

After the Basel Committee issues the definitive paper, the U.S. agencies will jointly draft and put out for additional public comment the final version of the regulations that will implement Basel II. At some point during that process—earlier rather than later, I hope—we will conduct an additional quantitative impact study to determine exactly what the capital impact will be.

We will then consider all the comments that are received in the NPR process and come to a final decision as to whether we should issue the final U.S. implementing regulation and what it should look like. If we find that our current target implementation date of January 1, 2007 is simply not doable, consistent with that process—and my personal opinion is that realization of that target may be very difficult—we will take additional time. But I think it is still too early to draw that conclusion.

The important point here is that we will take great care not to let the timeframe shape the debate. If we determine that changes to the proposal are necessary, we will make those views known to the Basel Committee. And we will not implement the accord until those changes are made.

I would like to make one more point. Some have viewed the new Basel II approach as leaving it up to the banks to determine their own minimum capital essentially, putting the fox in charge of the chicken coop. I do not think that is the case by any means.

While the banks internal models and risk assessment systems will be the starting point for the calculation of capital, bank supervisors will be heavily involved at every stage of the process. We will publish extensive guidance and standards that the banks will have to observe. There will be standards set out in the Basel documents themselves. We will not only validate the models and systems that banks propose to use, but we will assure that they are being applied with integrity.

In my view, the bank supervisory system that we have in the U.S. is unsurpassed anywhere in the world, in both its quality and in the intensity with which it is applied, and we are not going to allow Basel II to change that. In fact, if we do not believe, at the end of the day, that Basel II will enhance the quality and effectiveness of our supervision, we should have serious reservations about proceeding in this direction.

Moreover, while Basel II has largely been designed by economists and mathematicians and while these "quants" will play an important role in our oversight of the implementation of Basel II, the role of our traditional bank examiners will continue to be of enormous importance. Such values as asset quality, credit culture, managerial competence and the adequacy of internal controls cannot be determined by mathematical models or formulas, nor can many of the risks that banks face be properly evaluated except by the application of seasoned and expert judgment. I can assure you that those national banks covered by Basel II will continue to be closely monitored and supervised by highly qualified and experienced national bank examiners who will continue to have a full-time, on-site presence.

I am pleased to have the opportunity to provide our views on this important initiative, I would be happy to answer any questions you may have.

[The prepared statement of Hon. John D. Hawke can be found on page 141 in the appendix.]

Chairman BACHUS. Thank you.

Chairman Powell?

STATEMENT OF DONALD POWELL, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. POWELL. Thank you, Chairman Bachus and members of the Subcommittee for your interest in the new Basel Capital Accord. I believe that Basel II ranks among the most important pieces of proposed banking regulation in our nation's history.

The FDIC supports the goal of lining up capital regulation with the economic substance of risk that banks take. Basel II encourages a disciplined approach to risk management and it addresses important weaknesses in our current capital rules. We applaud the intense and prolonged efforts that have been made to address these important issues.

Since my testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, on February 27, 2003, there has been good progress on the domestic implementation efforts. The federal banking and thrift regulatory agencies are working hard to issue an Advance Notice of Proposed Rulemaking for comment this summer. The proposed rulemaking will identify those aspects of Basel II that will be proposed for adoption in the U.S. for application to a small group of large banking organizations. At this time, we are addressing various technical issues, developing interagency guidance and conducting industry outreach.

Specifically, we have conducted outreach sessions to banking institutions of varying size at meetings held in Chicago, Atlanta and New York. We are approaching a crossroads where judgments will need to be made on some critical issues. The interagency process and the public comment period will help us reach those judgment, and I am confident that our process will result in an appropriate outcome. My written testimony provides a broad overview of some of the critical judgments that will need to be made before the agencies commit to adopt Basel II in the United States.

The first key issue is capital adequacy. The Basel II formulas allow, at least in principal, for significant capital reductions. The proposals issued by the Basel Committee specify that after a phase-in period, there would be no floor on the level of risk-based capital that banks would be required to hold.

The level of risk-based capital that banks actually hold would depend upon their own internal estimates of risk—validated by their supervisors—and on the demands of the marketplace. It is difficult to predict the ultimate effect of Basel II on overall bank capital, but we do know that the formulas are forceful tools for affecting risk-based capital requirements.

There is no question the Basel formulas will help the regulators segregate risk. But the formulas cannot stand on their own.

Banks face other risks besides credit risk and operational risk. Lending behavior can change over time, causing losses to escalate in activities perceived as low risk.

The simple fact is that no one knows what the future holds. For these and other reasons, the FDIC believes that Basel II must be supplemented by the continued application of existing regulatory minimum leverage capital and prompt corrective action requirements. I am gratified at the support that my fellow bank regulators have expressed for this conclusion.

We also understand that a leverage ratio alone cannot provide protection without the support of sound, risk-based capital rules. It will be necessary to better understand the impact of the proposals on the capital required for specific activities. Finally, maintaining capital adequacy under Basel II would be an ongoing task. Validating banks' internal risk estimates would be a challenge. Doing so consistently across agencies would be a greater challenge, for which an interagency process would be needed.

The other key issue is competitive equity. Basel II has been expected to provide some degree of regulatory capital relief. The banks that stand to be directly affected by Basel II have expressed strong support for such capital relief. They have expressed concern where they believe Basel II capital was too high.

The key policy question is: what economic benefits and costs would come with changes in regulatory capital requirements? Would the economic benefit of lower risk-based capital requirements for large banks enhance their competitive posture or accelerate industry consolidation?

We recognize there are differences of opinion about the importance of competitive equity issues, and that is why we need to pay close attention to the comments we receive on this issue. The agencies received a number of comments on both sides of this issue at recent industry outreach meetings, and this dialogue will continue.

With respect to proposed House legislation, the FDIC appreciates the goal of H.R. 2043, "The United States Financial Policy Committee for Fair Capital Standards Act." We share in Congress's desire to ensure that uniform U.S. positions are developed and communicated to the Basel Committee. However, we do not believe that H.R. 2043 is the best means to accomplish this end. The legislation would, in effect, move the important task of capital regulation away from the agencies with decades of experience in this arena to the United States Treasury Department.

This could compromise the independence of the federal banking regulators and impair our ability to handle an important function of prudential regulation at a particularly sensitive time.

As our testimony indicates, we are working with the other regulatory agencies to develop interagency positions regarding the domestic application of Basel II. The bank regulatory agencies are actively engaged in an almost daily dialogue on issues and concerns. We will take whatever time is necessary to seek input from all interested parties prior to the final adoption of the new framework in the U.S., especially the concerns of banks that may feel they will be disadvantaged in competing with Basel II banks.

In short, the ingredients for the success of Basel II continue to be: one, appropriate minimum capital standards; two, a consistent approach to validating banks' risk estimates; three, an adequate vetting of competitive issues; and four, time to address these and other policy issues as we finalize our views on this new Accord.

We will continue to work closely with our fellow regulators to work through these important issues and reach the right conclusions. We are committed to evaluating the cost and benefits of the Basel II proposal and their impact on the U.S. banking industry and the safety-and-soundness of the financial system. Thank you for the opportunity to present the views of the FDIC.

[The prepared statement of Hon. Donald Powell can be found on page 167 in the appendix.]

Chairman BACHUS. All right.

Director?

Thank you. Thank you.

Mr. Gilleran, I am sorry.

STATEMENT OF JAMES GILLERAN, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. GILLERAN. Mr. Chairman, Ranking Member Frank, thank you for including me in this panel.

Chairman BACHUS. I think we have a microphone problem.

Mr. GILLERAN. I think all of the concerns that I have—the OTS has—have been already expressed. So I will just make some general comments before we turn it over to questions. I would ask that my written comments be included in the record.

Up until this time, the OTS has not been involved in the international accord efforts, even though we have had people who have been involved in Subcommittee work here in the United States. Bill McDonough did invite me to attend the last Basel meeting as an observer, which I did.

And subsequently, I have asked the replacement for Mr. McDonough as head of the Basel Committee, who is now the head regulator in Spain, for an official seat on the Basel Committee. And I am told that that is a definite possibility for the future.

I think it is important that the OTS be included as a full voting member on Basel because of the OTS unique focus on the mortgage industry. And our interest is, number one, to share with others our perspective on mortgage lending here in the United States and internationally, since at least one of our major thrifts will be included within the Basel Accord, if it is adopted.

And we also have a focus on interest rate risk that is unique in the industry. And each quarter, we mark to market our entire industry, from an interest rate-risk point of view. So I think that

that also is a contribution to the understanding of interest rate and the whole subject of risk and capital.

My own personal views on Basel are that I believe that the Basel work to date has moved the ball forward in terms of understanding the relationship of risk and setting capital. Basel I was a simple method, but very effective really, since it was first adopted because Basel I capital has held up very well over very tumultuous economic times.

And it has produced capital levels that are now viewed as being quite substantial. And in fact, the financial services industries have just completed 2 years of probably the best results it has ever had. And in addition, this year looks awfully good too.

So Basel I has functioned well, even though I think that almost everybody would admit that if we just stayed with Basel I, we would want to make additions to it, so that it takes into consideration more of the kinds of differentiation of risks that we now have in the financial services industry. So I completely support the fact that we would have to do additional work on Basel I if that was the only thing that we had.

It has been expressed here that Basel II would only be applicable to 10 of the major international banks in the United States and perhaps 10 others who will opt in. I have received information from a number of people that there will be literally hundreds of other banks that will make application to the regulators to be able to use Basel II because I think it is perceived that Basel II will result in lower capital levels.

And I think everybody—almost everybody—concludes that lower capital levels will mean greater competitiveness. It is also an issue too in connection with what happens to the community banks in the United States.

Because if the major banks are allowed to have lower capital levels but the community banks will continue with higher capital levels under Basel I, then that will mean that they can be acquired, quite simply, by the major banks. And we will have a further roll-up of the community banking system here in the United States. And that has to be evaluated by Congress, along with everything else, as to whether or not that is a good thing to have happen.

So I believe we have to do a lot of work. I believe a lot of work has been done.

I salute those who have really been working on it so hard in the past. We intend to be part of it going forward in the future. And I believe that your attention to this matter is very well deserved.

Thank you for inviting me. I look forward to questions.

[The prepared statement of Hon. James E. Gilleran can be found on page 114 in the appendix.]

Chairman BACHUS. Thank you. At this time, we will start questions.

And Vice Chairman Ferguson, my first question is, you have commented—let me read testimony from yesterday's hearing in the Senate. D. Wilson Ervin, Credit Suisse First Boston, are you aware of his testimony on Basel II?

Mr. FERGUSON. I am generally aware of it. But it would certainly be helpful for you to read the quote that you want me to respond to.

Chairman BACHUS. He said the proposed accord is not a minor refinement to the banking regulatory process, but is instead a wholesale reform of bank regulation, a regime that covers roughly $2 trillion of capital and is a key economic engine. Do you agree with that?

Mr. FERGUSON. I believe that what the proposed accord is doing is to catch up with where the leading edge banks are. So yes, it is a change. It is a change from Basel I, without question.

We have to move from Basel I because we believe it is no longer appropriate for our largest banks. It does not give good signals on the risks that they are undertaking. I do believe it is a major change, yes.

It is, however, a change that is catching up with what the leading edge banks are doing. The ideas embedded in Basel II are not things that we, as regulators, thought up independently from the industry. It is a catching up to where the industry is.

But yes, it is a major change.

Chairman BACHUS. All right. What I guess I am having trouble seeing is—and you said that Basel II is an acknowledgment of what the largest banks are doing today.

Mr. FERGUSON. What the leading edge largest banks are doing—not all of them, but what many of them are doing.

Chairman BACHUS. Many of them. And your part of your testimony—is designed to have a regulatory capital system that reflects what the largest banks are doing today. And I think Senator Sarbanes asked you. And you saw it as just an acknowledgment about what they were doing today.

You mean what they need to be doing today or what they are doing today?

Mr. FERGUSON. I am trying to use the word “leading edge.” Out of the many banks that we have, there are some—not all, some—that are using the kind of quantitatively-driven approaches to estimating their own internal capital, economic capital, getting a much better feel for the risks in their lending behavior, their credit behavior.

Importantly, we had a discussion at the Federal Reserve Bank of New York about 10 days ago, almost 2 weeks ago now, where we saw again some leading edge banks are doing exactly the same kind of quantified approach to operational risk that is being proposed under the AMA. So both on the credit risk side and the operational risk side, there are examples of banks that are moving very much in this direction.

There are some large banks that I think are further behind, some that are further ahead. So it is a validation, in a sense, that we reflect, and we encourage banks and give them incentives to continue to move in this direction. And we think it is quite doable because there are a number of banks that have already started to move in this direction.

It still will require the, supervisory validation of the databases that they use, the approaches that they use to quantify. So as my colleague, Comptroller Hawke has indicated, there is still a great deal of room for supervisory oversight to guarantee that what comes out seems appropriate.

And, it is important to recognize that the information that the banks provide is an input to formulas that the supervisors put forward. So that ultimately, it is the supervisors and the supervisory approaches and formulas that determine the capital.

Chairman BACHUS. Let me ask you this. The same gentleman testified that the current Basel proposal is unnecessarily complex and costly. But you are actually saying that——

Mr. FERGUSON. I am the first to admit that it is complex. I am not denying in any sense the complication here.

I think it is too simple to say that, in my view, it is complex because we live in a complex world. That is partially true. But that is——

Chairman BACHUS. Can you tell me some banks that would comply with this today? You say that some of the leading edge banks already are?

Mr. FERGUSON. Well, would comply with every component of it today? I am not sure there are any banks that would comply with every component.

Chairman BACHUS. With the major components.

Mr. FERGUSON. There are a number that are moving in this direction relatively quickly. I am a little cautious here to give out confidential information. But I will assure you that there are some banks that we have looked at. And we are comfortable that, certainly by the implementation date, they will be ready.

Chairman BACHUS. But all your major banks today——

Mr. FERGUSON. I am sorry, sir?

Chairman BACHUS. All your major banks today are sound.

Mr. FERGUSON. This is not a question of sound——

Chairman BACHUS. I understand that. But their own models show that several of them are going to have to raise significant amounts of capital. Do you disagree with their models?

Mr. FERGUSON. That they are going to have to raise capital? I think what will happen is that some will find that their regulatory minimum capital goes up. Some will find that the regulatory minimum——

Chairman BACHUS. Right. Some go up, some go down. But for those that go up——

Mr. FERGUSON. But that is not a bad sign. It means that their regulatory capital is going to reflect what many of them already recognize as what they need to hold internally.

I do not think there are any banks that are going to have to go out and raise new capital. They will simply have regulatory capital that is adjusted either up or down. But it is not inconsistent with their own view, necessarily, of their risk.

Chairman BACHUS. Okay. All right. Let me ask you this. This is probably, maybe, the most important question I will ask you today.

Comptroller Hawke and Chairman Powell said that we will take whatever time necessary to reach a consensus. Do you agree with that statement?

Mr. FERGUSON. I do. As Comptroller Hawke was describing areas of agreement and disagreement, I sent him a little note and perhaps a little body language that suggest otherwise. But I think we are in close agreement on exactly that point.

I have said in my opening statement here that the original timetable of trying to meet in November is unreasonable at this stage, and seems likely to slip. He described it as daunting. I would not have made it to this table if I were not prepared to take on a daunting challenge, so I am not intimidated by it.

But I know we will have a lot of work to do. I am cautiously optimistic that we will get to the end of the year and have plenty of time to look at the comments, listen to the comments and respond to them, and develop a negotiating position.

If it turns up that we cannot, then we will take the time required.

Chairman BACHUS. Okay. So we do not have—there is no deadline out there. We cannot say we have to do it by a certain——

Mr. FERGUSON. Let me be very clear. As with anything in life, there are cost and benefits. It is appropriate to get the benefit of taking a sufficient amount of time, sir. But it is also important for all of us to recognize that there are great costs of uncertainty to our banks.

There are a number of banks that want to know where they should be investing, what kind of databases are required. So we have to move ahead as expeditiously as possible, in order to minimize the uncertainty in the banking industry.

This is not a matter to take lightly on either side. It is not a matter to rush into and ignore the comments, which we would not do. Nor is it a matter to go too slowly and leave uncertainty in the banking industry. Having seen 4 to 5 years of consultative papers, outreach meetings, quantitative impact studies, they are asking for a certain amount of certainty.

And one of the things that you certainly will have seen, because you followed yesterday's testimony as well, while there are a range of views, when it is wrapped up, everyone recognizes that we need to move off of Basel I, both on the first panel and the second.

I think Senator Sarbanes asked the question, in which the agreement was yes. Everyone recognizes that we need to move to a framework that is quite like Basel II, without question.

There is still room to discuss a lot of the details. But the concept of moving in this direction is well accepted, both by the regulators and, I think, in general the private sector.

And we have to be careful not to slow it down unnecessarily, slow it down enough to listen to the comments, but not unnecessarily to the point that we are leaving uncertainty in the banking industry and leaving our largest banks on an old accord that we know has passed its useful life, as far as the largest banks are concerned.

Chairman BACHUS. Thank you.

Ms. Maloney? Mr. Frank, I am sorry.

Mr. FRANK. Thank you, Mr. Chairman. I know there has been frankly some effort to say that there really is agreement and you are all going to be able to work this out.

But I would just make a suggestion to you. If this is an agreement, if you guys ever disagree, sell tickets, because it will be a hell of a show.

Mr. Powell on June 9th said in a memo that we have, "The framework is being rushed into place with discussions of significant alternatives now virtually ruled out by the timeline and by the international collaborative nature of the project." You do say, in a generous show of courtesy, you acknowledge the recognition by Vice Chairman Ferguson that this may, indeed, be the case.

You know, virtually anything may indeed be the case in this world. But then Mr. Ferguson expressed his view that this great rush to judgment may indeed be the case, in his answering memo, by saying, "The Fed believes it is important to move on to the next step in an international process that has already created too much uncertainty."

I mean, there is clearly more disagreement here than people are acknowledging. And I do not understand what you think you gain by that. And I understand there are some constraints and let's be polite.

But I have to say, Mr. Ferguson, you lose some credibility with me when you say, "We are all together here." There seems to be much more disagreement.

I do have a couple of specific questions.

Mr. Hawke, you say that when you were for Pillar 2 instead of Pillar 1, you were the only member of the Committee who felt that, so you were outvoted. Mr. Powell, did you have a horse in that race between Pillar 1 and Pillar 2?

Mr. POWELL. I did not.

Mr. FRANK. You did not. So Mr. Hawke, you were outvoted one to one.

Mr. POWELL. I am sorry?

Mr. FRANK. Then Mr. Hawke was outvoted one to one. I mean, there were three federal agencies on this. You did not have a vote.

Mr. POWELL. I came into the process late. But I would have to refer to some of our folks that were in the process. But I think we were in support of Pillar 2.

Mr. FRANK. You were for Pillar 2? And Mr. Hawke, you were for Pillar 2. And Mr. Ferguson was for Pillar 1. So Pillar 2 lost one to two.

Mr. HAWKE. Pillar 2 lost, Congressman Frank, in the Basel Committee. Pillar 2 lost by——

Mr. FRANK. Oh, not within the United States, but internationally, is that?

Mr. HAWKE. Yes.

Mr. FRANK. Okay, so the United States position——

Mr. HAWKE. I made that argument in the Basel Committee.

Mr. FRANK. I was not clear about that. The other question I would have for the gentleman from the OTS, you said you were asked to be made a voting member of the Basel Committee.

Mr. GILLERAN. I was not a voting member, no. Not.

Mr. FRANK. You said you had asked to be one.

Mr. GILLERAN. Yes.

Mr. FRANK. Well, who are the voting members of the Basel Committee. Are the other three? I mean, there is an international Basel Committee. You are all voting members. I am now unclear.

Mr. GILLERAN. There are three U.S. members.

Mr. FRANK. What?

Mr. GILLERAN. One is the head of the New York Fed. And then there is a Washington——

Mr. FRANK. Excuse me, are you asking to be a voting member of the International Basel Committee or the American Basel Committee?

Mr. GILLERAN. I would like to be either. But I will take the U.S.

Mr. FRANK. So you are asking to be a voting member of the U.S. Committee. But they do not seem to count the votes. I mean, that is like—I do not know why you want to vote.

Then I continue to be perplexed by this. And let me ask, Mr. Ferguson, both Mr. Powell and Mr. Hawke seem to have severe reservations about the current timeline. At least, that is—can you tell us that until they agree, their agencies agree that we are ready to go, that we are not going to go? Is that something we can——

Mr. FERGUSON. I can tell you that. Yes.

Mr. FRANK. Okay. Then let me ask you another question. And I understand, Mr. Powell, you make a point about getting Treasury into it. And that is something I will think about.

But I still have to say, this is the most incoherent decision making process I have encountered on very important issues. And by the way, who will it be up to to make him a voting member?

Do you know? You said you talked to the guy from Spain. I mean, is he deciding who is a voting member in America?

Mr. GILLERAN. Right. Well, he is the Chairman of the Basel——

Mr. FRANK. But does he decide who gets a vote in the United States?

Mr. GILLERAN. He has a vote. And he is now Chairman. So he will determine when other countries and whether or not——

Mr. FRANK. But what is his input into whether you get a vote in the United States Committee? I mean, I thought you said you were trying to get to be a voting member of the U.S. Committee. And we are going to ask a guy from Spain to do that?

Mr. GILLERAN. Well, I did.

Mr. FRANK. That is why I think we need some clarity.

Now Mr. Ferguson, one substantive question. I understand one of your arguments has been—and I appreciate the willingness you have had to meet with us and talk and explain these things. I mean, it can be frustrating because these are complicated and we do not ever know as much about them as you do because of the difference in our focus of attention—and maybe even our attention span, but I will speak only personally there.

On the question, you have said, well, the amount of capital may not be that much. It would not be necessarily increased. But there is a big gain in transparency.

And you and I have had this conversation, that you said that you thought some of the institutions, while they might now have capital, have not been transparent about it. I relayed that concern to some of the institutions that had raised this with me.

And I am told that one of them, State Street Bank, said that they would be willing to work on ways to increase the transparency of the capital. And that did not seem to resonate much.

So are there not ways or are there ways that we could require these institutions—talking about operational risk now—to increase the transparency of the capital that might be helpful here? And I was frankly—I encouraged them to go and talk to you about that.

And the impression I got was that they did not think this really meant as much to you as I had thought it did.

Mr. FERGUSON. Transparency always means a great deal to me. And there should not be any doubt about it.

And yes, the institution that you talked to called me the other day to say they would be interested in pursuing ways to have more transparency. Recognize the benefits of Pillar 1, which is what we are talking about, versus Pillar 2 are in part because of transparency, not exclusively.

Mr. FRANK. Right.

Mr. FERGUSON. I am sorry, Congressman Frank, may I finish?

Mr. FRANK. I am sorry. I thought you were finished.

Mr. FERGUSON. No, not yet.

Mr. FRANK. My attention span again. I apologize.

Mr. FERGUSON. There are a number of other benefits from Pillar 1 that are important. One is that it allows for greater comparability because it is important to have framework——

Mr. FRANK. Okay. In other words, what you are saying is that even if they could resolve the transparency issue, that would not affect your view on——

Mr. FERGUSON. No, I did not say it did not have any effect on my view. What I said, Congressman, is not that it would not have an effect on my view. Obviously, it would have an effect on my view.

I think it is not the only reason to favor Pillar 1.

Mr. FRANK. Okay.

Mr. FERGUSON. And as you have heard now at this stage, the regulatory group in front of you——

Mr. FRANK. By a vote of one to two.

Mr. FERGUSON. No, Congressman Frank, that is unfair.

Mr. FRANK. How did the American—what was——

Mr. FERGUSON. It is unfair because, as I think you heard the Comptroller say, we collectively developed what we think of as a very solid middle ground.

Mr. FRANK. After he felt he had been outvoted, he said that.

Mr. FERGUSON. He had been outvoted by the entire Committee.

Mr. FRANK. But let me—if the Comptroller thinks I am misquoting him, he is free to interrupt me. I give him that permission.

The last question I have is this. You say one of the reasons for speed or for moving quickly, despite others' reservations, is——

Mr. FERGUSON. Can I interrupt you? I did not say "moving quickly." I said "reasons to move ahead."

Mr. FRANK. Okay. But you said one of the problems was the uncertainty that the financial institutions are suffering from. I just want to give you a comment.

Not a single bank has called me up and said, "Hey, I am really feeling angst here from the uncertainty. Would you move quickly?"

So you say that it is important to move quickly because you want to relieve the uncertainty of the banks. But they are calmer than you think they are.

Mr. FERGUSON. It is a good thing we have calm regulators and calm banks. I did not say "move quickly." I said to "continue to move."

Mr. FRANK. I understand. But you said a reason for progress and not as much delay.

Mr. FERGUSON. Right.

Mr. FRANK. Are you not in disagreement with your colleagues about how much delay?

Mr. FERGUSON. No, I am not in disagreement with my colleagues at all.

Mr. FRANK. Dr. Ferguson, I have to say I do not believe that. I mean, you are not leveling with us. There is clearly a difference of opinion on how quickly this ought to go.

Mr. FERGUSON. No, Congressman Frank, there is not a disagreement on how quickly this should go. We all agree that we have to put out an ANPR in about——

Mr. FRANK. Okay, well then——

Mr. FERGUSON. We all agree that we need to have a comment period. We all agree——

Mr. FRANK. Report to——

Mr. FERGUSON. Sir, may I finish?

Chairman BACHUS. Let me say this, we have actually got 2 minutes left on the floor.

Mr. FRANK. All right. I apologize.

Mr. FERGUSON. No, I think it is fair to ask questions. But I am giving you honest answers. I am not, in any sense, disagreeing with what anyone else here——

Mr. FRANK. That is not what these two memos clearly suggest.

Chairman BACHUS. Could I interject? Vice Chairman, could you—would you write Chairman Oxley and Chairman Frank a letter and just confirm what you have said this morning?

Mr. FERGUSON. That we will have a comment period?

Chairman BACHUS. That you will not——

Mr. FERGUSON. Of course.

Chairman BACHUS. That you will not move forward until——

Mr. FRANK. Mr. Chairman, I will return to listen, not to ask any questions. But I owe them. I will return after I vote to listen.

Chairman BACHUS. We will return. And we ask the panel—we will reconvene at a quarter till 12. Thank you.

[Recess.]

Chairman BACHUS. The hearing will come to order. We welcome our four witnesses back. And at this time, two of the witnesses wanted to respond to Mr. Frank. So I will recognize the ranking member for that purpose.

Mr. FRANK. I simply—both Dr. Ferguson and Mr. Gilleran had comments to make. And I, having used up my time, I hope they will get as much time as they need to respond.

Mr. GILLERAN. I just wanted to clarify the record is that the OTS is fully engaged with the other regulators here going forward in the United States. And we are a party to the ANPR that will be coming out.

And it is the international piece in Basel that I was talking about, that we have not been—had a seat at the table. I have been informed by Comptroller Hawke that Basel has never really ever taken a vote.

So you cannot be a voting member. But we would like to be at the table going forward, so that we can add our unique perspective on the mortgage market to the group.

Mr. FRANK. Dr. Ferguson may have felt that I did not give him a chance. So I apologize.

Mr. FERGUSON. I have the impression that some of my colleagues here want to deal with some of your questions.

Mr. POWELL. May I make a comment, Congressman? With regard to the different views and differences of opinions, clearly that is true.

In my short period in Washington, I have watched; there is not much consensus on very many issues. And time builds consensus. People have an opportunity to express their views.

I indeed did send that memorandum to Vice Chairman Ferguson and to Comptroller Hawke and expressed our views. And I have met with Vice Chairman Ferguson at least on two different occasions, going over some of my concerns and some of my views.

He has accepted those concerns and views in the spirit they were given. On one occasion, he called me back and said that he is doing some more study about one of the specific issues that I talked about.

I am confident—I am confident—in the process. As Comptroller Hawke mentioned, people of good will, in fact, have differences of opinion. And I think it is important that we express our differences of opinion.

But I am confident that the process will ultimately get us to a consensus. There will be give and take in this process, and as each of the panel members here have expressed, we will not be governed by the timeline just in order to make a certain timeline. Governor Ferguson, Comptroller Hawke, Director Gilleran, and I do have differences of opinion. But we have worked through other issues. And I am confident we will work through these issues.

Mr. FRANK. Let me just—you do not then feel pressured by any timeline? You feel you have adequate time to work it out?

Mr. POWELL. No, sir. I do not feel pressure in any way.

Mr. FRANK. And you will not feel pressured to give in before you are satisfied?

Mr. POWELL. Nor do I feel pressure to change my views, nor feel any pressure not to express my views.

Mr. FRANK. I have never noticed a deficiency in your willingness to deal in those regards.

Mr. POWELL. Thank you.

Chairman BACHUS. Let me clarify something. Right before we left, Vice Chairman, I asked you—in fact, Chairman Powell's statement just then sort of reminded me that he is confident. And Comptroller Hawke has said he is confident that you all will come to a consensus at some point.

And you assured us that—I believe I have heard that you have assured us that you will not sign off until there is consensus and agreement between the regulators?

Mr. FERGUSON. That is correct.

Chairman BACHUS. Now in that regard, we are talking about the same thing, and that is the international Basel agreement?

Mr. FERGUSON. Yes, that is correct.

Chairman BACHUS. Okay. Thank you.

So you will not sign the international agreement until there is.

Mr. FERGUSON. I cannot. I mean, you have to understand that the Fed is only one of the regulators here. We cannot, independently of the other regulators, move forward. We need to have exactly what you want us to have, which is a common view before we go ahead.

Chairman BACHUS. But there is a U.S. agreement on how you regulate between the regulators. There is also the international agreement which you sign.

And what I am focusing on is that you will not sign.

Mr. FERGUSON. First, there is nothing to sign. But we will not agree to anything that we are not all appropriately comfortable with.

Chairman BACHUS. Okay.

Comptroller Hawke?

Mr. FERGUSON. Are you comfortable with that, sir?

Chairman BACHUS. Yes.

Mr. HAWKE. Mr. Chairman, let me go back to the timeline of the process itself. The comment period on our ANPR closes in October. There is a meeting of the Basel Committee scheduled in December. We will take a broad range of comments that come out of that ANPR process and make an initial judgment about whether and to what extent we think changes should be made in the final document that is going to come before the Committee in December. The Committee will then put that out as the final document. The Committee, in the 4.5 years that I have been on it, has never taken a vote on anything. Things seem to get done by osmosis.

That document will be the Committee's view on the final paper. We are not obligated to apply it to U.S. banks until we complete our domestic rulemaking process that implements Basel II through our rules.

The final step in that rulemaking process will be the Notice of Proposed Rulemaking, which will come after the issuance of the Basel paper. That is when we are going to do the final quantitative impact study that will measure the impact on capital of the Basel paper. If that quantitative impact study returns information to us that suggests that the impact on U.S. bank capital is going to be unacceptable, as the Vice Chairman said, there are a number of things that we can insist on with the Basel Committee before we go final with our implementing regulations.

So there are a number of decision points along the way before we get to the very end of the line, which is the adoption of the U.S. regulations implementing Basel II.

Mr. FRANK. Mr. Chairman, would you yield to me for 30 seconds for a question? Because that is interesting to me. And I must say, my impression before the Comptroller spoke was that once the agreement was signed, our flexibility was not very great.

I mean, how much could you undo? Are you not bound by—are you talking about details? Or could you say, "Well, we do not want operational risk capital" or "We do not want this?"

Subsequent to signing, when we do our regulation, how much are we constrained by international obligation? How free are we?

Mr. HAWKE. Well, first of all, this is not a treaty where we have a legal obligation. But I think it is probably fair to say that once the Basel Committee goes out with its final paper, we either should object to it if we have fundamental reservations, or we should acquiesce in its being published. But during the subsequent domestic rulemaking proceeding and the quantitative impact study that will accompany that, we are going to have to make a very important judgment, and that is: what is the impact of this paper going to be on the capital of our banks? We have not had a reliable——

Mr. FRANK. How free will you feel to undo parts of what you agreed to?

Mr. HAWKE. Well, I would feel free if we conclude as a result of the quantitative impact study that the capital impact on our banks would be unacceptable—unacceptably high or unacceptably low to simply not implement it.

Chairman BACHUS. And that would mean, even if it resulted in some competitive disadvantages for certain banks over other banks or if it impacted specialty banks or if it impacted banks with high commercial real estate holdings.

Mr. HAWKE. Those are issues, Mr. Chairman, that I think we ought to have a better hold on at the end of the ANPR process. We are going to be receiving comment on the competitive impact before the end of this year. So we ought to be informed on those issues before we go back to the Basel Committee in December.

Mr. FRANK. Can we hear from Dr. Ferguson on that, Mr. Chairman?

Mr. FERGUSON. Let me first agree with the direction that Comptroller Hawke was going in response to your question, Congressman Frank. We should have a strong sense of agreement about the broad contours before the Committee wraps up its work, without question.

I agree with him that the proposal or the approach for next year will be to put out a notice of proposed rulemaking; to start a quantitative impact study; to get the comments from that notice of proposed rulemaking; to get the input from the quantitative impact study; to collectively make a judgment as to whether or not there is a need to go back and reopen; to do what we call recalibration, which is to adjust some of the weights in one way or the other, to make other adjustments that we think are appropriate before we sign on.

And as the Comptroller has indicated, this is not self-executing. It needs some rules here in the U.S. And before we finalize those rules, I think it is important to do the process.

Mr. FRANK. But you are assuming——

Mr. FERGUSON. And, if we need to, go back and renegotiate. And we have said that. This is not the first time we have said that.

Mr. FRANK. When you talk about the timetable, you are assuming that this would be done by the end of this year, the international agreement.

Mr. FERGUSON. As the Comptroller says, it is a daunting task. We have to work hard to see if we can get there. We will go to the December meeting with our collective reflections on the comments and lay out to our negotiating partners what the U.S. positions are. And we will see how far we can get.

The expectation, the commitment the Committee has made to the world, is that we will attempt to get some finality the end of this year. I want to try to live up to that if we can.

If it turns out that we cannot reach a consensus on the Committee, then so be it.

Let me add one other point on this. If I can take another minute to give the Committee a really clear view, because I see this is an issue of some uncertainty.

Not only is 2004 a chance where we will have a quantitative impact study. But as I said in my opening statement, there will be—I think—a quantitative impact study in 2005. There will probably be one in 2006.

At each one of those, we will get a better handle on the impact on our banks and the banking system overall. And frankly, I believe that if we have to go back and reopen and recalibrate to some degree, we have the right to do that. We have been clear that we intend to do it.

Chairman BACHUS. When you say you think that we have that right.

Mr. FERGUSON. No, we intend to do it. We have the right.

Chairman BACHUS. We do have the right?

Mr. FERGUSON. We have the right to do it. We will, if we do not like and are uncomfortable with the quantitative impact on the banks in the U.S., go back and recalibrate. Period. Full stop. Declarative sentence. I hope it is clear.

Mr. HAWKE. Mr. Chairman, can I just add one point on that?

Chairman BACHUS. Yes.

Mr. HAWKE. Up until now, the Committee itself has done three quantitative impact studies, but they have not had a final document to work against. So it has not been possible to calculate the impact of Basel II on our banks because we were dealing with a work in progress. It will not really be possible to calculate the impact until our banks get all their systems up and running and we have a fully operational system. But after the Committee comes out with the final version of the paper, we will be in a much better position to go through a quantitative impact study, that will be carefully overseen by the regulators, to make a judgment about what the impact will be. That is an absolutely essential step, in my view, and satisfactory results will be a precondition to our final adoption of the implementing regulation.

Chairman BACHUS. Thank you. And let me say this, what I am going to do at this time, Mr. Toomey, the gentleman from Pennsylvania, is going to take the chair and recognize Mr. Gilleran. He has been wanting to respond.

What we are doing, as you have noticed, is we are going to give each member remaining here 10 minutes of questioning because these are very important matters. And I think, Mr. Frank, I would agree, we have taken close to 10 minutes.

[Laughter.]

Mr. FRANK. Is 12 close to 10?

[Laughter.]

Chairman BACHUS. So what we will do is Mr. Toomey will take the chair. He will have his 10 minutes to question. Then we will go to Ms. Maloney and the other two members that are here.

And the other members that arrive after that will have 5 minutes.

Mr. TOOMEY. [Presiding.] Thank you, Mr. Chairman. At this time, I would recognize Mr. Gilleran to respond.

Mr. GILLERAN. I just want to say that Basel II is no different than Basel I as far as it relates to the authority of the U.S. supervisors to request capital and to obtain capital that they think is necessary. If Basel I came up with the calculation that the regulators disagreed with, the regulators are not bound by Basel I, in terms of the capital that is required.

And they would not be bound by Basel II in any different way. And I think it is very important to point that out, that Basel II is a technique to get to a number. But it does not bind the regulators as to what is required in any specific instance.

Mr. TOOMEY. Thank you. I would like to begin my questions following up on the question of the question of the impact on the competitiveness of American banks if we were to proceed with the Basel II proposals. And specifically, it is my understanding that the majority of the institutions that engage in the asset management operations, for instance, do not come under Basel requirements at all. It does not apply to them.

And in addition, it is my understanding that the actual capital required by the market for the conduct of this business is considerably less than what the Pillar 1 requirement under Basel II would impose. So I guess my first question for either Mr. Ferguson and/or Mr. Hawke would be, number one, does this discrepancy between what the market requires and what the Basel proposal proposes, does that suggest a flaw in the requirements?

And secondly, if we were to adopt this Pillar 1 requirement, wouldn't that put our American institutions at a significant competitive disadvantage and have all the unintended consequences that flow from that, including creating incentives to push this business elsewhere to avoid this capital requirement?

Mr. FERGUSON. Was that question addressed to me, sir?

Mr. TOOMEY. Actually, if you and Mr. Hawke would both address the question, I would appreciate that.

Mr. FERGUSON. Okay. Well, I hope we get the same answer.

First, we will be asking questions about the competitive impact broadly. And it will include, by implication, the kinds of issues that you have just raised. So we will get the facts, as far as the industry sees them.

Secondly, I would say, recognize that there are already bank and non-bank participants in the asset management activity. As far as I can tell, the capital requirements are probably slightly different because the market has slightly different requirements versus what the banks have to hold.

There are reasons that we have capital requirements for banks, obviously, because they are regulated institutions. They have access to a variety of things that deal with the safety net. And so as we think about the competitive differences, we have to calibrate it against what currently exists, as opposed to an ideal world.

To try to respond to a technical question, just to make sure you understand what the accord calls for, it calls for capital with respect to the credit elements of the asset management activity. Insofar as a bank that is an asset manager makes a loan as part of that activity, that would require capital.

General asset management as an activity does not, I believe, attract capital. And the way that gets calculated will depend very much on the inputs, the probability of default, et cetera, that are involved.

Mr. TOOMEY. I may have misspoke. I was referring to the operational activities generally.

Mr. FERGUSON. Oh, operational activities generally. Oh, I am sorry. So your issue then is about operational risk.

Mr. TOOMEY. That is right.

Mr. FERGUSON. Oh. I thought you said asset management.

Mr. TOOMEY. I am sorry. I did, I think.

Mr. FERGUSON. Let me then, since you and I know Congresswoman Maloney is also interested in this issue, I will also continue a bit on operational risk.

The first point to make is operational risk already attracts an implicit capital charge. We are not doing something new by having capital for operational risk.

Excluding or even leaving what the regulators call for, large financial institutions, large banks in particular, already hold economic capital, the capital they themselves determine, in order to deal with the challenge of operational failures. We have done a survey that shows in the world at large, for larger institutions, out of their economic capital, the capital they impose upon themselves, about 14 to 15 percent of that capital is being held for operational risk matters.

So just to get the lay of the land, there is already regulatory capital for operational risk, regulatory minimum capital and the banks themselves impose their own economic capital.

Mr. TOOMEY. But that is a significantly lower number than what is contemplated by Pillar 1?

Mr. FERGUSON. No, that is not true. No, that is not true.

Mr. TOOMEY. Oh, it is not.

Mr. FERGUSON. I think there may be a little bit of a misunderstanding. There was a time, several drafts ago, when operational risk charges were either tied to gross revenue or you may be thinking of a number of 20 percent that was floated at one point.

That is not the proposal. The proposal under the Advanced Measurement Approach, the AMA approach, as I have described it and as Comptroller Hawke, who was part of developing this idea described a bit, is a principles-based approach that does not have implicit in it a specific target number of capital.

Rather, it asks the banks to use some quantification that we as regulators can replicate, that we can understand, that is not purely top-down, judgmental, a guess, if you will. But based on an analysis of their own experience, the experience of others, what is called scenario analysis and a few other techniques that are relatively common in this area, to determine their perception of the operational risks they might face.

Mr. TOOMEY. Okay.

Mr. FERGUSON. And then how they offset it. And that will lead to a capital charge. But it will not necessarily be higher. We do not know if it is going to be higher or lower than the 15 percent that—

or 14 to 15 percent—of economic capital that is currently held, that I have just alluded to.

Mr. TOOMEY. Okay.

Mr. FERGUSON. I hope that is clear.

Mr. TOOMEY. Yeah, it is surprising. I was under the impression that it is extremely likely that it would be considerably higher than the economic capital that the market requires today. But that is——

Mr. FERGUSON. I do not think we can have a point of view that it is extremely likely to be one thing or another until the banks work their way through it. A number of banks have already developed some of these approaches and are moving along, which gives me some comfort that what we are proposing, what is being proposed with this AMA approach, is really quite doable.

But it is, I think, premature to say it is extremely likely to lead to a particular number in the industry.

Mr. TOOMEY. Okay.

Mr. Hawke, is that your view as well?

Mr. HAWKE. I generally agree with Governor Ferguson. I would just make a couple of points.

We already have differences today between regulated financial institutions that carry on such things as asset management activities and non-regulated institutions that carry on the same activities. There are pluses and minuses in each case. The regulated institutions have access to the discount window. They have the benefit of the federal safety net and the like. The non-regulated institutions do not have the burden or regulatorily imposed minimum capital requirements.

We are going to be seeking comment on the competitive effects in the Advanced Notice of Proposed Rulemaking proceeding. We would be concerned if one of the consequences of Basel II were to cause the de-banking of banks that were engaged in these activities. So this is an issue that we are going to focus on in this process.

Mr. TOOMEY. Okay. So do you share the view that it is not possible to determine, generally speaking, that these rules would require greater capital than the market currently imposes?

Mr. HAWKE. I think it is premature to make that judgment. The AMA approach has a lot of complexities to it. We have very extensive supervisory guidance that is about to be put out for comment that details this whole process. Until that guidance is finalized and we get a final Basel paper, I think it is premature to make a judgment about what the ultimate capital impact is going to be from the operational risk charge.

Mr. TOOMEY. My next question for you, Mr. Hawke, is that you had mentioned earlier that you had previously argued against the Pillar 1 capital for operational risk, if I understand correctly. And I am not aware of what has changed with regard to the arguments that have historically been made against that. So I am just wondering what your thought process was to cause you to come to a different conclusion.

Mr. HAWKE. Well, in part—and I do not mean to be facetious—but in part, it was deference to the shortness of life. I argued in the Committee for 4 years that because operational risk was a subject that involved the need to make qualitative judgments about a bank's internal control systems, it was appropriate to deal with it under Pillar 2.

The Committee does not take votes, but I can tell you that there was nobody on the Basel Committee—25 people—who shared that view. It was not going to prevail. So rather than continuing to make the argument, we and the Fed worked together, I think very constructively, to develop the AMA approach.

I am completely comfortable with the AMA approach to operational risk because I think it imports exactly that degree of supervisory discretion and supervisory qualitative analysis that I would have hoped for under Pillar 2. And I made the point earlier that even if this were a Pillar 2 issue, we would still have to have a framework for the supervisors to assess operational risk. My guess is that that framework would end up looking a lot like what we have in the AMA approach.

Mr. TOOMEY. Okay. Well, thank you very much. My time is running out.

I would be happy to recognize the gentlelady from New York.

Mrs. MALONEY. Thank you, Mr. Toomey. Thank you. And I thank all of the panelists.

What I am most concerned about is the competitiveness feature. And apparently, all of you agree that it will not be a disadvantage to American financial systems.

I would just want to know what proof there is. You mentioned we have had two quantitative studies. There is another one that will be ongoing.

So I would like to ask Mr. Ferguson and Mr. Hawke, I would like to see the proof and the studies that you have done to make sure that American institutions are not disadvantaged. You testified that the capital requirement would be lower under the number two accord.

Is that correct? Requirements for American banks? I heard someone say that. No?

It will not be? Okay, but——

Mr. HAWKE. That remains to be seen.

Mrs. MALONEY. It remains to be seen. And what studies have you done and what proof do you have—beginning with Mr. Ferguson—to show that we will not be at a competitive disadvantage? What was your process to determine that?

Mr. FERGUSON. First, what we are expressing is an opinion. We will be asking questions in the ANPR to determine how others view this.

Let me explain a bit of how at least I have come to the opinion at this stage that——

Mrs. MALONEY. Do you have anything in writing that supports your opinion? Any studies or research that support the opinion you came to?

Mr. FERGUSON. Well, if you would let me, I will tell you what I have and then you can tell me if it is sufficient. Does that work?

Mrs. MALONEY. Great.

Mr. FERGUSON. Good. Here is why I had the view that I have. First, the reason we are engaged in an international exercise is to create a level playing field across nations. If we chose one capital approach and other countries chose another, the probability of an uneven playing field would go up.

So the entire goal of having an international accord that is hammered out over 4 years and has a variety of approaches that you have heard about, is to increase the probability of a level playing field internationally. Because large, internationally active banks will be on a comparable set of rules, by and large.

Secondly, one of those rules involves transparency, which is to say banks disclosing not just the regulatory minimum capital under the set of rules, but also disclosing some of the inputs—not anything that is competitively sensitive, but some of the inputs—so that market analysts can observe the inputs of Bank A versus Bank B, whether or not the capital outcome looks the same. So it is not just that the rules are, broadly speaking, similar, but also the disclosure allows the market to do some comparisons across institutions.

The third thing that we have tried to do in order to minimize the risk of disparities is create a process within this Committee, called the Accord Implementation Group that brings together the various regulators from around the world that are involved in this to talk about how they are making judgments on things, such as: How do you validate the inputs? What data does one look at? That type of thing, to try to create a strong sense of a level playing field among, if you will, the umpires, the regulators internationally. So that we, here in the U.S., are to some degree encouraging improved supervisory oversight that we think will come closer to ours, which again should give us some comfort.

The fourth degree of comfort frankly is that if it turns out that this is not the case, that these three things I have just talked about are not the case, we will certainly hear from our institutions if they are feeling competitively disadvantaged. I have not heard that at this stage. But it will be the ultimate control.

And finally, as I said, we will be asking questions to see if the industry or others see within the accord and the approaches that we are planning to take to implement it, any flat spots, any lacunae, any gray areas where they can see some room for competitive disadvantage.

I believe that those different approaches should be sufficient to give us a much better feel in response to your question. And you may have other questions. But that is the basis on which I have based the opinion I have so far.

Mrs. MALONEY. Well, are you concerned that the vigor with which the Basel Accord is implemented in the U.S. by our regulators, which are very vigilant, could be a potential disadvantage for other international banks where their regulators are not as stringent? That could be a possible disadvantage to our banks.

Mr. FERGUSON. Are you addressing that question to me or to someone else?

Mrs. MALONEY. Yes, to anyone.

Mr. FERGUSON. Well, I will answer. But then I would be more than happy to have some of my colleagues on the panel answer as well.

Mrs. MALONEY. It may be applied differently in different countries.

Mr. FERGUSON. That is the reason why we have developed this Accord Implementation Group, to try to create a more consistent application of this accord across borders. I would say one other thing as well, I believe that we have the world's strongest banking system, some of the most sophisticated banks.

Mrs. MALONEY. Without a doubt.

Mr. FERGUSON. Without a doubt.

I believe that is partially the case because they are, by their nature, well managed. In fact, much of it is due to that.

I think some of it is due to the fact that we have very solid regulators here that are pushing the best practice. I think there is—and one can look at other countries where their banking system is, to use a colloquial term, "flat on its back" because they have had frankly perhaps lax—too lax—regulations.

Mrs. MALONEY. Exactly, that is my point.

Mr. FERGUSON. Exactly. But let me finish. I understand. And the point I am making is that a strong banking system does not result from lax regulation. A strong banking system results from good regulation.

We are going to continue to do good regulation here, supporting a strong banking system. And, through this Accord Implementation Group, encouraging others to maintain a level of supervisory behavior —

Mrs. MALONEY. In all due respect, I have noticed our country, through the United Nations and through other means, try to impress other countries with certain standards. And they really have not listened to us, from the Presidents, the premiers, their elected government. But I would like to hear from Mr. Hawke. I am specifically interested in written documentation that I can read that shows that our financial institutions will not be placed at a disadvantage.

This is tremendously important to me. The financial system is the main employer in the district that I represent. And they are domestic banks, international banks.

And I am concerned that there be some type of way, that either with this capital charge or the operational charge or whatever, we could be placed—or even with regulatory, more severe regulatory oversight, placed at a disadvantage. And I am interested in any written documentation that shows the process that we will not be disadvantaged.

Do you know of any? Or have you done any, Mr. Hawke?

Mr. HAWKE. Congresswoman Maloney, I do not know that there is any—or could be any—written documentation of the sort that you are asking for. Let me say that I completely agree with everything that Governor Ferguson has said. I think he gave a very complete and cogent answer to the question of competitive equality. The whole purpose of this Basel effort is to try to bring about competitive equality.

I do share the concern that differences in the nature of supervision from country to country could result in disparate application of Basel II, but the Accord Implementation Group will be one of the safeguards there. Frankly, I think the Basel Committee itself needs to address standards of supervision in member countries. That is certainly something that we will be arguing for.

But I cannot hold out that there is any documentation that could be created or that exists of the sort you are looking for on these issues. We are going to be making a quantitative impact study that will look at the impact of Basel II on the capital of our banks. We will have to make a judgment whether that is acceptable or not acceptable and what it does to the competitiveness of our banks.

Mrs. MALONEY. So that will be written evidence when you complete this study.

Mr. HAWKE. That will be some evidence that will enable us to make a judgment, that is right.

Mrs. MALONEY. Can I ask, Mr. Hawke, how would a regulatory capital charge, as contemplated by Basel II, have benefited a bank located near the World Trade Center on September 11th? Can you explain what benefit and operational risk-based capital charge could have played in preventing the financial impact of the terrorist attack?

Specifically, are you concerned that requiring banks to hold capital for such extreme events as September 11th could divert resources from contingency planning and development of backup facilities?

Mr. HAWKE. No, not at all. I think, with great respect, that pointing to the September 11th events and catastrophic events of that sort misses the point. The point is that every bank has operational risks that adhere in the nature of the business to one extent or another.

The objective is to focus banks' attention on how they manage those risks. How does the bank itself get prepared to deal with a whole variety of different types of operational glitches, whether it is the defalcation of a key employee or a system going down because of some external event? And the objective is to assure that the bank is holding capital that would help it protect itself against those risks. So you cannot really say that operational risk is going to do something specific with respect to a catastrophic event like——

Mrs. MALONEY. Well, then another specific question for you and Mr. Ferguson on operational risk, as it now stands, the capital proposal includes a charge for the potential costs associated with U.S. tort liability, discrimination, suitability and similar laws that we have passed. Many of the protections are not available to individuals in the EU or Japan or other countries.

In the U.S., these protections are the result of decades of work to promote civil rights. And do you think a capital charge for this will have an adverse competitive impact on U.S. banks and perhaps reduce the compliance efforts?

In other words, is there a danger that we are encouraging other countries not to protect civil rights or undermining our own protections by requiring capital for these kinds of suits? And what is the evidence that the costs associated with litigation has resulted in a bank failure?

Mr. FERGUSON. I guess I will take the first pass to that. And let me echo and reinforce something that Comptroller Hawke said.

The purpose of having capital is not to prevent. We could not possibly with capital prevent something like September 11th. That is not what capital does.

Mrs. MALONEY. I want to talk about the response from it.

Mr. FERGUSON. Let me—let me——

Mrs. MALONEY. Okay.

Mr. FERGUSON. The point of this focus, as Comptroller Hawke has indicated, on operational risk is that it is a real risk. In my statement, I have included 10 examples. A few of them were ones in which banks failed because of an operational problem—fortunately, small and medium-sized banks, not large banks.

A number of them are examples where an operational failure, failure to comply with laws, failure to run a system smoothly, led to a large reduction in or could have led to a large reduction in capital, costing literally $600 million, $700 million—hundreds of millions of dollars. So part of the challenge here is to build a sufficiently strong capital base to deal with a risk of an operational failure.

The advantage, as Comptroller Hawke implied and I will try to make clear, and we saw this on September 11th, is that institutions that have a strong capital base continue to have access to markets so they can get the liquidity that they need to keep their ongoing operations. It will not prevent a failure.

Now the second part of it, the second reason to have this focus on operational risk and to have a capital charge associated with it, is that a number of banks have indicated and we have seen as an independent supervisory judgment, that the need to understand the operational risk that an institution might be subject to does, in fact, do just what you want to have does, in fact, do just what you want to have done. That understanding gives those banks an incentive to comply with laws, to build the kinds of safeguards to avoid defalcation, to move their backup sites to locations that are more secure, et cetera.

All of that gets an advantage under these kinds of accords, the AMA that we are talking about. Or purchasing insurance also will give an advantage.

So the entire structure of the AMA is meant to give incentives to make the investments, to comply with laws, et cetera, that you have indicated. It does not undercut it. In fact, it reinforces the kinds of good management behavior that you and we both want to reinforce in these operational areas.

Mr. HAWKE. Can I just add one point? I think there is some misconception about how this works.

We are not going to tell a bank that they have to have an operational risk charge that deals with tort liability and another charge that deals with some other potential risk. We are going to be asking the banks, first of all, to assemble data about the kinds of losses that they have had in the past and to look at where the losses have been with other banks. We are going to be looking at their internal risk management systems and how they themselves address these operational risks.

If tort liability is a risk that U.S. banks have that their foreign counterparts do not have, that is not caused by bank regulators. That is caused by our legal system. The practical reality is that it is a risk that our banks have that other banks do not have. The question that we ask is how are our banks managing that risk? How are they responding to that risk? The idea of an operational risk charge is to make sure that the capital base of our banks takes into account the whole variety of operational risks that our banks face.

Mr. FERGUSON. And one other thing, international banks that operate here in the U.S. should be holding capital for the kinds of risks they face here in the U.S. And so if they are operating in the U.S. and are subject therefore to the kinds of concerns that you have just raised, one would expect, their regulators should expect and we should expect their local subsidiaries, if they are on this approach, to be holding capital. So there is no international inequity that would emerge in this.

Mrs. MALONEY. Okay, my time is up. But these small banks that you say failed would not have been covered by Basel II.

Mr. FERGUSON. There are large banks. The whole goal here is not only to avoid failure. It is also to deal with having a capital cushion so that when you have a large hit of hundreds of millions of dollars, and if you look at my chart, you see hits as big as $1.2 billion—$1.1 billion, $1.3 billion you can survive.

It is true, medium-sized banks have failed. But it is also true that large banks have been asked to leave the United States or have had a change of ownership or have also had some difficulties, for which we want and they should have a capital base, even if they do not suffer a failure.

One should not think of this as an on-off switch. Either you fail or you do not. There is also a risk of a severe reduction in capital for which you want to build a cushion to avoid failure.

And so you should not think of this as purely: did they fail or did not they fail? You should also think of whether or not you need the capital base to keep ongoing operations and avoid failure. And that is what capital does. It allows you to continue in the market and continue to thrive, to fund yourself.

So that failure is not the only test that matters here. It is also significant loss of hundreds of millions of dollars that would eat into the capital base.

And there is a great deal of evidence of losses of the $400 million, $500 million, $600 million amount, that we as regulators should not simply ignore because it was not a failure.

Mrs. MALONEY. My time is up.

Chairman BACHUS. [Presiding.] Thank you.

Mr. Ferguson, I am going to ask you one question. Then Mr. Watt will conclude the panel's questions.

You have indicated on page five of your testimony that we have concluded that despite our supervisory judgment on the potential risk of these exposures—I am talking about the commercial real estate loan capitalization—that we could not support requiring a higher minimum capital charge on these loans. And we will not do so.

What do you see the final standards will look like on the capital charge for commercial real estate?

Mr. FERGUSON. The proposed accord has the possibility of two different types of capital charges for commercial real estate, some higher and some lower, depending on the nature of the real estate. Based on the data that has come forward—and there may be some new data that comes—but based on the data that has come forward, I believe the proposal will have most commercial real estate on what is called the low volatility curve or a lower curve that is similar to the C&I, the commercial and industrial loan curve. And that is, I think, quite consistent with the input from a number of banks.

There may be some kind of high volatility real estate—acquisition, development and construction loans of certain sorts—where the data still suggests they should have a slightly higher charge. But I think the vast majority of commercial real estate will be on the lower curve and have a charge similar to commercial and industrial loans.

Chairman BACHUS. And you know I have expressed my concern to you before. And I appreciate the changes that you all have made, based on this new evidence.

We do not want to retard growth. And in some areas of the United States, they are growing very rapidly. And you mentioned construction loans. Obviously, that is new construction. And that is evidence of growth.

And I hope that you will continue to look at that.

I am not sure that construction lending, in my mind, is as risky—and I am just anecdotally—because that represents someone's investing in a new project.

Mr. FERGUSON. We do not want to retard growth at all. We want capital to reflect risk. And as you know, because you were referring to it, when the data come in, we change our minds if the data are supportive of a change of opinion. We will continue to watch this pretty closely.

We have already shown a great deal of flexibility. And if new data sets suggest that we should rethink the position we have now, you have my commitment that we will do that because we have already given evidence that we have done it in the past.

Chairman BACHUS. Because as you know, we have states that are growing at 20 percent every 10 years in population, unlike most parts of Europe, where they do not have those.

Mr. FERGUSON. Well, this is an area, sir, where there is national discretion. So we will develop a capital approach with respect to real estate and these two different curves that reflect U.S. data primarily.

Chairman BACHUS. Thank you.

Mr. Watt?

Mr. WATT. Thank you, Mr. Chairman.

I want to assure the Chairman that I will not take the full 10 minutes, unless you all take it answering two questions. And I want to apologize to the witnesses for not being here for the testimony.

Unfortunately, I would much have preferred to have been here. I was in a hearing about whether we should prohibit lawsuits against—on behalf of people who get fat against McDonald's and other fast food providers.

[Laughter.]

No pun intended, a very heavy responsibility.

Just two questions. First of all, I have noted in Mr. Ferguson's testimony and Mr. Powell's testimony—and I did not get a chance to look at Mr. Gilleran's testimony. I did not see anything on it in

Mr. Hawke's testimony. At least Mr. Ferguson and Mr. Powell think that H.R. 2043 could be counterproductive.

I wanted to see if that was the uniform opinion of everybody on the panel. I have Mr. Ferguson and Mr. Powell. What about Mr. Hawke?

Mr. HAWKE. Congressman Watt, in my oral statement, I said that while I am sympathetic with the underlying concerns that led to H.R. 2043, we did not think that it was necessary at this time. There has been a very collaborative process that has been followed by the regulators. There are dozens and dozens of issues that come up, most of which we agree on, some of which we do not agree on. The need for some external process to force resolution of issues, I think, is not there.

We have a collaborative process going forward that is going to involve joint notices of rulemaking and joint publication of supervisory guidance. I think we are very much together on these issues going forward.

In addition, there is an executive order that requires certain kinds of economic analysis to be made in connection with any rulemaking that would have a substantial effect on the economy. That is defined to mean an effect of $100 million or more annually. We will be soliciting comment in our Advance Notice of Proposed Rulemaking to give us the information to determine whether this rulemaking will actually have that kind of impact. And if it does, then much of the same kind of economic analysis that would be called for in H.R. 2043 would be provided under that executive order.

So, with great respect, we do not think that legislation of this sort is needed at this time.

Mr. WATT. Mr. Gilleran?

Mr. GILLERAN. As I said in my written testimony, to the extent that the OTS is mentioned in it, we completely agree with it, and that is that we be part of the process going forward. I think that the regulators have shown——

Mr. WATT. Have you not been part of this process?

Mr. GILLERAN. We have not been part of the international process up until this time. We have been part of the working groups here in the United States. And we will be part of it going forward, in the sense that we will be a party to the ANPR that we have put out and the deliberative process that will take place going forward. So your support in that regard is welcome.

On the issue of how this decision is made going forward, I believe that the regulators have shown the ability to cooperate, to deliberate and come to very, very reasonable conclusions. So that I believe the process of Basel II, with your strong oversight and interest, I believe your interest has made a difference already. And I believe the Senate Banking Committee's interest has made a difference.

But I believe that the process, going forward, should be left to the bank regulators.

Mr. WATT. Now while you have the floor, I noticed that when Ms. Maloney was asking questions, you raised your hand at one point. And apparently, nobody saw you. I wanted to make sure you got a chance to make the point, whatever that point was, that you wanted to make.

Mr. GILLERAN. Thank you. Well, I was just going to, on the point of international competitiveness, I wanted to react to that. Because in a prior career, I was superintendent of banks in California and worked with a great number of international regulators.

And it is my view, as has been already expressed here in our written documents and in person, that the United States is the strongest bank regulator, without question. And we have countries out there where bank regulation is weak and that they have not applied concepts that we apply here in the United States correctly.

There are countries out there that have not written off loans and that are just starting to react to the loans they have in their bank portfolios now. Their inability to have a strong international banking system has been to their detriment.

Because what has happened in those countries that do not have one is that they have a misallocation of capital within the country. They keep funding companies that are losing and not funding new technology.

So I think that they are the biggest losers of not correctly allocating capital. And I believe that since there are countries that are not doing it well now, there will be countries that will be not doing it well in the future.

I do not think it disadvantages the United States or United States banks because I think we are the winner for strong bank supervision.

Mr. WATT. Thank you.

Finally, a natural segue from my first question about H.R. 2043 and your responses to the need for that, in general, is there anything that you can identify that this Subcommittee, the full Committee or Congress needs to be doing as you keep going through the schedule that is outlined in your testimony? And if there are any things that we need to be particularly aware of, it would be helpful for at least me to know that.

Mr. HAWKE. I think, Congressman Watt, that the Financial Services Committee's involvement has been very healthy for this process. It has certainly strengthened our hand in the Basel discussions.

Some of the other countries that are participating in this process have had their legislatures involved from the very outset. And some members of the Basel Committee were constrained in the positions that they could take in the Committee by their parliaments right from the beginning of the process. We were not. We have worked together as a group of regulators and participated in that process.

But I welcome the oversight and the interest of the Committee in the process. I think the Committee's continued dialogue with the regulators is important. I think ultimately, it will strengthen our position vis-a-vis the Basel Committee. We look forward to it.

Mr. WATT. Mr. Powell, anything else you can think of that we need to be doing? Mr. Gilleran? I am going to come back to Mr. Ferguson and give him the last word on this.

Mr. GILLERAN. I think you should continue what you are doing. I think your interest and your oversight is important to us. I think that we should have a meeting like this sometime in November or early December, so that we can report back on our findings and assure you that whatever those findings are, that we are in a position to go forward.

Mr. WATT. Mr. Ferguson?

Mr. FERGUSON. I would echo many of the comments from Comptroller Hawke. And I would add one other, which is that in a democracy, it is extremely important, I think, to have these kinds of hearings, to give some legitimacy to a regulatory process.

I realize that I and we have all been appointed by the President and confirmed by the Senate. But to have both sides—Senate and House—asking tough questions and being educated, I think gives us a greater sense of legitimacy to the industry overall because they know that we have had to come here and deal with some very tough questioning.

And I think, therefore, this kind of oversight is very useful, not just because of the ability to talk to our negotiating partners overseas about the messages we are receiving, but also frankly our ability to talk to each other and to the U.S. population about the fact that indeed, we have gone through a full process that has not just the usual external comment period, but this kind of give and take. So I do also endorse your interest and thank you for the opportunity to——

Mr. WATT. Any suggestions about any other things we need to be doing, other than maybe getting a follow-up report at some point?

Mr. FERGUSON. I would say—well, there are two things that I am sure you will do. One is I am sure you will keep those cards and letters coming. And so, by definition, I welcome that.

And secondly, I think——

Mr. WATT. Only to the extent our banks keep those cards and letters coming—and constituents keep those cards and letters coming.

Mr. FERGUSON. And I am sure they will because that is what this is all about. And I would say just asking for feedback in the form we all collectively think would be appropriate, obviously is the other thing.

Mr. WATT. Thank you.

Chairman BACHUS. Thank you, Mr. Watts. At this time, we will discharge the first panel. We very much appreciate your testimony. And I very much agree with you that the Committee's activity has been productive.

So I appreciate all of your candor and participation in this important issue. And we are confident that you all will come to a consensus.

Thank you.

At this time, we will call our second panel. I want to welcome our second panel. I am actually going to introduce three of the panelists. And then Ms. Hart is going to introduce Mr. Elliott.

The first panelist or the second panelist, seeing as Mr. Elliott is going to be introduced by Ms. Hart, is Dr. Benton Gup. He is the Chair of Banking at the University of Alabama. Prior to that, he was the Chair of Banking at both the University of Virginia and the University of Tulsa.

Prior to that, he was a staff economist for the Federal Reserve Bank of Cleveland and has been the author of so many books, it would be impossible to list them, many of them used widely in the banking industry and also in the university. His publications have appeared in a number of journals.

So we welcome you, Dr. Gup.

Mr. GUP. Thank you.

Chairman BACHUS. Our second panelist or our next panelist is Micah Green of the Bond Market Institute. And I notice, between our third and fourth panelists, is that you both have your doctorate degree from George Washington University, so both graduates. That is correct, isn't it?

Mr. GREEN. My law degree. But thank you for the——

Chairman BACHUS. Law degree. I consider that a graduate degree or post-graduate degree. Micah Green is President of the Bond Market Association. That is an association of 220 member firms, which collectively account for 95 percent of the nation's municipal security underwriting and includes all the primary dealers and other key participants in the U.S. government and federal agency security market and all major dealers and municipal and corporate debt securities, mortgage securities and money market instruments. And you will be testifying on behalf of the Bond Market Association.

He received his J.D. and bachelor's degree from George Washington University.

Our final panelist is Ms. Karen Thomas. She is Director of Regulatory Affairs and Senior Regulatory Counsel for the Independent Community Bankers of Alabama—not of Alabama, of America, a national trade association representing 5,000 community banks. She has frequently published articles in the Wall Street Journal, American Banker and quoted in American Banker and BNA's Report for Executives and appeared on numerous TV shows—CNBC, Nightly News, et cetera.

You are a graduate of the College of William and Mary and received her J.D. with honors from George Washington University's Law Center. So you are both law graduates from George Washington.

So I welcome you both.

At this time, I am going to turn the chair over to the gentlelady from Pennsylvania, Ms. Hart. And we will try to expedite this hearing. Thank you.

Ms. HART. [Presiding.] Thank the Chairman also for allowing me to introduce Mr. Elliott, who is from my area. Steven G. Elliott is Senior Vice Chairman of Mellon Financial Corporation. He is responsible for the corporation's asset servicing and human resources services businesses, including global security services, securities lending, foreign exchange, Mellon investor services, Buck Consultants and Mellon HR Solutions.

The corporation's finance, treasury, technology and real estate and Mellon's venture capital businesses also report to Mr. Elliott. And he serves on the Board of Directors of Mellon Financial Corporation and also on the Board of Directors of Mellon Bank, N.A.

Mr. Elliott joined Mellon in 1987 as Executive Vice President and head of the Finance Department. He was named CFO in 1990, Vice Chairman in 1992 and Senior Vice Chairman in 1998. There was clearly no age requirement for that job.

Previously, Mr. Elliott served in executive positions at First Commerce Corporation, Crocker National Bank, Continental Illinois National Bank and First Interstate Bank of California. He is a member of the American Institute of CPAs, the Financial Executives Institute and the Financial Services Roundtable.

He also serves on the boards of the Pittsburgh Cultural Trust and the UPMC Health System. That is the University of Pittsburgh Medical Center Health System.

He is a native of Delta, Colorado. Mr. Elliott also received a bachelor's degree in finance from the University of Houston and a master's in business administration from Northwestern University's Kellogg School of Management.

I will also add, it is nice to see the reverse migration from Colorado to Pittsburgh, instead of from Pittsburgh to Colorado. Thank you for joining us also, Mr. Elliott.

Is that a vote? Okay. We are going to have a vote. But I am going to let you start, Mr. Elliott. And we may suspend in just a little while so that members can actually get over to the vote.

STATEMENT OF STEVEN G. ELLIOTT, SENIOR VICE CHAIRMAN, MELLON FINANCIAL CORPORATION

Mr. ELLIOTT. Thank you very much, Representative Hart.

Mellon is a financial services company with 22,500 employees in 21 countries. As indicated, we provide institutional asset management, mutual funds, private wealth management, asset servicing, human resources and treasury services. Mellon has approximately $2.9 trillion in assets under management, administration or custody, including $566 billion under management.

It is indeed a pleasure to appear today before you to discuss our views on the pending changes to the capital, supervision and disclosure rules. Although complex, sometimes very much so, these new rules will have a profound impact on the competitiveness of U.S. financial services firms and on the products they provide to American consumers, companies and investors.

Basel will have a particularly dramatic impact on Mellon's lines of business, where U.S. banks now have a global comparative advantage through aggressive investment and leading edge technology and the sophisticated risk management and related systems developed to support these activities.

Basel's rules also will have a profound impact on the global economy. Although the rules are not now scheduled to go into effect before 2007, they will in fact have a major impact on financial markets far more quickly. Thus, your review—and that of other panels in the Congress—is timely and commendable.

At the outset, I would like to express Mellon's gratitude to all of the regulators—U.S. and global—that spent literally thousands of hours crafting these revisions. Of particular note is the new emphasis on a more balanced approach to bank regulation—what Basel is calling the Three Pillar Approach.

I strongly agree that capital rules are not the sole touchstone of bank safety and soundness. Indeed, undue reliance on capital adequacy can divert attention from latent, serious problems in internal controls, strategic decision-making and other key risk areas.

Thus, Basel's decision to look not only at capital, but also at supervision and disclosure, will result in a far stronger global financial system going forward. All of the hard work is also justified by the worthy goal with which Basel started: an end to regulatory capital arbitrage.

All sophisticated banks and their holding companies—Mellon included—have gotten better in the past decade at spotting inconsistencies between the regulatory capital standards that bind us and the economic ones that are demanded by the broader markets. Better alignment of regulatory and economic capital will reduce this dichotomy and ensure that capital requirement incentives promote the laudable supervisory goal of increased bank safety and soundness.

Unfortunately, since Basel started, its goals appear to have changed. As recently stated in a document released by U.S. regulators, the Basel goals now are improving internal controls and capital allocation, promoting market discipline and adding a new capital charge for operational risk.

Mellon strongly supports the first two goals. But the third—a new one—in fact undermines the first two by creating perverse incentives to undue risk taking. The operational risk-based capital requirement could also put U.S. banks at a serious competitive disadvantage versus non-banks here—and I want to emphasize versus non-banks here—and non-U.S. financial services firms around the world.

The U.S. decision not to impose the most flawed operational risk-based capital proposals does not negate the fact that these will be mandated elsewhere, with potential serious safety-and soundness results. Setting operational risk-based capital as a simple percentage of gross revenue creates perverse incentives to risk taking, as I have mentioned in my written testimony. And the U.S. should fight hard against this in Basel II to ensure that all of the world's large banks are under a proper regulatory capital regime, not just those here in the United States.

Systemic risk must be an overriding consideration as Basel II is finalized. And the operational risk-based capital proposal thus poses especially serious challenges, in our view. As requested by the Subcommittee, I shall focus my comments today on issues of particular importance in the U.S., with a focus on recommendations for the pending advance notice of proposed rulemaking to be released by the bank regulators.

I would recommend: first, complete elimination of the Pillar 1 operational risk capital charge. The goal of promoting internal controls and capital allocation can far better be achieved through addressing operational risk-based capital in Pillar 2; namely, improved bank supervision.

Second, the U.S. should not force all large banks into the most advanced versions of Basel II, as these are also the most complex and not necessarily appropriate for all large banks. Specialized banks like Mellon, for example, which holds less than $5 billion of loans in our lead bank, do not require the advanced internal ratings-based approach for our credit book. The standardized approach for credit risk that will be used by the European Union appropriately controls regulatory arbitrage for specialized banks.

Third, there is no need to continue the arbitrary eight to 10 percent capital ratio or the overall leverage capital standards. To achieve the end of the regulatory arbitrage that Basel and the U.S. regulators rightly seek, low-risk banks should hold regulatory capital appropriate to this position, which could be well below current regulatory levels set in 1988.

On the other hand, high-risk banks should similarly hold the appropriate amount of capital, likely far more than what they currently do. A simple, overall capital ratio undermines the goal for which Basel and the U.S. have worked so hard for so long.

Finally, operational risk-based capital should not be used as a Pillar 1 or a Pillar 2 top off to credit risk capital. Each bank should hold regulatory capital appropriate to its risk profile, with market forces and the bank's judgment determining when more than the risk-determined amounts of capital be held.

Thank you. And I would be pleased to answer any questions.

[The prepared statement of Steven G. Elliott can be found on page 66 in the appendix.]

Ms. HART. Thank you, Mr. Elliot. At this time, we are going to recess the Committee so that the members can vote. And we are going to reconvene at 1:45, with a pretty long series of votes. So if the panel wants to maybe grab lunch or something, feel free to do that.

But we will be back at 1:45.

[Recess.]

Chairman BACHUS. [Presiding.] The Subcommittee on Financial Institutions and Consumer Credit will come back to order. I apologize to our panelists for the interruption. We had votes on the floor.

It is my understanding, Mr. Elliot, that you testified.

And Dr. Gup, we look forward to your testimony. And I recognize you at this time for your testimony.

STATEMENT OF BENTON GUP, CHAIR OF BANKING, UNIVERSITY OF ALABAMA

Mr. GUP. Mr. Chairman and members of the Committee, thank you for the opportunity to testify here. I am going to summarize my written comments that I would like included in the record.

The 1988 Basel Accord provided a minimum capital standard of eight percent of risk weighted assets for internationally active banks to ensure an adequate level of capital and provide competitive equality. The "one size fits all" capital standard was a good starting point.

But as banks face a growing range of risks and new technologies, it became clear that the capital requirements had to be made more risk sensitive. The result is Basel II.

Federal Reserve Vice Chairman Ferguson said on June 10th that regulators expect to require 10 or more of the largest banks to use the Basel II Advance Internals Risk-Based approach for credit risk. Other large banks may elect to use the Advanced IRB approach. And the remaining banks will continue to use the 1988 capital standards.

In my written testimony, I said the regulators would require about 20 banks to meet the new standards. The difference in the number of banks required to use the advanced IRB does not affect my conclusions.

The major point is that about 70 large banks, with assets of $10 billion or more, those banks whose stocks are actively traded believe that if they want to be considered major league players by equity analysts and their stockholders must use the advanced IRB approach. In addition, they must declare that they are using it in their financial reports.

The advantage to banks using the advanced IRB approach is that they may have lower capital charges on certain loans than banks using the 1988 capital standards. This creates competitive inequality.

The disadvantage is the high cost of implementing Basel II, which ranges from $10 million to $150 million.

The treatment of real estate loans in Basel II is another problem because real estate loans constitute a large portion of the portfolios of large regional banks. The U.S. bank regulators' perception of risks associated with real estate loans are based in part on the loss experiences of the late 1980's and early 1990's.

During that period, the losses on real estate loans were highly concentrated geographically in Texas, Massachusetts and Connecticut and mostly in small banks. It is important to keep in mind that this occurred before deregulation and significant changes in financial technology.

Thus, looking at the 1980's and early 1990's to determine capital requirements for today is analogous to driving down a steep, winding mountain road by only looking out the back window; a crash is inevitable.

Today, real estate lending at large regional banks is different for the following reasons: banks can expand geographically and avoid excessive concentration; they can buy or sell mortgages via securitization; they can hedge with derivatives; they can have low loan-to-value ratios and they can use high credit scores, such as FICO scores.

Fannie Mae and Freddie Mac provide examples of how these tools may be used. In addition, Fannie Mae and Freddie Mac have only three percent capital requirement.

In conclusion, the Basel II capital requirements create an uneven playing field, giving an advantage on capital charges to those banks using the advanced IRB approach. The capital charges on commercial real estate loans in Basel II are excessive. A risk weight of 150 percent may mean that a bank must hold more than eight percent capital on such loans.

However, as noted previously, banks can manage their portfolios using the same tools as Fannie Mae and Freddie Mac. And these government-sponsored entities have only three percent capital requirement.

The bottom line is that there will be competitive inequality in bank capital under Basel II.

Thank you very much. And I will be glad to answer any questions.

[The prepared statement of Benton E. Gup can be found on page 128 in the appendix.]

Chairman BACHUS. Appreciate that.

Mr. Green?

STATEMENT OF MICAH S. GREEN, PRESIDENT, THE BOND MARKET ASSOCIATION

Mr. GREEN. Thank you, Chairman Bachus, for the opportunity to testify today on Basel II.

As you indicated earlier, the Bond Market Association represents the U.S. and global bond markets. Together with our affiliates, the American and European securitization forums, we also represent many of the major participants in the growing securitization markets in the United States and Europe.

The following comments focus on those issues related to Basel II that are most important to our membership. First, let me say the association supports the Basel Committee's overall goal of rationalizing the current risk-based capital regime and aligning regulatory capital requirements more closely to actual risk.

We are grateful to the Federal Reserve Board in particular, Vice Chairman Roger Ferguson and other U.S. bank regulatory agencies for working with us to address the issues presented by the proposed capital accord revisions that are important to our membership. We are still concerned, however, that if not amended, Basel II will diminish the economic benefits derived from large and growing sectors of the capital markets, benefits which accrue to consumers, as well as businesses.

And I also want to congratulate you, Mr. Chairman, and Chairman Oxley and Congressman Frank, for bringing this Committee hearing together today. It really has been important to the process of elevating the dialogue between regulators, the Congress and the affected parties. And I think it is a very positive development.

I will first make one general comment on the direction of Basel II and then focus on two areas of most importance to us—securitization and the repurchase agreement and securities lending market.

With regard to Basel II broadly, we believe it is important that this agreement not be viewed as the last word on regulatory capital. Risk management techniques are continually evolving. And the financial markets need a regulatory capital accord that evolves with them.

Basel II must therefore be crafted in a way that ensures it can better adapt to changing market products and development. Ultimately, the global financial community will need to move toward a broader reliance on internal risk models to determine appropriate capital levels.

On securitization, which is a process of converting illiquid financial assets, like loans or other receivables, into securities which can be traded in the capital markets, it is a large and growing marketplace, with tremendous economic benefits for consumers and businesses.

Securitization lowers borrowing costs for consumers and others, improves risk management, draws new sources of capital to the lending markets. Consumers benefit from these efficiencies with lower interest rates; in a sense, bringing the high finance, the technology of finance down to the consumer level through lower cost home mortgage.

To give you an example of the size of the markets, in the last 7 years, the U.S. securitization market has grown fivefold to $2.7 trillion. In Europe, it has grown twentyfold—to a smaller level—but twentyfold to $151 billion. And in Asia, where the securitization market is just getting started, it has grown in the last 7 years 510-fold to $51 billion.

Financial institutions participate in this marketplace as issuers and investors and as part of their risk management functions. For securitization generally under Basel II, the proposed risk weights for securitization positions held by banks are simply too high in light of the actual credit risk presented by these products.

The proposed rules use unrealistically conservative assumptions that cumulatively would require financial institutions to set aside excessive levels of capital. Considering who ultimately benefits from a vibrant securitization market—home and car buyers—this is very important.

These concerns must be addressed. And they are addressed fully in our written testimony.

Lastly, repo and securities lending transactions, although little known outside the wholesale financial markets, are vital to our capital markets' liquidity and efficiency. Repo and securities lending transactions allow market participants to finance and hedge trading positions safely, cheaply and efficiently. In fact, the Federal Reserve uses this marketplace to implement monetary policy.

Basel II may require banks to take capital charges inconsistent with the actual level of risk present in repo and securities lending transactions. Financial institutions should have greater flexibility to employ supervisory-approved internal risk models created to assess counter party risk in order to accurately reflect risks present in these transactions. These issues are also dealt with in more detail in my written testimony.

And finally, we agree completely that the current regulatory scheme for bank capital—Basel I—needs significant revision. The current regulations are outdated and inflexible.

Updating the regime can produce significant benefits, including the promotion of fair global competition, incentives for better internal risk management and an economically efficient allocation of capital. Getting it wrong, however, and implementing capital regulations which do not reflect modern practices or true credit risks on banks' balance sheets will diminish or eliminate market efficiencies that benefit everyone.

The Basel Committee is on the right track in developing new capital standards. But significant work still needs to be done.

In order to preserve the efficiency of our capital markets, the treatment of securitization, repo and securities lending products, it needs to be amended. We intend to continue our active dialogue with U.S. and international bank regulators on the issues addressed above. We have every hope that these issues can and will be resolved before Basel II becomes final.

Thank you for the opportunity to testify, Mr. Chairman.

[The prepared statement of Micah S. Green can be found on page 122 in the appendix.]

Chairman BACHUS. Thank you. I would say this, Mr. Green, securitization, which we also are hearing that a lot in our FCRA hearings, because with many auto loans, as well as mortgage loans and in consumer loans, securitized, it is important that we have a national uniform credit reporting system too.

And I had heard, in those hearings we have been conducting, amazing testimony on how much that does bring down interest rates. It is quite amazing. So I just point that out. I appreciate that.

Ms. Thomas?

STATEMENT OF KAREN M. THOMAS, DIRECTOR OF REGULATORY AFFAIRS AND SENIOR REGULATORY COUNSEL, INDEPENDENT COMMUNITY BANKERS OF AMERICA

Ms. THOMAS. Mr. Chairman, thank you very much. I am pleased to appear today on behalf of the Independent Community Bankers of America, to discuss Basel II and its implications for community banks in the United States.

First and foremost, ICBA applauds the U.S. regulators for their announced intention to limit the scope of application of Basel II in the U.S. and not to require it for second-tier and community banks. Capital adequacy rules must be appropriate to the size and complexity of operations of the bank.

The Basel I Accord has worked well for community banks and generally remains well suited to assess capital adequacy for these banks. The significant and far-reaching changes to the capital adequacy framework contemplated by Basel II are unduly complex and costly for U.S. community banks and would be unnecessarily burdensome.

Stated simply, Basel II is overkill for non-complex community banks. And the cost and burdens of adhering to Basel II would outweigh the benefits—if any—of moving to the new accord.

The internal ratings-based approach is simply infeasible for community banks. Community banks do not have the resources to use costly, sophisticated internal risk rating models.

A community bank is not likely to have a sufficient volume of credits to maintain a sophisticated, statistically valid model with sufficiently meaningful risk refinement to justify the high cost of extensive data collection, recordkeeping and model maintenance.

The standardized approach, despite its additional complexity over Basel I, may not materially affect a non-complex bank's minimum capital requirements once the additional charge for operational risk under Basel II is taken into account. But as with any change, the standardized approach would present the burden of learning and mastering a new scheme, changing systems and software, and retraining management, boards and employees with little corresponding benefit to justify the cost for community banks.

Even though we are pleased with the decision regarding the scope of application of Basel II in the U.S., that does not mean we do not have some concerns about the impact of Basel II on community banks. In particular, we are concerned that Basel II may place community banks at a competitive disadvantage.

Basel II will yield lower capital requirements for retail credit, including mortgages and other loans to individuals and small businesses. These are the very credits where community banks compete with large banks.

Regulatory capital is a key factor in profitability and return on equity. There is a cost to a bank for maintaining capital. The lower capital requirements for retail credits may result in a cost advantage and correspondingly, a pricing advantage for large banks that are subject to Basel II.

Our concern is heightened by the Quantitative Impact Study 3, which compares the average risk weights and capital charges under Basel I and Basel II. Total retail credit capital charges under the advanced IRB approach are estimated to decrease by 50 percent, including 60 percent for mortgages and 41 percent for non-mortgages.

ICBA urges U.S. regulators to examine the question of competitive impact on Basel I banks closely. Small and medium-sized institutions play an important role in the economy by providing credit to consumers and small and medium-sized businesses.

For this reason, it is imperative to consider the competitive impact and implications Basel II will have for second-tier and community banks, as well as for their customers. To balance any competitive inequities, regulators may have to consider making appropriate adjustments for Basel I banks, such as additional risk buckets or changes in risk weights to increase risk sensitivity.

In addition, regulators should consider whether to allow second-tier banks and community banks the option to apply the Basel II standardized approach in order to avail themselves of its lower risk weights for retail credit. Problems with the operational risk charge under a standardized approach would have to be addressed, however.

In sum, ICBA supports limiting the scope of application of Basel II in the U.S. At the same time, the concerns about competitive equity between Basel I and Basel II banks must be carefully examined and addressed.

Thank you for the opportunity to appear before you today. I would be happy to respond to your questions.

[The prepared statement of Karen M. Thomas can be found on page 182 in the appendix.]

Chairman BACHUS. Thank you. I am going to ask the first two questions of the entire panel. And I will start with Mr. Elliott and answer in order. And you do not have to, if you do not want to respond to either one of these two questions, you do not have to.

First, would you share with the Committee your organization's involvement in the development of the Basel Capital Accords and the third consultative paper, if at all. Did you meet with all the regulators involved? Or only with some of them? And do you feel that the concerns you raised were properly addressed in the third paper?

Mr. ELLIOTT. At Mellon, we have been very actively involved in not only the most recent paper, but all of the previous papers as well. I had a number of dialogues with the regulators. For us, our primary regulators are the Comptroller of the Currency and the Federal Reserve Board.

Not only have they visited us at our headquarters in Pittsburgh, but we have gone to a series of outreach meetings that they have conducted. And there has been a lot of ability to be part of the process.

So I think from a process perspective, Mellon is comfortable that the regulators have been giving us adequate opportunity to have our views heard.

Chairman BACHUS. Were your concerns addressed?

Mr. ELLIOTT. No. We still have a major concern as it relates to the operational risk charge. Part of it obviously is with our mix of businesses, where we do very little lending directly. And thus, the operational risk issue becomes larger.

And the one in which we have difficulty is that most of our competitors, many of them are non-banks and would not be subject to the same type of capital requirements, not only here, but also globally. And a lot of the risks that are currently part of Pillar 2 supervisory, like interest rate risk, liquidity risk, strategic risk, these will continue to be dealt with in Pillar 2.

And we are puzzled, if you will, as to why operational risk by itself is being singled out for an explicit capital charge. Our view is that it should be back in Pillar 2, along with these other major type of risks that affect all institutions.

Chairman BACHUS. So you feel like this could actually put you at a competitive disadvantage?

Mr. ELLIOTT. Yes, we do.

Chairman BACHUS. Dr. Gup, I do not guess—you have not actually been part of the process?

Mr. GUP. Well, the University of Alabama has no direct interest in this.

Chairman BACHUS. Sure.

Mr. GUP. I have a research interest in this. I am working on a book of selected readings and invited articles by myself and others on the subject of Basel. We will have a panel that presented some of this in a meeting last week in Ireland, dealing with Pillar 3, which has not been discussed here.

At the Financial Management meeting in Denver in October, we are having a panel of government regulators, academics and others, practitioners, discussing Basel II. The following year in Zurich, we are having another panel on this.

So we are presenting a wide variety of views. I will be presenting some of my views also to the Australian Institute of Banking and Finance, which is like the American Bankers' Association Down Under, later this summer. So we are getting a global perspective. And I am trying to get some research input into this area.

Chairman BACHUS. You said that you talked to your colleagues in Europe about Basel II when you were in Ireland?

Mr. GUP. Asia, all over. Yes, sir.

Chairman BACHUS. What can you share with the Committee about what you learned over there in Ireland?

Mr. GUP. I could not find anybody that likes it. Everybody seems to agree that Basel I is outdated and we have to move forward. But the degree of complexity is a major disadvantage of using Basel II. It has a lot of problems.

It is a good starting point. It is a work in progress.

Chairman BACHUS. So the Europeans have some of the same concerns?

Mr. GUP. Absolutely.

Chairman BACHUS. Okay.

Mr. Green?

Mr. GREEN. Mr. Chairman, the Bond Market Association, since our principal focus—not our sole focus, but our principal focus—has been around the product areas I mentioned, has been deeply involved for a long time, particularly in the United States, working with the Federal Reserve, as well as the New York Fed, where President McDonough was so deeply involved in the Basel Committee for many years. And there has been very good dialogue over that period of time.

Also, since the U.S. securitization market was so well formed already, there was a sense that the European participants in Basel may not be fully aware of the impact that would have on the European securitization market. And our affiliate organization, the European Securitization Forum, which is a purely European-based organization, has had regular ongoing dialogues with European regulators to try to ensure that they have a full and complete understanding of that market. And together, we have also had discussions with them on the repurchase agreement side.

Also, the Bond Market Association, both through its office London but also in its membership in the International Council of Securities Association, which is made up of 25 or 26 various associations and self-regulatory organizations from around the world, meets a couple of times a year. And Basel has been a subject matter of discussion for many years to ensure that, at the association representational level, there is some degree of coordination.

Are we there yet? I am not sure we would be here testifying, saying that it needs improvement, if we were fully satisfied with the Third Consultative Paper.

Our hope is that on the issues that we have talked about on securitization and repurchase agreements, that between Third Consultative Paper and the final Basel agreement, there will be continued improvement to address those issues. Because the issues that we feel are our focus affect real people and consumers who need to buy homes and buy cars and need access to capital.

In fact, the University of Alabama may, in fact, care about that. And we would hope that before Basel is complete, these issues can be addressed.

Chairman BACHUS. If the Basel Accord went into effect, as presently constituted, and there are no more changes with regard to securitization, what will be the impact on the securitization market?

And number two, will the Bond Market Association support Basel II, even if the changes you have suggested are not adopted or included?

Mr. GREEN. Answering your second question first, there is unanimity among the market participants in our organization that Basel I is outdated and inflexible. And therefore, the status quo is not good.

The general direction of Basel II is very promising. And the specifics—in a sense, the details—need improving. But the general direction is an improvement upon the status quo, which is why we are supportive of the general direction of Basel II.

If the issues that we have raised are not fixed, the impact would be focusing on securitization. Financial institutions, if they have to charge more risk capital on their balance sheet than what is appropriate, based on the actual risk, then their ability to participate in that marketplace will be hampered.

The depth of liquidity in that marketplace will be hampered. That affects the pricing in that marketplace.

And since that marketplace is where home mortgages and car loans and credit card receivables are securitized, when you adversely affect the pricing in that market, it will raise the cost of borrowing in that market, which then gets down to the consumer level.

So I am not going to say the sky is going to fall out of the sky. But pure market logic would have it that if you inhibit their ability to participate and you inhibit liquidity, you change pricing and you increase the cost of capital, which affects consumers.

So that will happen. And that is why we are here today. And we appreciate the opportunity.

Chairman BACHUS. Yeah, thank you. Well, that would not only maybe drive up the loans, it would also—would it affect the amount of funds available to make loans?

Mr. GREEN. Absolutely because one of the principal purposes of the securitization marketplace is to ensure that on financial institutions' balance sheets are not loans that are just stagnant. And they can get rid of those loans on their balance sheet and get fresh capital.

They can also, in a very sophisticated way, manage their risks and match their assets with their liabilities much better. So by inhibiting their ability to participate in that marketplace, it will in fact lower the supply of lendable capital.

Chairman BACHUS. And that would, I think, affect your lower and middle income families probably disproportionately.

Mr. GREEN. Certainly, as any consumer who needs a car or a house or a refinanced mortgage or a credit card, yes.

Chairman BACHUS. Okay. Thank you.

Ms. Thomas, do you recall the original question?

Ms. THOMAS. Yes, I do.

[Laughter.]

Chairman BACHUS. Would you like to respond?

Ms. THOMAS. Certainly. ICBA has had a number of opportunities and a variety of opportunities to meet and talk with the regulators about Basel II. This has included a number of our banker members as well.

We have met with individual agencies on an informal basis. We have met with all the agencies on an interagency basis together, as well. We have participated in the comment letter process regularly on this issue.

And we know that the regulators' door is always open to us if we have any questions. If we need to be briefed, if we have any concerns we want to express, we know well that we can do that.

The other thing I would like to mention is that ICBA was the only U.S. trade association that participated in a meeting with the Basel Committee itself in July 2001. The Committee convened a meeting of representatives of small and medium-sized banking institutions around the world to hear our concerns.

So we had an unprecedented opportunity to speak directly to the Basel Committee itself. And it was there that the U.S. regulators first signaled their intention not to apply Basel II to community banks.

And at that point, that was our major concern. We saw incredible increase in regulatory burden, if that were the case. Our concerns were certainly addressed there, as the agencies have announced that they do not intend to do that.

I think now one of the main issues that we see is the competitive impact. And I think you heard from the first panel that they intend to take a close look at that issue.

And they have been looking at it. And they intend to look at it closely, moving forward, particularly in the ANPR process.

Chairman BACHUS. And that is on small lending, mortgage lending and residential mortgage——

Ms. THOMAS. For our bankers, we are concerned about those retail credits, which are defined as mortgages and other loans to individuals and small businesses.

Chairman BACHUS. Okay. And even though the agreement does not specifically apply to you, it would wash over and could affect your competitiveness on that market?

Ms. THOMAS. Yes. We see that the Basel II banks, they plan on using the changes in Basel II to more finely price their products and services. They want the ability to price according to economic, as opposed to regulatory capital, try to match the economic capital more to regulatory capital.

Our concern is that smaller banks, not being subject to Basel II, are going to have higher capital requirements for those same loans and credits. And all other things being equal, a larger institution will be able to price something lower but still achieve the same return on capital as the smaller bank, which has to price it at a higher level.

So we are concerned about the competitive impact there. Some of the larger community banks that are publicly traded, they compete in the capital markets for capital. And they need to realize certain returns on equity in order to be competitive.

And so we do see that as an issue. And one of the answers may be to make some additional adjustments for Basel I banks to address those inequities.

Chairman BACHUS. Have you suggested any change in Basel II to address your concern about these business lines?

Ms. THOMAS. Not so much in the Basel II. I think we think that it will be more appropriate to make an adjustment for the Basel I banks.

Chairman BACHUS. All right. Thank you.

Ms. Maloney?

Mrs. MALONEY. Thank you very much. My biggest concern with Basel II is the impact on the competitiveness of the U.S. financial services industry. And I understand some banks support it and some have questions.

But as a whole, I think this competitiveness issue is the most important to address before the accord is implemented. And I want to be clear that I am not looking for an American advantage. I just want to make sure that our industry does not face a disadvantage.

With this as a priority, I worked with the Chairman to introduce H.R. 2043. And one of the primary aspects of the bill establishes an interagency Committee, made up of the Treasury Secretary, the Federal Reserve, OCC and FDIC, to develop a uniform position on issues before the accord, before Basel II.

If the members of the interagency Committee could not agree on apposition, the position of the Secretary of the Treasury would be the determinative position. It also requires a report to Congress before a decision is made; not that we could stop any decision, but at least we would be informed of what it is.

And I was particularly concerned about not having any concrete evidence on the fact that our financial institutions were not disadvantaged. I would like to ask any of the panelists if they would like to comment on the legislation, if you think it is necessary or not.

Mr. ELLIOTT. One place where this may be into the competitiveness issue that you are referring to is that Basel II, as designed, really is only on the banking institution component of financial services. There are many parts of financial services here in the U.S., as well as globally, that Basel II would not apply to.

And an institution like Mellon that I am associated with, many of our competitors are non-bank financial institution competitors. And here is where we feel the real inequality of the proposal.

Our hope would be that, from a regulatory perspective, the regulators would be able to come to an agreement that would not penalize the banking sector, if you will, of financial services and that hopefully legislation would not be required.

But having said that, at the same time, we are looking very much in terms of how competitive we can be. If our capital is higher, that means our return on equity is lower. That means our stock to investors is not viewed as attractively.

And our ability then to access the capital markets to, in essence, grow the institution, is in essence hindered. In many ways, many of these risks we have been talking about, earnings, current earnings basically cover all of the risks. And we think that is a part of the dimension that they really have not addressed.

Mrs. MALONEY. Well, Mr. Elliott, just following up on it, we had quite a discussion earlier with the regulators. And they seem to be in agreement now on the Pillar 1 approach to operational risk.

And I want to know, on a daily basis, what do you do to manage operational risk? And how will a Pillar 1 approach lead to greater transparency? Or will it not?

Could you—if you heard that earlier comment on operational risk.

Mr. ELLIOTT. Yes, I did. Obviously, risk management for any financial institution has to be a core competency at the end of the day. And if you were to look in terms of not only the human capital that we put against it—you know the human intellect—as well as our internal systems, this is something that we are constantly enhancing and spending a great deal of money on, on a current basis.

And we do not feel an explicit capital charge is going to enhance that process. In fact, if you think about it, it is really paying for it twice. You are paying for it in capital. And you are paying for it through earnings by having a very robust risk management system.

So our view would be that disclosure, which is part of the Pillar 3, which we really have not talked about a whole lot today. This transparency issue, we think, is very important. We are very willing. And we think frankly that most financial institutions are leaders in transparency.

The tradeoff in transparency is if you have too much, in essence, there is too much overload possibilities of all your disclosures. So they do have to be focused. They do have to be on the relevant things.

Obviously, from a regulatory perspective, the regulators have access to all of our internal systems, all of our internal ways of looking at risk, be it either operational risk or interest rate or liquidity. And our view is that the strength of the regulatory system basically is the way that you address this, as opposed to a capital charge that is difficult, if not impossible, to calculate and then compare from institution to institution.

Mrs. MALONEY. Thank you.

Would Mr. Green like to comment on the legislation?

Mr. GREEN. Congresswoman Maloney, while we appreciate the spirit with which the legislation was introduced, we do not have a formal position on it. I would just comment, and again, from our relatively narrow markets' perspective, but I would just comment, thinking about the last 2 days. I testified at the Senate hearing yesterday.

And the combination of these two hearings has probably done a great deal to achieve the underlying purpose, and that is developing a dialogue with the regulators, sending a signal to the regulators, allowing those affected by Basel II to have a forum to speak and have the regulators and legislators hear that. And I think we are all coming from these hearings with a clearer direction of what needs to happen between the Third Consultative Paper, the final Basel Accord and then the ultimate national implementation of it.

So we applaud what you have done to this date. And for that reason, in our narrow market's perspective, we do not have a position on the legislation.

Mrs. MALONEY. Would anyone else like to comment? And the Chairman has informed me that we need to get ready for the next hearing.

They gave us additional time on this incredibly important issue. And I thank the Chairman.

If anyone else would like to comment, fine.

Chairman BACHUS. Thank you. I would make just one final comment.

Dr. Gup, I notice that you mentioned that some of our banks that do not participate in Basel II could be competitively disadvantaged. And Ms. Thomas, I think you have some of the same concerns.

And I did note—and I do not know whether it was in the Senate testimony or in the submitted testimony today—that Director Gilleran, actually one of the concerns he expressed is that this may result in a wave of acquisitions, which is obviously a concern.

That could even happen to a larger institution that was maybe, like Mellon Bank, that your business model was such that it caused you to be non-competitive. And you might actually, you know, your one alternative would be to be acquired, I would think. I am not sure that would happen.

The other thing I would say, Mr. Elliott, the Federal Reserve or the regulators have never expressed any concern over how you address operational risk today, I would not think. Have they? Not to a great extent.

Mr. ELLIOTT. Mr. Chairman, I am not sure I understand your question.

Chairman BACHUS. Okay, have you—maybe I will ask another way. Have you ever had a problem or a concern with your management of operational risk? Or have they ever had a problem or concern?

Mr. ELLIOTT. With respect to our organization, no, they have had no concerns as to either our management of operational risk or how we would invest in the risk process. We get very high scores with respect to how we manage that aspect of our business.

Chairman BACHUS. Right. And yet, under this agreement, they would substitute basically, with a complex and costly formula, for how you presently manage that risk.

Mr. ELLIOTT. And part of the costliness would be adding a capital charge to our organization that, in essence, we would have to pass on to our customers or, in essence, be uncompetitive against our competition that would not have such a charge.

Chairman BACHUS. Certainly, the description that this will simply bring some of our larger banks in is simply a reflection of what they are already doing. That is certainly not the case with Mellon.

Mr. ELLIOTT. That is correct, yes.

Chairman BACHUS. Thank you.

If there are no further questions, I thank the second panel for your testimony. And you are discharged at this time. Thank you.

[Whereupon, at 2:35 p.m., the Subcommittee was adjourned.]

A P P E N D I X

June 19, 2003

Opening Statement

Chairman Michael G. Oxley
Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit

"The New Basel Accord — In Search of a Unified U.S. Position"

June 19, 2003

I would like to thank Subcommittee Chairman Bachus for holding this important and timely hearing on the new Basel Capital proposal. I look forward to hearing from the witnesses on the state of the Basel negotiations, the third consultative paper, and on H.R. 2043, the "United States Financial Policy Committee for Fair Capital Standards Act," which I have co-sponsored along with my colleague, the Ranking Member on the Committee, Mr. Frank. This legislation was developed following a hearing the Committee held in February on the Basel negotiations. What we learned from that hearing was that not only were many financial institutions concerned that Basel II could adversely affect them, but more importantly that the federal regulators responsible for negotiating the proposal could not agree on how Basel II would be implemented or the impact it would have on U.S. banks.

This lack of consensus among the agencies responsible for ensuring the safety and soundness of our banking system is alarming and should cause us to pause before moving forward on Basel II.

In February we heard concerns related to the mandatory capital charges for operational risk and credit risk, the effect this agreement will have on real estate lending, and the potential for disparate treatment of small to medium sized institutions. As a result of that hearing, I understand that there has been some progress made on the real estate concerns, however additional issues have come to light. Non-bank financial institutions have expressed concerns over the potential impact of Basel II on their businesses. Additionally, there have been concerns raised by the EU over the decision to apply Basel II to only the 10 largest financial institutions in the U.S. I would like to know how the third consultative paper addresses all of these outstanding issues and whether there is any willingness to entertain further changes to the Basel II proposal.

I understand the comment period on the third consultative paper will close in July and the Advanced Notice of Rule Making will begin shortly there after. I do not understand why the regulators are moving forward with rule making prior to examining all of the comments filed during the comment period and prior to a final agreement on Basel II which is scheduled for December of this year. It seems to me that the concerns that have been raised are being largely ignored while the proposal continues to move forward.

I would like the record to reflect that we did try to have additional witness on the second panel that would be supportive of the Basel II proposal, however we could not find any institution that was completely supportive of Basel II. I am in agreement that there needs to be changes to the Basel Accord. The practice of risk arbitrage has made Basel I less effective than when it was adopted in the late 1980s. My concern is that Basel II goes too far and will hinder the banking system more than it will protect it. Basel II has been in development for several years and has gone through many stages.

We are in the process of the third consultation on the Basel II proposal. In my opinion, there are still some kinks that need to be worked out. With a proposal that is so far reaching, and which changes the fundamental way many banks do business, it is my hope that the regulators will develop a unified position on Basel II, go back to the Basel Committee, and return with an agreement that protects the banking system while ensuring that there are no unintended consequences.

###

OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE "THE NEW BASEL ACCORD - IN SEARCH OF A UNIFIED U.S. POSITION" JUNE 19, 2003

The Subcommittee meets today to examine the proposed Basel II Capital Accord and its potential effects on the domestic and international banking systems. The goal of Basel II is to develop a more flexible and forward-looking capital adequacy framework that better reflects the risks facing banks and encourages them to make ongoing improvements to their risk assessment capabilities.

The Subcommittee on Domestic and International Monetary Policy, Trade and Technology (DIMP) held a hearing in February to examine the Basel II proposal where we heard from a distinguished panel of regulators, including Federal Reserve Vice Chairman Ferguson, Comptroller Hawke, FDIC Chairman Powell and a panel of private sector witnesses. This hearing revealed that the federal regulators did not have a unified position on the scope and the merits of the Basel II proposal.

Following this hearing, I along with Congresswoman Maloney, Chairman Oxley and Ranking Member Frank introduced H.R. 2043, the United States Financial Policy Committee for Fair Capital Standards Act. H.R. 2043 requires the federal banking regulators to develop a unified position on issues under consideration in the Basel Committee on Banking Supervision. Today we will again hear from the Federal Reserve, OCC, and FDIC along with OTS Director Jim Gilleran. Our second panel of private sector witnesses includes a large bank, financial services trade associations and an academic. I look forward to hearing from today's witnesses and thank them for taking time from their busy schedules to join us.

I applaud the intent and objectives of the Basel II Agreement: to ensure solvency of our banking institutions and protect against substantial losses, and to create international standards to better manage risk and align regulatory capital to economic risk. The distinguished witnesses on our first panel are to be commended for the work they have already accomplished on this agreement.

Nonetheless I have concerns regarding Basel II on several grounds. First, I believe it is unnecessarily complex and costly with inflexible formulas replacing current rules and supervisory examinations. In addition, I believe that the current draft would create an uneven playing field – one that unfairly penalized many banks in this country, particularly our regional banks. But my main concern is about the transparency of the Basel process as a whole and specifically, about how the U.S. position at the Basel Committee is determined.

I know that there has been an extensive comment process, and representatives of the Federal Reserve Board assure me that the banks that would be subject to Basel II approve of it. Nonetheless, some of those banks have indicated to me through their representatives that they are, in fact, concerned about Basel. I understand that banks that have reservations about the United States position are hesitant to object openly to a regulatory agency that exercises power over them. This concern seems reasonable to me, and I believe we must arrange for a full airing of the views of all interested parties without institutional constraints.

In addition, it has become clear to me that the banking regulators are not in agreement on the desirability of the accord as currently drafted. I am hesitant about supporting fundamental changes to our banking system in the face of a lack of consensus among thoughtful regulators.

H.R. 2043 would require the regulators to reach agreement by establishing a procedural framework for further deliberations on Basel. Our bill would create an inter-agency committee chaired by the Treasury Department and include federal banking regulators. If the members cannot reach consensus on a position, the position of the Treasury would prevail. It is important that the Secretary, as part of the elected Administration, set U.S. policy. Yesterday, I announced at the Exchequer club that the subcommittee plans to mark up this legislation in July.

In closing, I want to thank Chairman Oxley, Ranking Member Frank and Mrs. Maloney for working with me to develop this legislation. I look forward to working with them and the other members of this subcommittee on this important issue.

I am now pleased to recognize the Ranking Member, Mr. Sanders, for an opening statement.

June 16, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit Hearing entitled, "The New Basel Accord – In Search of a Unified U.S. Position"

Thank you, Mr. Chairman, for holding this important hearing. I appreciate this opportunity to be updated on negotiations regarding the new Basel Capital Accord (Basel II) to regulate international banking risk.

Currently, over 100 nations utilize the original Basel Accord (Basel I) model for capital standards. However, I understand many financial institutions concerns that this general approach failed to take into consideration the specific characteristics of larger entities, frequently changing market conditions, and risk reduction strategies implemented by individual financial institutions.

Basel II addresses these concerns under its three pillar system including: minimum capital requirements, supervisory review, and greater public disclosure. Basel II provides for greater flexibility in the determination of a bank's capital requirements, allowing two separate methods to be utilized by small and large institutions.

As was made clear during this committee's Subcommittee on Domestic and International Monetary Policy, Trade and Technology hearing on Basel II, federal regulators have failed to take a unified position on the current proposal. I look forward to learning more regarding their opinions this morning and to hearing from industry representatives on any remaining concerns with the Basel II proposal. In particular, I want to be sure that allowing the separate methods for determining credit risk does not put one type of institution at a competitive disadvantage.

Thank you again, Mr. Chairman, for bringing these important negotiations to this subcommittee's attention. I look forward to a very informative session.

TESTIMONY

Steven G. Elliott
Senior Vice Chairman
Mellon Financial Corporation
Pittsburgh, Pennsylvania

Before the

Financial Institutions and Consumer Credit Subcommittee
Financial Services Committee
U. S. House of Representatives

June 19, 2003

It is a pleasure to appear today before you to discuss Mellon Financial Corporation's views on the pending changes to the capital, supervision and disclosure rules. Although complex—sometimes extraordinarily so – these new rules will have a profound impact on the competitiveness of U.S. financial services firms and on the products they provide to American consumers, companies and investors. Basel's rules also will have a profound impact on the global economy. Although the rules are not now scheduled to go into effect before 2007, they will in fact have a major impact on financial markets far more quickly. Thus, your review – and that of other panels in the Congress – is timely and commendable.

The Basel rules are of keen concern to Mellon because we focus on specialized lines of business around the world. We are a financial services company with 22,500 employees in 21 countries. Headquartered in Pittsburgh, Mellon is one of the world's leading providers of financial services for institutions, corporations and individuals, providing institutional asset management, mutual funds, private wealth management, asset servicing, human resources and treasury services. Basel will have a major impact on all of these lines of business, where U.S. banks now have created a global comparative advantage through aggressive investment in leading-edge technology and the sophisticated risk management and related systems developed to support these activities. Mellon has approximately $2.9 trillion in assets under management, administration or custody, including $566 billion under management.

At the outset, I would like to express Mellon's gratitude to all of the regulators – U.S. and elsewhere – who have spent literally thousands of hours crafting these revisions. Of particular note is the new emphasis on a more balanced approach to bank regulation – what Basel is calling the "three pillar" approach. I strongly agree that capital rules aren't the sole touchstone of bank safety and soundness. Indeed, undue reliance on capital adequacy can divert attention from latent, serious problems in internal controls, strategic decision-making and other key risk areas. Thus, Basel's decision to look not only at capital, but also at supervision and disclosure will result in a far stronger global financial system going forward.

All of the hard work is also justified by the worthy goal with which Basel started: an end to regulatory capital arbitrage. All sophisticated banks and their holding companies – Mellon included – have gotten better in the past decade at spotting inconsistencies between the regulatory capital standards that bind us and the economic ones that are demanded by the broader markets. Better alignment of regulatory and economic capital will reduce this dichotomy and ensure that regulatory capital incentives promote the laudable supervisory goal of increased bank safety and soundness.

Unfortunately, since Basel started, its goals appear to have changed. As recently stated in a document released by U.S. regulators, the Basel goals now are improving internal controls and capital allocation, promoting market discipline and adding a new capital charge for operational risk. Mellon strongly supports the first two goals, but the third – a new one – in fact undermines the first two by creating perverse incentives to undue risk taking. The operational risk-based capital (ORBC) requirement could also put U.S. banks at a serious competitive disadvantage versus non-banks here and non-U.S. financial services firms around the world. The U.S. decision not to impose the most flawed ORBC proposals, namely the basic and standardized capital approaches, does not negate the fact that these will be mandated elsewhere, with potential serious safety-and-soundness results. Setting ORBC on a simple percentage of gross income creates perverse incentives to risk-taking, as I shall discuss in more detail below, and the U.S. should fight hard against this in Basel II to ensure that all of the world's large banks are under a proper regulatory capital regime, not just those here at home. Systemic risk must be an over-riding consideration as Basel II is finalized, and the ORBC proposal thus poses especially serious challenges.

As requested by the Subcommittee, I shall focus my comments today on issues of particular importance in the U.S., with a focus on recommendations for the pending advance notice of proposed rulemaking (ANPR) to be released by the bank regulators. I would like to recommend:

- complete elimination of the "Pillar 1" ORBC charge. The goal of promoting internal controls and capital allocation can far better be achieved through addressing ORBC in "Pillar 2" – i.e., improved bank supervision;
- the U.S. should not force all large banks into the most advanced versions of Basel II, as these are also the most complex and not necessarily appropriate for all large banks. Specialized banks like Mellon (which holds less than $5

billion in loans in its lead bank) do not require the advanced internal ratings-based approach for our credit risk book of business. The standardized approach for credit risk that will be used in the European Union appropriately controls regulatory arbitrage for specialized banks;

- there is no need to continue the arbitrary 8% or 10% capital ratios, or the overall leverage capital standards. To achieve the end of the arbitrage that Basel and the U.S. regulators rightly seek, low-risk banks should hold regulatory capital appropriate to their position – which could be well below the current regulatory levels set in 1988. High-risk banks should similarly hold the right amount of capital, likely far more than now imposed. A simple, overall capital ratio undermines the goal for which Basel and the U.S. have worked so hard for so long; and
- operational risk-based capital should not be used in either Pillar 1 or Pillar 2 to "top off" credit risk capital. Each bank should hold regulatory capital appropriate to its risk profile, with market forces and the bank's preferences determining when more than the risk-determined amounts of capital are held.

Operational Risk-Based Capital: Take it Out of Mandatory Regulatory Capital Requirements

Like many specialized U.S. banks, Mellon is extremely concerned that imposition of the ORBC charge will have an unintended and undesirable impact – and not just on us. We see very unfortunate policy consequences, as well as adverse competitive ones, from this proposal. As a result, Mellon is a member of the Financial Guardian Group, an organization for those U.S. banks most concerned with this section of Basel II.

Let me first detail the policy concerns we have with the ORBC charge. Fundamentally, Basel – and the U.S. regulators, if they follow it or if it can't be changed – would impose a regulatory capital charge against a risk that can't be measured or even defined in a fashion on which all agree. Indeed, the Risk Management Group of the Basel Committee's most recent review of operational risk said that its own data should be used with "caution" because they "do not permit identification of business lines and/or event types that are the largest source of operational risk." Basel in this survey found that banks in the still small sample from which data can be obtained (only 89 banks in 19 countries responded to the survey) view appropriate amounts of operational risk in ranges from .09% to 41% — a huge range from which no meaningful conclusions can be drawn. How can Basel or the U.S. press on with a capital charge on which there is so much variation?

How is operational risk defined? Basel of course has tried to do so, but there's still no agreement on whether catastrophic risk – September 11, for example, is in or out. The most recent version of Basel II indicates that banks under the most sophisticated version of the ORBC charge must account for this catastrophic risk, even though no one knows how to measure it, let alone decide just how much capital would be enough – or if any amount of capital would be sufficient.

There's also still no agreement on how to differentiate operational risk from credit risk and how to reflect well-understood risk mitigation steps like reserves and insurance. Fraud, for example, is counted by Basel as an operational risk, but most lenders – especially retail ones – consider this a routine credit risk. Credit-card lenders, for example, have well-tested models that accurately predict how much fraud to expect in their various books of business, and these are reflected in pricing, earnings, and reserves. A capital charge atop these simply serves no purpose – other than perhaps to increase the cost of credit to American consumers. As I shall discuss a bit later, the new capital charge for "legal risk" puts U.S. banks at an undue competitive disadvantage because of the unique nature of our laws. However, it is also one where reserves are required when material legal problems arise. Basel II includes no credit for these reserves, even under the advanced measurement approach. This double-charge is unnecessary and inappropriate, and it also shows how much work remains to be done to understand when operational risk truly poses a safety-and-soundness problem.

Fundamentally, regulatory capital is the wrong way to address operational risk, especially catastrophic events. Had this requirement been in effect on September 11, what good would it have done? Just how much capital could the banks at Ground Zero have held to fend off the planes or ensure quick resumption of operations? Capital is intended in part as a discipline on management and directors to ensure that shareholder money is at first risk before deposit insurance funds or the resources of a central bank lender of last resort are called upon. This makes lots of sense in areas where banks run risk for profit, but no institution puts itself at catastrophic operational risk to bypass the regulators. What works to prevent and mitigate operational risk – even catastrophic ones – are back-up facilities, extensive policies and procedures, training, contingency planning and insurance – all of which proved their worth on the tragic day of September 11 and the days thereafter.

In fact, a regulatory ORBC charge creates a perverse incentive to avoid these proven forms of operational risk management and mitigation. The U.S. appears to have recognized this by its decision not to impose the "basic indicator" and "standardized" versions of ORBC in Basel II. These are based solely on a percentage of gross income – a crude number which has no known relationship to the actual amount of operational risk a bank may run. Indeed, gross income is often inverse to risk, as less profitable banks may very well run higher amounts of operational risk. Moreover, such an approach penalizes those institutions that have better controls and systems, as such attributes will be recognized in the marketplace of sophisticated buyers and those institutions will likely have higher gross income but thereby incur a larger ORBC charge. Even though the U.S. doesn't plan to impose the gross income-based charge, it should fight hard against it in Basel because imposition of this approach creates risk for the global financial system and, thus, U.S. banks and the economy that depends on them.

Further, the "advanced measurement approach" (AMA) the U.S. plans to impose does not correct the fundamental flaws in the regulatory ORBC proposal. As noted, there's no agreed-upon definition of operational risk, nor any good measurement of it. Putting ORBC in Pillar 1, even with deference to internal models, doesn't solve these basic policy problems and creates serious competitive problems for specialized U.S. banks as a result.

Unique U. S. Considerations

Under U.S. law (for example, the FDIC Improvement Act and Gramm-Leach-Bliley Act) capital counts. This is right and proper, but it is sadly not the case in many other jurisdictions where large financial services firms compete vigorously against Mellon and other U.S. institutions. Pillar 2 in the Basel rules is intended to address problems where banks do not meet the capital standards, but the Basel II proposal says sanctions can include "moral" guidance and directives to improve risk management – that is, closed-door discussions that can allow banks to operate below Basel standards for years. In sharp contrast, U.S. banks are subject to major sanctions if they fail the "adequate" capital tests (such as Prompt Corrective Action sanctions), and financial holding companies must hold only "well-capitalized" banks. Thus, once ORBC is in the regulatory capital standards – regardless of its manifest flaws – U.S. banks will absolutely and unconditionally have to comply with its requirements, and European or Japanese banks could be held to far less stringent account.

A Pillar 2 supervisory standard would give U.S. regulators all the power they need to impose the appropriate amounts of operational risk-based capital – indeed U.S. regulators are already holding banks here to that standard under Federal Reserve Supervisory Letter SR 99-18. Thus, U.S. regulators should be putting their effort into ensuring that other national supervisors adopt the tough approach to appropriate regulatory capital for credit and market risk, not super-imposing a flawed charge here to keep the Basel II negotiations moving forward. It should be noted that Interest Rate Risk, which led to the enactment of FDICIA and the massive thrift failures of the late 1980's, is not subject to a Pillar One capital charge, although that risk is quite measurable and has actually led to bank failures and instead is treated under Pillar Two.

Further, the ORBC capital charges under Basel II – including the advanced one planned here – includes a regulatory capital charge for "legal" risk. This is defined to include the risk resulting from tort liability, securities suitability standards, and the laws against loan and employment discrimination – among many others. These standards, of course, do not apply in many other nations. We fail to understand why U.S. regulators would agree to a capital charge for U. S. banking institutions arising from laws and regulations unique to the US that are designed to achieve our own social objectives – especially given the unique U.S. requirement for reserves against material legal risk. In addition, these are laws which have no known bearing on any bank's failure. In cases where a bank may be subject to legal risk, securities law requires full disclosure of material concern – with the ORBC proposal thus having no impact on market discipline.

As U.S. regulators consider Basel II's impact, another unique factor should be given careful scrutiny. Not only does regulatory capital matter the most in the U. S. for banks, but banks (and their parent financial holding companies) are also the only financial services firms that come under bank regulatory capital standards. Thus, to the degree that bank regulatory capital differs from the economic capital demanded by the marketplace, U.S. banks will be placed in a different competitive position from major financial services firms that operate outside the banking rules. When bank capital standards are too low – as is the case in some key credit risk areas – this pushes low-risk assets out of the bank with perverse safety-and-soundness impact. When regulatory capital is too high – as will be the case with ORBC – non-banks have a major competitive advantage.

U.S. regulators could address this competitive problem by adopting a truly "functional regulatory" approach to the Basel standards. Currently, Basel II requires imposition of all of the new capital requirements at the holding company level. This may make sense in the EU or Japan, where the laws permit up-streaming banking standards to the parent level, but it raises profound competitive problems here where the law does not allow this. To date, the Federal Reserve – the holding company regulator – has generally mandated consolidation of capital to include bank-like standards on non-banking operations. The sole exception to this is investment companies, which Congress mandated in GLBA be outside of bank-like capital imposed through the holding company. Imposing bank-like capital in the U.S. only on banks would help resolve the many competitive problems in this market where bank holding companies compete against major non-bank financial services firms.

This competitive issue is of particular concern to specialized banks. In areas like asset management and payments processing, many major competitors operate outside the banking rules. U.S. law allows these companies to have insured depositories for specialized purposes – credit cards, for example – but to offer asset management or similar services in holding company entities that don't come under the bank regulators' oversight and supervision. In fact, 180 of the largest 200 asset managers in the U.S. are non-banks. Similarly, the four largest payments processors are non-banks. This makes such firms major competitors with a competitive leg up. Should the U.S. rules include the Basel ORBC charge, specialized banks will be placed at such a competitive disadvantage that they will have to consider revising their charters into the non-banks their competitors successfully manage free of ORBC capital charges. This does nothing to promote the safety-and-soundness objectives that bank regulators rightly seek. In fact, it would increase systemic risk by potentially pushing business outside the strong and effective U.S. bank regulatory system.

Regardless of all of the acknowledged flaws in the ORBC proposal noted above, EU regulators at least have the luxury of knowing that they will bring all large financial services firms into the new scheme. This won't do anything to solve the systemic risks caused by perverse incentives, but it at least won't push key financial activities outside the banking charter.

No One-Size-Fits-All Approach

U.S. regulators are considering a unique approach to Basel implementation not only by imposing the new rules only on the largest internationally active banks, but also by imposing only the most sophisticated versions of the capital rules, namely, the Advanced Internal Ratings-Based approach on the credit side and AMA on the operational risk side.

As noted, this does nothing to fix the admitted flaws in the simpler approaches to ORBC. Further, it could force U.S. banks with small books of credit risk to assume substantial and unnecessary cost.

Mellon concurs that the standardized version of the credit risk-based capital (CRBC) rules includes many simplifications that lead regulatory capital to diverge from economic capital. However, we believe these differences do not pose serious risk in banks with small, relatively simple and generally low-risk credit risk books. Mellon is one such bank, as our major focus is on the specialized lines of individual and institutional services I have noted above.

A recent survey of the cost of Basel implementation at large banks puts the cost of developing the data and running the Basel models at between $50 million and $200 million per bank. We see no need to run this large cost when simpler CRBC models are at hand that address the largest problems in Basel I. Again, many of our competitors are non-banks, so this cost will put us at an undue competitive disadvantage in relation to the improved safety-and-soundness for which we, like our regulators, aspire. Given the other charter options available to U.S. banks, undue Basel costs with adverse competitive implications will exacerbate the move towards non-bank charters. The adverse competitive situation is aggravated where a nonbank affiliate of a bank or financial holding company is subject to Basel II while its nonbank competitors are free of those capital requirements.

Risk-Based Capital Should Vary with Risk

Another potential unique aspect of the U.S. Basel rules is a requirement that each bank's capital not fall below current requirements. Since Basel II's goal is to end the arbitrary capital standards mandated by Basel I, super-imposing a total amount of capital unrelated to risk atop the results of the complex Basel II models quite simply makes no sense.

We believe each bank's capital should rise or fall with its risk. Banks that invest in nothing but very high-quality assets and supplement these with state-of-the-art risk management techniques should not have to "top off" their regulatory capital to the same levels set for far riskier banks. Indeed, if required to do so, low-risk banks which will have to otherwise set aside capital to meet Basel II will very likely need to run higher risks in order to push for returns on capital high enough to meet market expectations. Basel II is intended to end risk arbitrage to promote safety-and-soundness, but an arbitrary requirement to meet an overall 8% capital standard on top of the results of accepted internal models will have a perverse result.

ORBC Shouldn't Be Used to Fill CRBC Holes

As the Basel II models have been run of late, banks with low-risk books of business are in fact finding that their CRBC might fall below current levels. This is a reward for appropriate risk management, and should be permitted in the final rule. Fearful of any such drops, however, regulators are using the ORBC requirement as one of their solutions to this non-existent problem. As the recent quantitative impact survey of Basel II makes clear, total capital under the advanced Basel II models could drop for all large banks in the G-10 countries (which includes the U.S.) by 11% — with the ORBC requirement bringing levels back to current requirements. Banks with big books of mortgages or consumer loans could see their CRBC drop still further, with ORBC again being used to plug any such holes.

Interestingly, some recent U.S. data suggest that the Basel results may under-estimate total CRBC, based in part on optimistic assumptions built into the models of reporting banks. U.S. regulators have seriously questioned some of these results, although they are in the Basel survey, and the actual U.S. CRBC standards could be far more stringent. If so, then ORBC will be an added charge on top of a sharp increase in overall credit risk-based capital, possibly resulting in a major curtailment of banking operations with undue economic consequences at home and abroad.

The Basel quantitative impact survey also indicates that the banks with the largest increase tend to be the most specialized institutions, even though they carry little credit risk. This is the result of the new ORBC charge, but Basel data also show that these same specialized banks have the lowest incidence of actual operational losses. Capital simply shouldn't go up so much for them in order to keep credit risk capital at its current level.

Further, credit and operational risk don't necessarily bear any relation to each other. Banks with lots of credit risk because of their subprime or similar loan portfolios can have terrific operational risk management and mitigation processes in place; conversely, banks with low credit risk can be ill-prepared for sudden operational disruptions.

As a result, regulators should assess safety-and-soundness on these two very different dimensions in a fashion appropriate to each. CRBC should be set in accordance with actual credit risk, and operational risk of concern to supervisors should be addressed through vigorous safeguards and, if necessary, sanctions. U.S. regulators have full authority to impose these – indeed, they do so now – and Basel II should focus on ensuring that all other nations bring their standards up to these levels and then enforce them.

In conclusion, we believe the issue of how operational risk is treated in Basel II has the potential to have major unfavorable competitive implications for the US banking institutions and affiliates that have made major investments in technology, systems and controls over the years. These prudent investments have resulted in favorable comparative advantages for those organizations and the US that could be quickly lost.

For release on delivery
10:00 a.m. EDT
June 19, 2003

Testimony of

Roger W. Ferguson, Jr.

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

U.S. House of Representatives

June 19, 2003

Chairman Bachus, Congressman Sanders, members of the Subcommittee on Financial Institutions and Consumer Credit, thank you for inviting me here this morning to testify on behalf of the Board of Governors of the Federal Reserve System on Basel II and H.R. 2043. Basel II, of course, is shorthand for the proposal being negotiated in Basel, Switzerland, among the major countries of the world to develop a new agreement on capital standards for internationally active banking organizations. This new accord would replace the existing accord, Basel I, developed fifteen years ago.

Basel I and the Changing Marketplace

Basel I has served the United States well, by facilitating an international capital standard that contributes to competitive equity between our banks and foreign banks in markets here and abroad. It has, unfortunately, outlived its usefulness for our larger banking organizations, which have become increasingly complex and driven by new technologies that permit financial transactions unimagined when Basel I was initiated as the international standard.

From the perspective of banks, supervisors, counterparties, and stakeholders, capital is a cushion to ensure banks' safety and soundness and to provide a benchmark by which their financial condition can be measured. The nature of how the large banks of the world do business has changed so much that, for them, Basel I now provides neither an appropriate cushion nor an accurate risk benchmark. For these large banks, Basel I has to be replaced, particularly in a world whose financial markets are so interrelated that significant difficulties at any one of the largest banks would place the world financial system at risk.

Basel I versus Basel II

We are fortunate that changes in technology in the last decade have permitted modem principles of finance to be applied in banking, especially at the larger banks. The new methodologies have already begun to revolutionize risk measurement and management in ways that promise greater safety, soundness, and stability in our banking and financial system, particularly if the new methods are harnessed to the supervisory process. Basel II holds out that promise and builds on the best practices in risk management in banking over the past decade.

The Federal Reserve believes it is imperative that both banks and their supervisors act now to improve risk measurement and management; to link, to the extent that we can, the amount of required capital to the amount of risk taken; to attempt to further focus the supervisor-bank dialogue on the measurement and management of risk and the risk-capital nexus; and to make all of this transparent to the counterparties and uninsured depositors that ultimately fund--and hence share--these risk positions. That is what Basel II seeks to do while at the same time also seeking a level regulatory playing field for banks that compete across borders.

How does Basel II differ from Basel I? As under Basel I, a bank's risk-based capital ratio would have a numerator representing the capital available to the bank and a denominator that is a measure of the risks faced by the bank, referred to as "risk-weighted assets." The definition of regulatory capital in the form of equity, reserves, and subordinated debt and the minimum required ratio, eight percent, are not changing. What would be different is the definition of risk-weighted assets, that is, the methods used to measure the "riskiness" of the loans and investments held by the bank. It is this modified definition of risk-weighted assets, the greater risk-sensitivity, that is the hallmark of Basel II. The modified definition of risk-weighted assets will also include an explicit, rather than implicit, treatment of "operational risk."

Developing Basel II

The development of Basel II has been highly transparent and over the past five years has been supported by a large number of public papers and documents on the concepts, framework, and options. The Basel consultative paper (CP3) published in late April was the third in the series. After each previous consultative paper, extensive public comment has been followed by significant refinement and improvement of the proposal. CP3 itself is out for public comment until July 31.

During the past five years, a number of meetings with bankers have been held in Basel and elsewhere, including in the United States. Over the past eighteen months, I have chaired a series of meetings with bankers, often jointly with Comptroller Hawke. More than twenty U.S. banks late last year joined 365 others around the world in the third Quantitative Impact Study (QIS3) intended to estimate the impacts of Basel II on their operations. The banking agencies last month held three regional meetings with banks that would not, under the U.S. proposal, be required to adopt Basel II, but may have an interest in choosing to do so. Our purpose was to ensure that these banks understand the proposal and the options it provides them.[1] In about one month the banking agencies in this country hope to release an Advance Notice of Proposed Rule Making (ANPR) that will outline and seek comment on specific proposals for the application of Basel II in this

[1] The documents used in these presentations are available at the Board's web site, http://www.federalreserve.gov/banknreg.htm (See "Documents Relating to U.S. Implementation of Basel II").

country. In the last week or so we have also released two White Papers to help commenters frame their views on commercial real estate and the capital implications of recognizing certain guarantees. These, too, are available at our website.

This dialogue with bankers has had a substantive impact on the Basel II proposal. I have attached to my statement a comparison of some of the major provisions of Basel II as proposed in each of the three consultative documents published by the Basel Supervisor's Committee (appendix 1). As you can see, commenters have had a significant effect on the shape and detail of the proposal. For example, comments about the proposed crude formulas for addressing operational risk led to a change in the way capital for operational risk may be calculated; the change allows banks to use their own methods for assessing this form of risk as long as these methods are sufficiently comprehensive and systematic and meet a set of principles-based qualifying criteria. Industry comments and suggestions have also led to a significant evolution since the first consultative paper in the mechanism for establishing capital for credit risk; as a result, a large number of exposure types are now treated separately. Similarly, disclosure rules have been simplified and streamlined in response to industry concerns. Most important, the Basel Committee, and certainly all the U.S. representatives, still have an open mind on all the provisions in CP3 and will try once again to evaluate commenters' views and suggestions as we try to complete negotiations by the end of this year.

Perhaps an example of the importance of supporting evidence in causing a change in positions might be useful. As some members of this committee know, the Federal Reserve had concluded earlier, on the basis of both supervisory judgment and the available evidence, that the risk associated with commercial real estate loans on certain existing or completed property required a capital charge higher than that on other commercial real estate and on commercial and industrial loans. In recent weeks, however, our analysis of additional data suggested that the evidence was contradictory. With such inconsistent empirical evidence, we concluded that, despite our supervisory judgment on the potential risk of these exposures, we could not support requiring a higher minimum capital charge on these loans, and we will not do so.

In the same vein, we remain open minded about new suggestions, backed by evidence and analysis, and approaches that simplify the proposal but still attain its objectives. Both the modifications of the proposals in CP3 and the changes in U.S. supervisory views, as evidenced by the commercial real estate proposal, testify to the willingness of the agencies, even at this late stage of the negotiating process, to entertain new ideas and to change previous views when warranted.

It should be underlined that response to public comments has eliminated complexity in some parts of the proposal but added complexity in others. Banking organizations have different procedures and processes; one-size-fits-all rules would force many organizations to spend large sums and reduce their operating efficiencies to change their approaches. Permitting banks to use their own methodologies requires regulatory options that, in turn, impose rules that are more complex. Indeed, recent suggestions from bankers have led us to add questions to our ANPR with the goal of obtaining information that may lead to additional options, and hence complexities, in Basel II in our final round of negotiations.

Scope of Application in the United States

We are interested in comments from all sections of the banking industry, even though nearly all the banking organizations in this country will remain under the current capital regime. I began my statement today with the observation that Basel I, the basis for the current capital rules, has outlived its usefulness for the larger banking organizations. How then did we conclude that most of our banks should remain under rules based on the old accord?

Banks Remaining Under Current Capital Rules

To begin with, most of our banks do not yet need the full panoply of sophisticated risk-management techniques required under the advanced versions of Basel II. In addition, for various reasons, most of our banks now hold considerable capital in excess of regulatory minimums: More than 93 percent have risk-weighted capital ratios in excess of 10 percent--an attained ratio that is 25 percent above the current regulatory minimum.

Moreover, U.S. banks have long been subject to a comprehensive and thorough supervisory process that is much less common in most other countries planning to implement Basel II. Indeed, U.S. supervisors will continue to be interested in reviewing and understanding the risk measurement and management process of all banks, those that remain on Basel I and those that adopt Basel II. Our banks also disclose considerable information through regulatory reports and under accounting and Securities and Exchange Commission rules so that our banks are already providing significant disclosures--consistent with another aspect of Basel II.

Thus, when we balanced the costs that would be faced by thousands of our banks under a new capital regime against the benefits--slightly more risk sensitivity of capital requirements under, say, the standardized version of Basel II for credit risk, and somewhat more disclosure--it did not seem to be worthwhile to require most of our banks to take that step. Countries with an institutional structure different from ours might clearly find universal application of Basel II to be of benefit to their banking system, but we do not think that imposing Basel II on most of our banks is either necessary or practical.

Banks Moving to Basel II

We have an entirely different view for our largest and most complicated banking organizations, especially those with significant operations abroad. Among the important objectives of both Basel I and the proposed Basel II is the promotion of competitive consistency of capital requirements for banks that compete directly in global markets. The focus on global markets is one of the reasons that we did not believe it was necessary to impose Basel II on most U.S. banks because they operate virtually entirely in domestic markets.

Another important objective in developing the negotiating positions for U.S. supervisors has been encouraging the largest banking organizations of the world to continue to incorporate into their operations the most sophisticated risk measurement and management techniques. As I have noted, these entities use financial instruments and procedures that are not adequately captured by the Basel I paradigm. They have already begun to use--or have the capability to adopt--the techniques of modern finance to measure and manage their exposures; and, as I noted, difficulty at one of the largest banking organizations could have drastic impacts on global financial markets. In our view, prudential supervisors and central bankers would be remiss if they did not address the evolving complexity of our largest banks and ensure that modern techniques were being used to manage the risks being taken. The U.S. supervisors have concluded that the advanced versions of Basel II--the Advanced Internal Ratings Based (A-IRB) approach for measuring credit risk and the Advanced Measurement Approaches (AMA) for measuring operational risk--are best suited to achieve this last objective.

Under the A-IRB approach, a banking organization would have to estimate, for each credit exposure, the probability that the borrower will default, the likely size of the loss that will be incurred in the event of default, and--where the lender has an undrawn line of credit or loan commitment to the borrower--an estimate of what the amount borrowed is likely to be at the time a default occurs. These three key inputs--probability of default (PD), loss given default (LGD), and exposure at default (EAD)--are inputs that would be used in formulas provided by supervisors to determine the minimum required capital for a given portfolio of exposure. While the organization would estimate these key inputs, the estimates would have to be rigorously based on empirical information, using procedures and controls validated by its supervisor, and the results would have to accurately measure risk.

Those banks that are required, or choose, to adopt the A-IRB approach to measuring credit risk, would also be required to hold capital for operational risk, using a procedure to establish the size of that charge known as the Advanced Management Approach (AMA). Under the AMA, banks themselves would bear the primary responsibility for developing their own methodology for assessing their own operational risk capital requirement. To be sure, supervisors would require that the procedures used are comprehensive, systematic, and consistent with certain broad outlines, and must review and validate each bank's process. In this way, a bank's "op risk" capital charge would reflect its own environment and controls. Importantly, the size of the charge could be reduced by actions that the bank takes to mitigate operational risk. This would provide an important incentive for the bank to take actions to limit their potential losses from operational problems.

To promote a more level global playing field, the banking agencies in the United States will be proposing in the forthcoming ANPR that those U.S. banking organizations with foreign exposure above a specified amount would be in a "core" set of banks--those that would be required to adopt Basel II. To improve risk management for those organizations whose disruption would have the largest effect on the global economy, we would also require banks whose scale exceeds a specified amount to be in the core set of banks, although the amount of overlap with the banks already included under the foreign asset standard is quite large. To further ensure that we meet our responsibilities regarding stability, the agencies will propose, as I noted, that all banks adopting Basel II in the United States would be required to adopt the most sophisticated versions of the new accord--the A-IRB for credit risk and the AMA for operational risk. We are proposing that U.S. implementation of Basel II exclude from use for credit risk the less sophisticated, Foundation Internal Ratings Based (F-IRB) approach and the least sophisticated, Standardized approach, and that it exclude from use for operational risk the Basic Indicator approach and the Standardized approach.

Ten U.S. banks meet the proposed criteria to be among the core group of banks and thus would be required, under our proposal, to adopt A-IRB and AMA. As they grow, other banks could very well meet the criteria and thus shift into the core group in the years ahead. We would also permit any bank that meets the infrastructure requirements--the ability to quantify and develop the necessary risk parameters on credit exposures and develop measurement systems for operational risk exposures--voluntarily to choose Basel II using the A-IRB and AMA. We estimate that ten large banks now outside the core group would make this decision before the initial implementation date after they make the necessary cost-benefit calculations. These banks would no doubt consider both the capital impact of Basel II as well as the message they want to send their counterparties about their risk-management techniques.

Over time, other large banks, perhaps responding to market pressure and facing declining costs and wider understanding of the technology, may also choose this capital regime, but we do not think that the cost-benefit assessment will induce smaller banks to do so for a very long time. Our discussions with the rating agencies confirm they do not expect that regional banks would find adoption of Basel II to be cost effective in the initial implementation period. Preliminary surveys of the views of bank equity security analysts indicate they are more focused on the disclosure aspects of Basel II, rather than on the scope of application. To be clear, supervisors have no intentions of pressuring any of the non-mandatory banks to adopt Basel II.

If, indeed, ten core banks and about ten other banks adopt Basel II before the initial implementation date, they would today account for 99 percent of the foreign assets and two-thirds of all the assets of domestic U.S. banking organizations, a coverage indicative of the importance of these entities to the global banking and financial system. These data are also indicative of our intention to meet our responsibilities for international competitive equity and best-practice policies at the organizations critical to our financial stability while minimizing cost and disruption for the purely domestic, less complicated organizations.

Competitive Equity

The proposed application of Basel II has raised some concerns about competitive equity for U.S. banks. Some are concerned that the U.S. supervisors would be more stringent in their application of Basel II rules than other countries and would thereby place U.S. banks at a competitive disadvantage. To address this concern, the Basel agreement establishes an Accord Implementation Group (AIG), made up of senior supervisors from each Basel member country, which has already begun to meet. It is the AIG's task to work out common standards and procedures and act as a forum in which conflicts can be addressed. No doubt some differences in application would be unavoidable across banking systems with different institutional and supervisory structures, but all of the supervisors, and certainly the Federal Reserve, would remain alert to this issue and work to minimize it. I also emphasize that, as is the case today, U.S. bank subsidiaries of foreign banks would be operating under U.S. rules, just as foreign bank subsidiaries of U.S. banks would be operating under host-country rules.

Another issue relates to the concern *among* U. S. Basel II banks about the potential competitive edge that might be given to any bank that would have its capital requirements lowered by more than that of another Basel II bank. The essence of Basel II is that it is designed to link the capital requirement to the risk of the exposures of each individual bank. A bank that holds mainly lower-risk assets, such as high-quality residential mortgages, would have no advantage over a rival that holds mainly lower-quality, and therefore riskier, commercial loans just because the former would have lower required capital charges. The capital requirements should be a function of risk taken, and, under Basel II, if the two banks have very similar loans, they both should have very similar capital charges. For this reason, competitive equity among Basel II banks in this country should not be a genuine issue, since capital should reflect the risks taken. Under the current capital regime, banks with different risk profiles have the same capital requirements, creating now a competitive inequity for the banks that have chosen lower risk profiles.

The most frequently voiced concern about possible competitive imbalance reflects the "bifurcated" rules implicit in the U.S. supervisors' proposed scope of application: that is, imposing Basel II, via A-IRB and AMA, for a small number of large banks, and the current capital rules for all other U.S. banks. The stated concern of some observers is that the banks that remain under the current capital rules, with capital charges that are not as risk sensitive, would be at a competitive disadvantage against Basel II banks that would have lower capital charges on less-risky assets. Of course, Basel II banks would have higher capital charges on higher-risk assets and would bear the cost of adopting a new infrastructure, neither of which Basel I banks will have. And any bank that might feel threatened could adopt Basel II if they made the investment required to reach the qualifying criteria.

But a concern remains about competitive equity in our proposed scope of application, one that could present some difficult trade-offs *if* the competitive issue is real and significant. On the one hand is the pressing need to reform the capital system for the largest banks and the practical arguments for retaining the present system for most U.S.

banks. Against that is the concern that there will be an unintended consequence of disadvantaging those banks that remain on the current capital regime.

We take the latter concern seriously and will be exploring it through the ANPR. But, without prejudging the issue, we see reasons to believe that banks remaining under the current capital regime, as outlined by the agencies' proposed scope of application and the resultant bifurcated regulatory capital system, would experience little, if any, competitive disadvantage.

The basic question is the role of regulatory capital minimums in the determination of the price and availability of credit. Economic analysis suggests that regulatory capital should be considerably less important than the capital allocations that banks make internally within their organization, so-called economic capital. Our understanding of bank pricing is that it starts with the economic capital and the explicit recognition of the riskiness of the credit and is then adjusted on the basis of market conditions and local competition from bank and nonbank sources. In some markets, some banks will be relatively passive price takers. In either case, regulatory capital is mostly irrelevant in the pricing decision, and therefore unlikely to cause competitive disparities.

Moreover, most banks, and especially the smaller ones, hold capital far in excess of regulatory minimums for various reasons. Thus, changes in their own or rivals' regulatory capital minimums generally would not have any effect on the level of capital they choose to hold and would therefore not necessarily affect internal capital allocations for pricing purposes.

In addition, the banks that most frequently express a fear of being disadvantaged by a bifurcated regulatory regime have for years faced capital arbitrage from larger rivals who were able to reduce their capital charges by securitizing loans for which the regulatory charge was too high relative to the market or economic capital charge. The more risk-sensitive A-IRB in fact would reduce the regulatory capital charge in just those areas in which banks are now engaging in capital arbitrage transactions that produce an effective reduction in their current regulatory capital charges. The more risk-sensitive A-IRB imposes, in effect, risk-sensitive capital charges that for lower-risk assets are similar to what the larger banks have been successful for years in obtaining through capital arbitrage transactions. In short, competitive realities may not change in many markets where capital charges would become more explicitly risk sensitive.

Concerns have also been raised about the effect of Basel II on the competitive relationships between depository institutions and their non-depository rivals. Of course, the same argument that economic capital is the driving force in pricing applies. It is only reinforced by the fact that the cost of capital and funding is less at insured depositories than at their non-depository rivals because of the safety net. Insured deposits and access to the Federal Reserve discount window (and Federal Home Loan Bank advances) lets insured depositories operate with far less capital or collateralization than the market would otherwise require and does require of non-depository rivals. Again, Basel II is not going to change those market realities.

Let me repeat that I do not mean to dismiss competitive equity concerns. Indeed, I hope that the comments on the ANPR bring forth insights and analyses that respond directly to the issues, particularly the observations I have just made. But, I must say, we need to see reasoned analysis and not assertions.

Operational Risk

This discussion has centered on addressing credit risk--the risk that the lender will suffer a loss because of the inability of a borrower to repay obligations on schedule. A few words on operational risk are now in order. Operational risk refers to losses from failures of systems, controls, or people and will, for the first time, be explicitly subject to capital charges under Basel II. Neither operational risk nor capital to offset it are new concepts. Supervisors have been expecting banks to manage operational risk for some time and banks have been holding capital against it. Under Basel I both risks have been implicitly covered in one risk measure and capital charge. But Basel II, by designing a risk-based system for credit risk, separates the two risks and would require capital to be held for each separately.

Operational disruptions have caused banks to suffer huge losses and, in some cases, failure here and abroad. At times they have dominated the business news and even the front pages. Appendix 2 to this statement lists some of these recent events here and abroad. In an increasingly technology-driven banking system, operational risks have become an even larger share of total risk; at some banks they are the dominant risk. To avoid addressing them would be imprudent and would leave a considerable gap in our regulatory system.

Imposing a capital charge to cover operational risk would no more eliminate operational risk than does a charge for credit risk eliminate credit risk. For both risks, capital is a measure of a bank's ability to absorb losses and survive. The AMA for determining capital charges on operational risk is a principles-based approach that obligates banks to evaluate their own operational risks in a structured but flexible way.

Importantly, a bank could reduce its operational-risk charge by adopting procedures, systems, and controls that reduce its risk or by shifting the risk to others through, for example, insurance. This approach parallels that for credit risk, in which capital charges can be reduced by shifting to less-risky exposures or by adopting risk-mitigation techniques such as collateral or guarantees.

Some banks for which operational risk is the dominant one oppose our proposal for an explicit capital charge on operational risk. Some of these organizations tend to have little credit exposure and hence very small *required* capital under the current regime, but would have significant required capital charges should operational risk be explicitly treated under Pillar 1 of Basel II. Such banks, and also some whose principal risks are credit-related, would prefer that operational risk be handled case by case through the supervisory review of buffer capital under Pillar 2 of the Basel proposal rather than be subject to an explicit capital charge under Pillar 1. The Federal Reserve believes that would be a mistake, greatly reducing the transparency of risk and capital that is such an important part of Basel II, and making it difficult to treat risks comparably across banks because Pillar 2 is judgmentally based.

The Federal Reserve takes comfort from the fact that most of the banks to which Basel II will apply in the United States are well along in developing their AMA-based operational risk capital charge and believe that the process has already induced them to adopt risk-reducing innovations. Late last month, at a conference held at the Federal Reserve Bank of New York, presentations on operational risk illustrated the significant advances in operational risk quantification being made by most internationally active banks. The presentations were from representatives of major banks in Europe, Asia, and

North America. Many of the presenters provided detailed descriptions of techniques their own institutions are incorporating for operational risk management.[2] Many banks also acknowledged the important role the Basel process played in encouraging them to develop improved operational risk measurement and management processes.

Overall Capital and an Evolving Basel II

Before I move on to other issues, I would like to address the concern that the combination of credit and operational risk capital charges for those U.S. banks that are under Basel II would decline too much for prudent supervisory purposes. Speaking for the Federal Reserve Board, let me underline that we could not support a final Basel II that we believed caused capital to decline to unsafe and unsound levels at the largest banks. That is why we anticipate that the U.S. authorities would conduct a Quantitative Impact Study (QIS) in 2004 to supplement the one conducted late last year; I anticipate at least one or two more before final implementation. It is also why CP3 calls for one year of parallel (Basel I and II) capital calculation and a two-year phase-in with capital floors set at 90 and 80 percent, respectively, of the Basel I levels before full Basel II implementation. At any of those stages, if the evidence suggested that capital were declining too much, the Federal Reserve Board would insist that Basel II be adjusted or recalibrated, regardless of the difficulties with bankers here and abroad or with supervisors in other countries. This is the stated position of the Board and our supervisors and has not changed during the process.

Maintaining the current level of average capital in the banking industry can be accomplished either by requiring each bank to maintain its Basel I capital level or by

[2] These presentations are publicly available on the Federal Reserve Bank of New York website, http://www.newyorkfed.org/pihome/news/speeches/2003/con052903.html

recognizing that there will be divergent levels among banks dictated by different risk profiles. To go through the process of devising a more risk-sensitive capital framework just to end with the Basel I result seems pointless. In the Board's view, banks with lower risk profiles should have, as a matter of sound public policy, lower capital than banks with higher risk profiles. Greater dispersion in required capital ratios, if reflective of underlying risk, is an objective, not a problem to be overcome. Of course, capital ratios are not the sole consideration. The improved risk measurement and management, and their integration into the supervisory system under Basel II, are also critical to ensuring the safety and soundness of the banking system. When coupled with special U.S. features that are not changed by Basel II, such as prompt corrective action, minimum leverage ratios, statutory provisions that make capital a prerequisite to exercising additional powers, and market demands for buffer capital, some modest reduction in the minimum regulatory capital for sound, well managed banks could be tolerable if it is consistent with improved risk management.

I should also underline that Basel II is designed to adapt to changing technology and procedures. I fully expect that in the years ahead banks and supervisors will develop better ways of estimating risk parameters as well as functions that convert those parameters to capital requirements. When they do, these changes can be substituted directly into the Basel II framework, portfolio by portfolio if necessary. Basel II will not lock risk management into any particular structure; rather Basel II will evolve as best practice evolves and, as it were, be evergreen.

The Schedule

A few words now about the Basel II schedule. In a few weeks, the agencies will be publishing their joint ANPR for a ninety-day comment period, and will also issue early drafts of related supervisory guidance so that banks can have a fuller understanding of supervisory expectations and more carefully begin their planning process. The comments on the domestic rulemaking as well as on CP3 will be critical in developing the negotiating position of the U.S. agencies, and highlighting the need for any potential modifications in the proposal. The U.S. agencies are committed to careful and considered review of the comments received.

When the comments on CP3 and the ANPR have been received, the agencies will review them and meet to discuss whether changes are required in the Basel II proposal. In November, we are scheduled to meet in Basel to negotiate our remaining differences. I fear this part of the schedule may be too tight because it may not provide U.S. negotiators with sufficient time to digest the comments on the ANPR and develop a national position to present to our negotiating partners. There may well be some slippage from the November target, but this slippage in the schedule is unlikely to be very great.

In any event, implementation in this country of the final agreement on Basel II will require a Notice of Proposed Rulemaking (NPR) in 2004 and a review of comments followed by a final rule before the end of 2004. On a parallel track, core banks and potential opt-in banks in the United States will be having preliminary discussions with their relevant supervisors in 2003 and 2004 to develop a work plan and schedule. As I noted, we intend to conduct more Quantitative Impact Studies, starting in 2004, so we can be more certain of the impact of the proposed changes on individual banks and the banking system. As it stands now, core and opt-in banks will be asked by the fall of 2004 to develop an action plan leading up to final implementation. Implementation by the end of 2006 would be desirable, but each bank's plan will be based on a joint assessment by the individual bank and its relevant supervisors of a realistic schedule; for some banks the adoption date may be beyond the end of 2006 because of the complexity of the required changes in systems. It is our preference to have an institution "do it right" rather than "do it quickly." We do not plan to force any bank into a regime for which it is not ready, but supervisors do expect a formal plan and a reasonable implementation date. At any time during that period, we can slow down the schedule or revise the rules if there is a good reason to do so.

H.R. 2043

This subcommittee has asked the Federal Reserve for its views on H.R. 2043. We agree with a key motivation of that bill: to ensure that the agencies work together and that any position taken in negotiation by U.S. representatives is reached with full understanding of its effect on the banking industry and the public more generally. We believe that the current process does just that, and that the bill may not help in the achievement of those goals and could be counterproductive. The agencies have long demonstrated that on various matters, including Basel II, they have been able to reach agreement and come to a common position. Sometimes the process is smooth and other times less so, but it always ends in a position that we believe reflects the best interests of the United States. The agencies also have demonstrated their open mindedness and willingness to look at facts, to evaluate alternative views and judgments, and to change their minds on the basis of both public comment and interagency discussions; my statement gives some examples of this. The agencies need to continue to have the room to disagree and work out their differences on the basis of their experience and expertise. A formal structure to force consensus on Basel issues is not needed.

Indeed, the Board is concerned that, if adopted, H.R. 2043 would reduce our ability to negotiate with other countries' representatives on matters of importance to American banks and our financial system. Our counterparties would know that we could not bargain or make commitments until we received congressional guidance, a process likely to slow negotiations or bring them to a halt. Meanwhile, Basel I, an outdated and ineffective regulatory structure for our largest banks, would continue in effect.

Finally, we believe that the bill, if enacted, would set an unfortunate precedent of congressional involvement in technical supervisory and regulatory issues. We both expect and welcome congressional oversight, but H.R. 2043 is, in our judgment, unnecessary.

Summary

The existing capital regime must be replaced for the large, internationally active banks whose operations have outgrown the simple paradigm of Basel I and whose scale requires improved risk management and supervisory techniques in order to minimize the risk of disruptions to world financial markets. Fortunately, the state of the art of risk measurement and management has improved dramatically since the first capital Accord was adopted, and the new techniques are the basis for the proposed new Accord. In my judgment, we have no alternative but to adopt, as soon as practical, these approaches for bank supervision of our larger banks.

The Basel II framework is the product of extensive multiyear dialogues with the banking industry regarding evolving best practice risk-management techniques in every significant area of banking activity. Accordingly, by aligning supervision and regulation with these techniques, it provides a great step forward in protecting our financial system and that of other nations to the benefit of our citizens. Basel II will provide strong incentives for banks to continue improving their internal risk-management capabilities as well as the tools for supervisors to focus on emerging problems and issues more rapidly than ever before.

Unfortunately, no change in bank regulatory policy can be made without inevitably confronting a number of dissatisfied banks, regardless of the potential benefits of the proposed change for the banking system, the economy, and the public as a whole. We now face three choices. We can reject Basel II. We can sidetrack it by delay. Or we can continue the domestic and international process, using the public comment and implementation process to make whatever changes are necessary to make Basel II work more effectively and efficiently. The first two options require staying with Basel I, which is simply not viable for our largest banks. The third option recognizes that an international capital framework is in the self-interest of the United States, since our institutions are the major beneficiary of a sound international financial system. The Board strongly supports the third option.

I am pleased to appear before you today to report on this effort as it nears completion. Open discussion of complex issues has been at the heart of the Basel II development process from the outset and will continue to characterize it as Basel II evolves further.

APPENDIX 1

Modifications to the New Basel Capital Accord

The following table provides a summary of modifications made by the Basel Committee on Banking Supervision (Committee) to its proposal for a New Basel Capital Accord (New Accord). Since release of its first consultative paper in June 1999, the Committee has been engaged in extensive dialogue with banking organizations and other interested parties regarding the new capital adequacy framework. These consultations have included release of three consultative papers as well as the completion of several quantitative impact studies in which banks were asked to assess the impact of the Committee's proposal on their current portfolios.

In many instances, the additional information obtained from market participants was instrumental to additional analyses conducted by the Committee. The table captures changes made to the approaches to be implemented in the United States: the Advanced Internal Ratings Based (A-IRB) approach to credit risk and the Advanced Measurement Approach (AMA) to operational risk. Modifications to the Standardized approach to credit risk, as well as the Basic Indicator and Standardized approach to operational risk are not featured.

	Proposals contained in the Committee's first consultative paper (CP1) issued June 1999	Modifications captured in the Committee's second consultative paper (CP2) issued January 2001	Modifications captured in the Committee's third consultative paper (CP3) issued April 2003
Minimum Capital Requirements (Pillar 1 of the proposed New Accord)			
Advanced Internal Ratings-based (IRB) Approach to Credit Risk: General Comments	The Committee's first consultative paper (CP1) introduced the possibility of an IRB approach for calculating minimum capital requirements for credit risk. The concept of an IRB approach was meant to allow banks' own estimates of key risk drivers to serve as primary inputs to the capital calculation, subject to minimum standards. CP1 made reference to further work of the Committee (in consultation with the industry) on key issues related to the IRB approach. The remainder of that section of CP1 highlighted some of the issues the Committee expected to consider.	The Committee's second consultative paper (CP2) described the IRB framework in detail. Among other elements, CP2 defined the various portfolios and outlined the mechanics of how to calculate the IRB capital charges. Another critical element was presentation of the minimum qualifying criteria that banks would have to satisfy to be able to use the IRB approach to credit risk. CP2 also outlined expectations regarding adoption of the advanced IRB approach across all material exposure types of a banking organization. A floor on the minimum capital requirement was specified.	After consideration of the feedback provided by industry participants, particularly that gathered through quantitative impact studies, the Committee made adjustments to the level of capital required by the IRB approaches. Among other elements (as described below), the IRB approach was refined to allow for greater differentiation of risk. For example, the Committee approved a new, more appropriate treatment of loans made to small- and medium-enterprises (SMEs). The retail portfolio was divided into three subcategories. CP3 also outlined a treatment for specialized lending. The qualifying criteria for the IRB approach have been streamlined. The criteria are now described in a principles-based manner. CP3 also simplified the floor capital requirement such that there will be one floor that applies to banks adopting the IRB approach to credit risk and advanced measurements approaches (AMA) to operational risk for the first two years following implementation of the proposed Accord.

Exposure Type: **1. Wholesale (corporate, sovereign and bank)**	Not specified in CP1.	Wholesale exposures were defined to include corporate, sovereign and bank exposures. Banks are expected to assess the risk of each individual wholesale exposure. CP2 described the mechanism for assessing the risk of each wholesale exposure. The quantitative inputs (probability of default (PD), loss given default (LGD), exposure at default (EAD) and effective remaining maturity (M)) by exposure type were specified. Additionally, CP2 relates the quantitative inputs to the risk weight formula applicable for all three wholesale exposures. Further, minimum qualifying standards for use of the IRB approach were described in detail. An adjustment was introduced for reflecting in regulatory capital any concentrations a bank may have to a single borrower within its wholesale portfolio.	Based on findings from the impact studies conducted by the Basel Committee, and in response to industry concerns about the potential for cyclical capital requirements and the treatment of SMEs, the slope of the wholesale risk weight function has been flattened. This has the effect of producing capital requirements that differ by a smaller amount as the estimated PD of an exposure increases. CP3 confirmed that banks making use of the advanced IRB approach would need to take account of a loan's effective remaining maturity (M) when determining regulatory capital, but that supervisors may exempt smaller domestic borrowers from that requirement. As part of the treatment of corporate exposures, another adjustment to the risk weight formula has been made that results in a lower amount of required capital for credit extended to SMEs versus that extended to larger firms. In response to industry feedback, the proposed adjustment for single borrower concentrations has been eliminated given the additional complexity it would introduce into the IRB framework. That said, banks would be expected to evaluate concentrations of credit risk under Pillar 2 of the proposed Accord.

2. Retail	Not specified in CP1.	Retail was identified as a single exposure type. The risk weight formula, the inputs to be provided by banks and minimum qualifying criteria also were specified. In contrast to the individual evaluation required for wholesale exposures, it is proposed that banks assess retail exposures on a pool basis.	Retail has been sub-divided into three separate exposure types (residential mortgages, qualifying revolving exposures (e.g. credit cards), and other retail exposures). Each of the three exposure types has its own risk weight formula in recognition of differences in their risk characteristics. Qualifying criteria pertaining to retail exposures have been further defined.
3. Specialized Lending	Not specified in CP1.	The second consultative paper provided a definition of project finance. An IRB risk weight formula for this exposure type was not specified.	Specialized lending (SL) has been defined to include various financing arrangements (project, object and commodities). Additionally, this exposure category has been defined to include income producing real estate and the financing of commercial real estate that exhibits higher loss rate volatility. For all but one SL category, qualifying banks may use the corporate risk weight formula to determine the risk of each exposure. When this is not possible, an additional option only requires banks to classify SL exposures into five distinct quality grades with specific capital requirements associated with each. A forthcoming Federal Reserve white paper will explore issues surrounding the valuation of commercial real estate.

4. Equity	Not specified in CP1.	A definition of equity exposures was provided in CP2. Reference was made to treating such holdings in a manner similar to that required of banks' investments in securities firms or insurance companies.	The definition of equity exposures has been expanded. CP3 outlines two specific approaches to determining capital for equity exposures. One builds on the IRB treatment of corporate exposures. The second provides banks with opportunity to model the potential decrease in the market value of their holdings. CP3 also described the qualifying criteria for such exposures.
5. Purchased Receivables	Not specified in CP1.	Not specified in CP2.	CP3 describes a capital treatment for purchased receivables (retail and corporate). Subject to certain qualifying criteria, banks will be permitted to assess capital on a pool basis for corporate receivables as they are permitted to do for retail exposures and purchased retail receivables.
Qualifying Criteria for Use of the Advanced IRB Approach	Qualifying criteria were not specified in CP1. However, a sound practice paper on the management of credit risk was issued shortly after CP1.	Qualifying criteria were developed to ensure an appropriate degree of consistency in banks' use of their own estimates of key risk drivers in calculating regulatory capital. The qualifying criteria for corporate exposures were provided in detail with less discussion of those pertaining to retail, sovereign and bank exposures.	The qualifying criteria have been streamlined. In response to industry feedback, the criteria are now described in a principles-based manner for all IRB exposure types. The intent is to allow for consistent application of the requirements, as well as for innovation and appropriate differences in the way in which banking organizations operate.
Other Elements of the IRB Framework	Not specified in CP1.	Not specified in CP2.	The IRB capital requirement includes components to cover both expected and unexpected losses. CP3 specified methods for recognizing loan loss reserves as an offset to the expected loss component of risk weighted assets by exposure type. CP3 also specified a definition of default and factors to be considered for use in the IRB approach.

Credit Risk Mitigation (e.g. collateral, guarantees, and credit derivatives)	An IRB treatment for recognizing credit risk mitigants was not specified in CP1.	A credit risk mitigation (CRM) framework was introduced in CP2. It allowed banks to recognize collateral in their own estimates of default. Guarantees and credit derivatives remain subject to a treatment where the risk weight of the guarantor is substituted for that of the borrower.	The qualifying criteria concerning recognition of CRM techniques have been further clarified. Banks are provided with greater flexibility to recognize guarantees and credit derivatives in the IRB risk inputs (e.g. PD and LGD). However, banks are not permitted to recognize "double default" effects when determining the impact of CRM techniques on their capital requirements. A Federal Reserve white paper attempts to analyze the issues surrounding default of a borrower and a guarantor ("double default") for losses to be incurred on a hedged credit exposure.
Securitization	An IRB treatment of securitization was not specified in CP1.	CP2 outlined an IRB treatment of securitization. Initial thoughts about how to address exposures held by banks (qualifying for the IRB treatment) that originate securitizations and those that invest in transactions put together by other parties were discussed in general terms. It was indicated that the Committee would continue its work to refine the IRB treatment of securitization during the comment period for CP2.	An IRB treatment of securitisation is discussed in detail. Banks may (subject to certain qualifying criteria) base the capital requirement on the external rating of a securitization exposure or the IRB capital requirement for the pool of assets underlying a given securitization. Capital treatments for liquidity facilities and securitizations containing early amortization provisions also have been specified.

Advanced Measurement Approaches (AMA) to Operational Risk	An explicit charge for operational risk was discussed in the context of capital requirements for other risks that the Committee believed to be sufficiently important for banks to devote the necessary resources to quantify and to incorporate into their capital adequacy determinations. Reference was made to a range of possible approaches for assessing capital against this risk.	The internal measurement approach (IMA) was introduced in CP2 for determining capital for operational risk. Subject to meeting a set of qualifying criteria, banks were expected to categorize their operational risk activities into business lines. Based on a number of inputs (some to be supplied by the supervisor and others to be estimated by banks themselves), a capital charge would be determined by business line. A floor was established for banks using the IMA below which minimum capital for operational risk could not fall.	The Committee confirmed that operational risk would be treated under Pillar 1 of the proposed New Accord. After extensive consultation with the industry, the advanced measurement approaches (AMA) for operational risk has been developed. The AMA builds on banks' rapidly developing internal assessment systems. Banks may use their own method for assessing their exposure to operational risk, so long as it is sufficiently comprehensive and systematic, subject to satisfying a set of principles-based qualifying criteria. Banks using the AMA may recognize insurance as an operational risk mitigant when calculating regulatory capital. The separate floor on the capital charges for operational risk introduced in CP2 has been abandoned, as noted in the general discussion of the Advanced IRB approach.
Supervisory Review (Pillar 2 of the proposed New Accord)	Four principles of supervisory review were established. In sum, the principles discuss the need for (i) banks to conduct their own assessments of capital adequacy relative to risk; (ii) supervisors to evaluate such assessments and to take appropriate action when necessary; (iii) supervisors to expect banks to operate above the minimum regulatory capital ratios; and (iv) supervisors to intervene at an early stage to prevent capital from falling below prudent levels.	The four principles of supervisory review were further refined in CP2. Reference was made to existing guidance developed by the Committee relating to the management of banking risks. Supervisory expectations regarding the treatment of interest rate risk in the banking book were outlined in this section of CP2.	To help address potential concerns about the cyclicality of the IRB approach, the Committee agreed that a meaningfully conservative credit risk stress testing by banks using the IRB approach would be required to ensure that they are holding a sufficient capital buffer. Additionally, the section on supervisory review (Pillar 2) discusses the need for banks to consider the definition of default, residual risks, credit risk concentration and the risk associated with securitization exposures.

Market Discipline (Pillar 3 of the proposed New Accord)	Some of the Committee's early expectations regarding bank disclosures were outlined. Reference was made to future work aimed at producing more detailed guidance on disclosures of key information regarding banks' capital structures, risk exposures and capital adequacy levels.	A comprehensive framework regarding banks' disclosures was provided. Qualitative and quantitative disclosures by exposure type were outlined. Distinctions were drawn between core and supplementary disclosure recommendations, and those considered requirements.	In response to industry feedback, the Committee completed efforts to clarify and simplify the market discipline component of the proposed New Accord. The aim was to provide third parties with enough information to understand a bank's risk profile without imposing an undue burden on any institution. The disclosure elements have been streamlined to accomplish this objective, and are now regarded as requirements.

APPENDIX 2
Large Losses from Operational Risk
1992-2002

10 Large Operational Losses Affecting Banks and Bank Affiliates

Loss #	Amount ($M)	Firm	Year	Description
1	1,110	Daiwa Bank Ltd.	1995	Between 1983 and 1995, Daiwa Bank incurred $1.1 bill in losses due to unauthorized trading.
2	1,330	Barings PLC	1995	A $1.3 billion loss due to unauthorized trading triggerec the bank's collapse.
3	900	J.P. Morgan Chase	2002	J.P. Morgan Chase established a $900 million reserve fc Enron-related litigation and regulatory matters.
4	770	First National Bank Of Keystone	2001	The bank failed due to embezzlement and loan fraud perpetrated by senior managers.
5	691	Allied Irish Banks	2002	Allied Irish Bank incurred losses of $691 million due to unauthorized trading that had occurred over the previou five years.
6	636	Morgan Grenfell Asset Management (Deutsche Bank)	1997	A fund manager violated regulations limiting investmen in unlisted securities for three large mutual funds. Deutsche Bank had to inject GBP 180 million to keep tł funds liquid, with total costs in the matter exceeding GE 400 million.
7	611	Republic New York Corp.	2001	Republic Bank paid $611M in restitution and fines stemming from its role as custodian of securities sold by Princeton Economics International, which had issued fa account statements and commingled client money.
8	490	Bank of America	2002	Bank of America agreed to settle class action lawsuits fi in the wake of its merger with NationsBank. The suits alleged omissions relating to its relationship with D.E. Shaw & Co.
9	440	Standard Chartered Bank PLC	1992	Standard Chartered Bank lost $440M in connection witl the Bombay stock market scandal. A government pane charged that the banks involved broke Indian banking la

EMBARGOED
until June 19, 10:00 am

Statement
of

James E. Gilleran, Director
Office of Thrift Supervision

concerning

Basel II Capital Accord

before the

Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
U.S. House of Representatives

June 19, 2003

Office of Thrift Supervision
Department of the Treasury

1700 G Street N.W.
Washington, D.C. 20552
202-906-6288

Statement required by 12 U.S.C. 250:

The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Basel II Capital Accord
by
James E. Gilleran
Director, Office of Thrift Supervision
before the
Subcommittee on Financial Institutions and Consumer Credit
of the
House Financial Services Committee

June 19, 2003

I. Introduction

Good morning, Chairman Bachus, Congressman Sanders, and members of the Subcommittee. Thank you for the opportunity to discuss the proposed revisions to the 1988 Capital Accord (Basel I) developed by the Basel Committee on Banking Supervision (BSC). Although the Office of Thrift Supervision (OTS) has been involved in the Basel process for some time, we have only recently attempted to engage ourselves in the process internationally. While we are very supportive of the Basel process, there are numerous policy implications involved in the recently proposed international capital standards for banking organizations in the United States. These include issues that we all must strive to understand and address. I welcome your efforts to highlight these pending and important changes.

The proposed change in capital standards currently under consideration arises from a third Consultative Paper, CP-3, recently issued for public comment by the BSC. CP-3 is expected to result in the New Basel Capital Accord, or Basel II. Basel II will directly affect the largest and most internationally active banking organizations around the world, including approximately ten banking organizations in the United States. Basel II may also significantly impact, albeit indirectly, all other banking organizations around the world, including roughly 9500 institutions in the United States. These institutions include large, medium, and small banks and thrifts that operate nationally, regionally, and at the community level, many of which compete domestically with our largest internationally active banking organizations.

Before getting into the substance of my discussion on Basel II, there is one point relevant to the ongoing Basel process that I believe is important. While we have been very involved domestically in the Basel process for a number of years, as I mention above, OTS is currently attempting to take a more active role internationally because of the impact of Basel on the institutions we regulate. In this regard, I would urge the Chairman and members of the Subcommittee to include

OTS within the context of any legislation, such as H.R. 2043, that would establish an interagency committee within the United States to oversee Basel issues. If a United States Financial Policy Committee is established, it is extremely important that OTS, the primary federal regulator of all savings associations, be included.

II. Development of Basel II

Basel I, signed in 1988, addressed only the largest, internationally active banks in G-10 countries and encouraged countries outside the G-10 to adopt the framework for their banks that were operating internationally. The underlying principles of Basel I, however, were intended to apply to all banking organizations of any size and activity. Thus, while OTS did not sign Basel I, we applied it along with the other federal banking agencies. Since Basel I, the four banking agencies have developed risk-based capital standards consistent with its underlying principles, but with modifications intended to enhance risk sensitivity.

In connection with our involvement and experience with Basel I, OTS has been monitoring for many years the work leading up to Basel II. Because of the potential impact of Basel II on the institutions we regulate, we recently stepped up our involvement in the Basel process. In anticipation of the domestic application of Basel II, OTS is participating fully in preparation of an interagency Advanced Notice of Proposed Rulemaking (ANPR), with accompanying supervisory guidance, to be published in the Federal Register in the near future. The initiative will trigger the official kick-off of the national debate on the subject of new international capital standards, but, as you are aware, many of the issues raised by Basel II have already attracted significant attention. While OTS has not been directly involved in the international deliberations to date, our role on the domestic front—particularly in the mortgage markets—provides us a unique and useful perspective for this discussion.

In Basel I, the BSC identified two fundamental objectives at the heart of its work on regulatory convergence. As the Committee stated, first, "the new framework should serve to strengthen the soundness and stability of the international banking system; and [second,] the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks." Although the BSC developed a far more detailed and risk-sensitive capital adequacy framework in Basel II than in the original accord, it does not stray from the objectives set 15 years earlier. In fact, the BSC expanded upon these objectives as a guide to its efforts in producing the current proposal. In particular, the Committee observed that Basel II should:

Continue to promote safety and soundness and at least maintain the current overall level of capital in the system;

- Continue to enhance competitive equality;
- Establish a more comprehensive approach to address risk;
- Contain approaches to capital adequacy that are appropriately sensitive to risk; and
- Focus on internationally active banks, although its underlying principles should be suitable for application to all banking organizations.

While the objectives for Basel II set forth by the BSC are important to ensure consistency and competitiveness among internationally active banking organizations, the impact of the proposed changes may affect many other banking entities domestically. It is important to encourage a thorough discussion among the regulators, Congress, and the thousands of banking organizations in the United States that may be affected, directly or indirectly, by Basel II. Hearings such as this and the upcoming ANPR will help stimulate this debate.

III. Overview of Basel II

Basel II contains three "pillars" that are intended to be mutually reinforcing. Pillar 1 is a minimum regulatory capital requirement; Pillar 2 addresses supervisory review; and Pillar 3 is intended to promote risk and capital transparency. Briefly, a description of these is as follows:

- Pillar 1 includes a credit risk component that is measured by either a standardized approach or one of two internal ratings-based approaches. The two ratings-based approaches or models are the Advanced Internal Ratings-Based (AIRB) approach and the "Foundation" approach. Pillar 1 also includes an operational risk component that has several optional approaches. The centerpiece of the operational risk component of Pillar 1 also permits use of an internal model, the Advanced Measurement Approach (AMA).

- Pillar 2 is viewed by the BSC as a way for the banking supervisors to attain better overall risk management and internal controls at the banking organizations we regulate.

- Pillar 3 includes a wide range of disclosure initiatives designed to make the risk and capital positions of banking organizations more transparent.

IV. Issues for Consideration

As I noted at the outset, OTS has only recently sought to be involved internationally in the Basel process. While we are supportive of this process and encouraged by the work completed so far, both domestically and internationally, there are a number of issues that we have considered regarding the application of Basel II in the United States. In the following discussion, I highlight some of these issues.

A. Competitive Equality

Regardless of how we strive to explain Basel II, the extraordinary technical detail at its core is substantial. Our banking organizations will need to master the complexity of Basel II to provide effective feedback during the upcoming ANPR comment process on the balance of its burdens and benefits. As we proceed, we need their input to weigh changes to our existing capital rules, and to assure ourselves that our actions do not significantly alter the competitive landscape for all U.S. banking entities. We want to assure that United States banking organizations remain healthy, competitive, and well capitalized.

The key principle underlying Basel II, and the basis for the advancement from Basel I, is greater risk sensitivity. This principle has as much meaning for a small community banking organization as it does for a large internationally active institution. The challenge lies in how to address this issue simultaneously for both types of banking organizations, especially considering that under the proposed scope of application in the United States all but the few largest banking organizations will not be "Basel II banks." A significant issue in this debate is whether we maintain consistent capital standards for all banking organizations for lending activities that have the same risk characteristics.

From our standpoint, maintaining competitive equality for community banks is important, particularly as our economy is showing encouraging signs of improvement. Community banking organizations play a significant role in small business lending, which feeds new job creation. "Community banks are one of the key sources of credit and other financial services to small businesses—the most prolific job creating sector of our economy. Small businesses employ 60 percent of the nation's workforce and have created two-thirds of all the net new jobs since 1970."[1]

---

[1] Statement of Paul G. Merski, Chief Economist and Director of Federal Tax Policy, Independent Community Bankers of America, before the House Small Business Committee, March 1, 2002.

Another aspect of this issue that we must consider is the extent to which we alter our existing capital rules, applicable to all banks, to accommodate changes proposed by Basel II. For example, under Basel I, the blunt-edged risk-based capital requirement for 1-4 family residential mortgages (a 50 percent risk-weight, or 4 percent capital requirement) is not commensurate with the historical risk associated with residential mortgage lending in the United States. For residential mortgage loans with relatively low loan-to-value ratios, a substantially lower risk-weight is more reflective of loss experience. By contrast, the federal banking agencies have concluded that for some concentrations of subprime loans, a significantly higher risk weight than 100 percent—and therefore, a capital requirement higher than 8 percent—might be more appropriate. While Basel II is intended to enhance the risk sensitivity of our capital rules, it is important that the proposed changes are truly reflective of actual risk, as measured over an appropriate historical timeframe.

B. Supervisory Effectiveness

Another important issue is the potential impact of Basel II on our supervisory effectiveness. The United States bank regulatory system is considered to be among the most comprehensive and admired in the world. Capital requirements are only part of our multi-faceted supervisory response to ensure safety and soundness. Our supervisory system is grounded in a regular program of on-site examinations complemented by comprehensive and frequent reporting and off-site monitoring—a level of supervisory review that may be unparalleled.

As we move forward with a relatively dramatic approach that places a tremendous emphasis on capital, we must be careful not to minimize or diminish the other supervisory tools and regulatory judgment that is integral to our supervisory system. In particular, we should focus on how Basel II fits within and improves our system, and how to strike the right balance between capital rules and effective supervisory oversight. In the end, sound regulatory judgment is the key to our supervisory effectiveness and cannot be compromised.

C. Accountability in a Ratings-Based Capital Model

A corollary to this issue is the role of examiners and our examination process in evaluating ratings-based models dictated in a Basel II supervisory world. The application of Basel II in the United States will include complex mathematical formulas and models used to measure regulatory capital levels for our largest financial institutions. While prior regulatory approval is required to use the models, once obtained, an institution would effectively set its own capital requirements. This would be based largely on inputs derived from credit assessments from the institution's own credit risk and operational risk models.

The accuracy and consistency of ratings is extremely important in any ratings-based system. Numerous subjective decisions are made daily by bank personnel regarding model inputs. These inputs involve judgments made on items such as rating a loan's probability of default, an estimate of loss given default, and the probability of a major loss arising from an institution's operational risk. It is important to keep in mind that these are human inputs, and are not infallible. Of particular concern is how to account for the subjectivity of the "human factor" as we implement and apply Basel II.

Equally important is that we take the steps necessary to support and train our examiners who will be expected to review the many subjective decisions made under, and evaluate the mathematical models of, Basel II. We must also consider how the Basel II models and mathematical formulas reconcile with our existing rules, such as with our asset risk classification and prompt corrective action rules. This includes whether any of our existing rules, in addition to risk-based capital, would have to be changed to accommodate Basel II.

D. Operational Risk

Another important issue is the operational risk capital charge in Basel II. The concerns include the difficulty of trying to measure something that cannot be readily modeled. Currently, the ability to measure and quantify operational risk is less advanced than the measurement and quantification of credit risk. In addition, the boundaries between credit risk and operational risk are not always clear. Another question is whether operational risk should receive a more qualitative Pillar 2 supervisory review as opposed to the quantitative Pillar 1 approach proposed in Basel II. This question is significant because assessment of operational risk inherently involves human judgment, which lies more squarely within Pillar 2.

There are also questions about the availability of good data to measure operational risk. Under the AMA model of Pillar 1, the most sophisticated institutions would use available external data to measure risk and compute their own capital charge. While data may be readily available for ordinary risk events that can be budgeted, truly high-risk loss events occur infrequently. We must consider how to proceed where there is a lack of readily available data for precisely the type of risk for which capital may be most relevant to a particular institution or group of institutions.

We will also want to consider the positive effect that an institution's internal systems and controls have on operational risk exposure. In computing their operational risk capital charge, it is important to understand whether and how different institutions would allocate capital appropriately for weaknesses in their internal systems and controls, as well as the disincentives in doing so. This is important to ensure both consistency and accuracy in the operational risk capital charge.

V. **Conclusion**

Thank you, Chairman Bachus, Congressman Sanders, and members of the Subcommittee for the opportunity to testify on Basel II. As you are aware, Basel II raises very significant issues not only for our very largest banking organizations, but potentially for all our insured institutions. I urge all of the members of the Subcommittee to remain involved in this process going forward. In addition, I reiterate my request that OTS be included on any committee formed by Congress to oversee Basel issues in the United States.

1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456
www.bondmarkets.com

360 Madison Avenue
New York, NY 10017-7111
Telephone 646.637.9200
Fax 646.637.9126

St. Michael's House
1 George Yard
London EC3V 9DH
Telephone 44.20.77 43 93 0
Fax 44.20.77 43 93 01

THE BOND MARKET ASSOCIATION

June 19, 2003

Statement of Micah S. Green

President
The Bond Market Association

Testimony Before
The Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
U.S. House of Representatives

On the Basel II Capital Accord

The Bond Market Association is grateful for the opportunity to testify on the Basel Committee on Banking Supervision's proposed new capital accords, or Basel II. The Bond Market Association represents securities firms and banks that underwrite, distribute and trade debt securities domestically and internationally. Association member firms account for in excess of 95 percent of all primary issuance and secondary market activity in the U.S. debt capital markets. Through our affiliate American and European Securitization Forums, we represent a majority of the participants in the growing securitization markets in the United States and Europe. The following comments focus on only those issues related to Basel II that are most important to our membership.

I. TBMA Supports the Goals of Basel II

The Association supports the Basel Committee's overall goal of rationalizing the current risk-based capital regime, and aligning regulatory capital requirements more closely with actual credit risk. This goal is critically important to the global financial market, in which capital flows are increasingly mobile and interdependent. Also, we are grateful to the Federal Reserve Board and other U.S. bank regulatory agencies for working with us to address the issues presented by the proposed capital accord revisions that affect the domestic bond market. While some of our concerns expressed previously were addressed in the Basel Committee's third consultative paper (CP3) on Basel II, critical issues still remain.

The Basel Committee has an important role in promoting a prudential but efficient allocation of capital throughout the banking system. An updated regulatory capital regime can produce significant benefits, including the promotion of fair global competition, the creation of incentives for better internal risk management, and an economically efficient allocation of capital to its most productive uses.

Although we support the direction and goals embodied in Basel II, the revised Accord should not be viewed as the last word on regulatory capital. In attempting to promulgate a universal rules-based system that applies the same basic capital requirements to all regulated financial institutions, Basel II—like its predecessor—is overly rigid and prescriptive in certain critical respects. However, no such "one-size-fits-all" regulatory capital regime can fully accommodate the unique needs of these diverse institutions, or flexibly respond to rapid changes in the financial markets in which they operate, without suffering from this basic limitation. To overcome this deficiency, the global financial community will need to move toward a broader reliance on internal risk models, with supervisory review and approval, to determine appropriate regulatory capital levels, and we encourage financial market regulators to continue moving in this direction.

In the meantime, our comments focus on aspects of the proposed Accord that we believe will, at least in the short term, facilitate the goal of aligning regulatory capital requirements more closely with actual credit risk.

The Association has principally focused on two areas of the proposed Basel Accord that significantly affect the bond markets—securitizations and collateralized transactions, including securities repurchase (repo) and securities lending arrangements. By creating more risk-sensitive capital standards in these areas, Basel II can ensure these transactions continue to serve as useful funding, liquidity and risk management tools.

Securitizations allow banks and other entities to obtain efficient funding and to remove certain risks from their balance sheet so they can be borne by other parties who desire such an exposure. Repo and securities lending transactions also aid institutions in managing risk by allowing them to readily obtain securities in order to meet delivery obligations and to hedge exposures arising from separate transactions. Setting regulatory capital charges too high for these increasingly important and widely used arrangements threatens to distort economic decision making on the part of a financial institution. This has the potential of eroding the significant benefits that consumers and businesses alike realize from securitization and collateralized transactions.

II. Background on the Securitization and the Repo and Securities Lending Markets

II. a. Market Size

The past several years have seen phenomenal global growth of the securitization market. Since 1995, the U.S., European and Asian markets combined have grown from $497 billion to $2.9 trillion The U.S. market by itself has accounted for about 95 percent of that volume.

The repo market has also shown steady growth over the same period. Approximately $1.7 trillion in repo and securities lending transactions were outstanding on average in 1996 and today an average $3.7 trillion are outstanding. Hundreds of billions of dollars in repo transactions are conducted daily to fund the positions of bond market participants and allow the Federal Reserve Board to conduct open market operations.

II. b. Benefits of Securitization and Securities Lending and Repo Agreements

Securitization offers numerous benefits to consumers, investors, regulators, corporations and financial institutions.

Securitization has developed as a large market that provides an efficient funding mechanism for originators of receivables, loans, bonds, mortgages and other financial assets. Securitization performs a crucial role for the entire U.S. economy by providing liquidity to nearly all major sectors including the residential and commercial real estate industry, the automobile industry, the consumer credit industry, the leasing industry, and the bank commercial lending and corporate credit markets. In addition, securitization has provided a means for banks to effectively disperse the risk of various positions they hold throughout the broader financial market.

Securitization provides low-cost financing for banks and other companies, lowers borrowing costs for consumers and home buyers, adds liquidity to banks' balance sheets, provides for efficient bank balance sheet and capital management, and draws non-traditional sources of capital to the consumer and corporate lending markets. The efficiencies introduced by securitization are passed on to consumers and businesses in the form of more widely available credit, lower interest rates and lower prices.

Securities Lending and Repurchase Transactions

Securities lending and repo transactions are integral to maintaining liquidity in the capital markets. They are a secure and flexible method of obtaining funding and securities for market participants. For example, a market participant may purchase securities which are then sold in a repo transaction, with an agreement to repurchase such securities sometime in the future. The repo seller can use the proceeds of this transaction to fund their initial purchase. The repo buyer is able to invest funds for short periods in a safe and liquid product. By providing a ready source of funding, repos and securities lending transactions are critical to maintaining liquidity in the bond markets. In the Treasury markets in particular, this liquidity ensures that the Treasury's borrowing costs are kept low. In short, America's capital markets operate as efficiently as they do because wholesale market participants can use repos and securities lending transaction to finance and hedge positions. The liquidity and efficiency provided by the repo market lowers financing costs for the federal government, home buyers, corporations and consumers.

III. Basel II's Impact on Securitization and the Repo and Securities Lending Market

The Association applauds the goal of the Basel Accord to allow financial institutions the ability to more closely tailor risk-based capital requirements to the actual amount of risk present in financial transactions. The proposed Accord, however, does not currently meet this goal because under the proposal, institutions would be required to maintain a higher level of capital than is warranted by the practical risk of their positions. We have summarized below some of our principal concerns in connection with the proposed capital treatment of securitization exposures and repo and securities lending transactions. The Association is continuing to develop additional quantitative and analytical arguments to support these points, which will be submitted prior to the July 31 comment deadline in response to the CP3. The Association will share our comments with committee members at that time.

THE BOND MARKET ASSOCIATION

III. a. Securitization

The Association is troubled by the treatment in Basel II of certain securitization products and positions. We are especially concerned that if Basel II is not amended, the onerous capital charges imposed on banks will discourage them from engaging in securitization transactions. As a result, the benefits conveyed by a robust and efficient securitization market would be diminished or lost.

Securitization Risk Weights Are Too High
The floor capital charge is too high for many types of securitization positions, given their actual risk profile. Sub-investment grade positions in particular attract too high a capital charge under the proposals, given the actual credit risk they present. Many of the key assumptions underlying securitization formulas and risk weights are too conservative, and lack a proper theoretical or empirical foundation.

By setting the floor requirements at a higher level than the actual risk of a position, Basel II reduces incentives for banks to participate in securitizations. This would lower incentives to conduct transactions that actually lessen a bank's risk exposure and that allow banks effectively to disseminate the risk of a particular transaction throughout the marketplace.

Conservative Rules Result in Inordinately High Charges
In establishing rules governing the manner in which regulatory capital computations are to be made, Basel II defaults to the conservative alternative so often that—cumulatively—these rules result in an inappropriately high capital charge for securitizations. For example, given the general ability under Basel II to rely upon qualified external ratings to determine regulatory capital requirements, we believe that originators of securitized assets should be able to use such ratings to determine risk weights, even if this produces a lower capital charge than if the assets had not been securitized. Originators do not have this ability under the proposal as drafted. There are numerous other examples of excessively conservative rules that—in the aggregate—produce unduly high capital charges for securitizations.

Synthetic Securitizations Should Not Be Discriminated Against
Higher capital charges should not be levied against synthetic securitizations, in comparison to traditional asset securitizations. (Synthetic securitizations involve the bundling and securitization of credit exposures, rather than the underlying financial assets.) Synthetic securitizations are increasingly used by financial institutions to manage their balance sheets, and provide additional options and flexibility for risk management. Since the risk profile of a synthetic asset is the same as for a cash asset,

the risk based capital treatment should be equivalent. However, this would not be the outcome under the proposals as currently drafted and, in several respects, synthetic securitization positions attract inordinately high capital charges.

Limited Credit Risk Inherent in Liquidity Facilities Should be Recognized

In a number of important respects the Basel II proposals would require financial institutions to hold disproportionately high levels of capital against liquidity facilities they provide in connection with securitizations. Such liquidity facilities are extended by financial institutions to a variety of securitization issuance vehicles, including but not limited to asset-backed commercial paper conduits. Through the securitization market, these conduits provide competitive short-term financing for a wide range of asset originators. The performance history of liquidity facilities in this context demonstrates that the likelihood of draws are extremely low, and the incidence of credit losses negligible.

We believe that internal modeling is the most appropriate method for determining regulatory capital for liquidity facilities. The key operational requirement for liquidity facilities is that there be an asset quality test that adjusts dynamically to preclude funding of defaulted assets. Such a dynamic test is one that is built into liquidity facilities that have been in the market for years, and that has led to historical performance data showing the relatively low risk of draws and of losses on such draws.

Under Basel II, if a liquidity position is not rated, we believe that a bank should be able to look through to the risk weight assigned to the underlying transaction that the liquidity supports if that underlying transaction has been externally rated. Given that the underlying transaction reflects the ultimate risk of a liquidity position, we see no reason not to permit the reliance on the rating of that transaction if a liquidity position itself is not rated.

III. b. Securities Lending and Repurchase Transactions

The Association is concerned that Basel II, as proposed, falls short with regard to recognizing modern risk-management techniques as they relate to secured transactions such as securities lending and repurchase transactions. By failing to account for methods widely used to mitigate risk exposure, capital charges for banks would not reflect true balance sheet risk. The undue capital charges would ultimately result in less efficient and more costly markets.

Encourage the Use of Cross-Product Netting as a Risk Management Techniques

The Association believes that the manner in which risk based capital requirements for repo and securities lending transactions are calculated should be revisited along with the treatment of similar collateralized transactions. The Association strongly believes that transactions which present similar risks—and mitigate against similar risks—as repo and securities lending transactions should be treated in the same way for risk-based capital purposes. Many financial institutions currently manage risks for all collateralized transactions in a uniform manner.

After conforming the manner in which risk is calculated for repo and securities lending transactions and other collateralized transactions, the Basel Accord should take the next logical step and allow for recognition of the netting of exposures across such transactions. Currently the Basel Accord contemplates netting only between repo and securities lending transactions. It is widely recognized that netting exposures across different transactions helps financial institutions reduce their exposure to the risks such transactions present. Providing incentives in the Basel Accord through broader recognition of cross-product netting will provide added incentives for financial institutions to implement this risk-reducing practice.

Encourage the Use of Internal Risk Models

It is the Association's view that allowing financial institutions to utilize internal risk models—as Basel II would—to determine counterparty risk for collateralized transactions is a step in the right direction. Basel II should not, however, dictate rigid rules as to what models financial institutions must utilize in determining risk. The Accord should allow financial institutions to utilize their own risk models subject to the review and approval of national supervisors under Pillar 2 of the Basel Accord. Otherwise, financial institutions would likely devote resources to creating a model that may not accurately capture the risks present in collateralized transactions. In addition, the Association believes the Accord should not set out a rigid backtesting regime for such models. (In this case, backtesting refers to evaluating the performance of a model based on historical data.) In any event, the backtesting regime currently set out in the Basel Accord risks dissuading financial institutions from improving upon their existing risk management practices through the use of internal risk models by risking the imposition of significantly increased capital charges. As currently contemplated, should the results of the backtesting regime generate a number of mismatches or "exceptions" between estimated and actual data, an institution's risk-based capital charge would be significantly increased. Such backtesting regime—and its potentially punitive results—do not have any commercially reasonable basis in relation to the repo and securities lending markets.

IV. Conclusion

The Association supports the overall goal of the Basel Committee to align capital requirements for financial institutions more closely to actual credit risk. While the revised Accord has the potential to move regulatory capital requirements in the right direction, the Association continues to have fundamental concerns with the proposal that must be addressed to uphold the Basel Committee's stated goals without causing economic distortions in the securitization, repo and securities lending markets.

The Association looks forward to continuing its dialogue with the Federal Reserve Board and other U.S. regulators on the issues we have addressed above. We plan to offer formal comments on the third consultative paper this summer, and when the Board issues its advanced notice of proposed rulemaking describing the U.S. implementation of Basel II, the Association will provide further input.

T stimony before the U.S. House of Representatives, Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, June 19, 2003
By
Benton E. Gup, Ph.D.
The University of Alabama[1]

BASEL II CREATES AN UNEVEN PLAYING FIELD

The 1988 Basel Capital Accord provided a minimum capital requirement of 8% of risk weighted assets for internationally active banks in order to 1) ensure an adequate level of capital and 2) competitive equality. It is the second point, *competitive equality* that is addressed here. Competitive equality referred to the fact that at that time, banks in the major trading countries had significantly different capital ratios. Those with lower capital ratios had lower costs of funds and a competitive advantage in the loan markets of the world. Thus, one of the purposes of the 1988 Accord was to even the playing field in terms of capital requirements. It was successful. By the turn of the century, the 8% capital standard has been adopted in more than 100 countries with internationally active banks.[2]

The 8% capital standard is a "one size fits all" measure. It focused on credit risk, which was a good starting point; but banks face a wider variety of risks. Accordingly, in 1996, an amendment was introduced that allowed banks to deal with trading/market risks. And in 1999, the Basel Committee on Banking Supervision proposed a New Capital Adequacy Framework to replace the 1988 Accord. The end product will be the New Basel Capital Accord (Basel II) that is expected to be adopted in 2006. The good news is that Basel II will provide greater flexibility and risk sensitivity than the 1988 Accord. The bad news is that it will create competitive inequality which was one of major reasons behind the framing of the 1988 Accord.

Basel II provides three options for calculating risk weighted assets for credit risk.[3]

> 1) The Standard Approach is similar to the 1988 Accord. However, some adjustments to the risk weights are made for sovereign exposures, non-governmental public sector entities, and multilateral development banks. A 100% risk weight means a full capital charge

---

[1] Benton E. Gup, Ph.D.
Box 870224
Room 200 Alston Hall
University of Alabama
Tuscaloosa, AL 35487

Phone 205-348-8984
Fax 205-348-0590

[2] "The New Basel Capital Accord," Press Release, January 16, 2001.
[3] "Overview of the New Basel Capital Accord," April 2003.

equal to 8% of that value. A 50% risk weight means a capital charge of 4% (0.5 x 8%) of that value. For corporate lending, Basel II provides risk weights of 20%, 50%, 100%, and 150%.

2) The Foundation Internal Ratings Based (IRB) Approach.

3) The Advanced Internal Ratings Based (IRB) Approach. The Advanced IRB approach is similar to the Foundation IRB approach. However, under the Foundation IRB, the bank supervisors provide the estimates of the values used in establishing losses (e.g., loss given default [LGD], exposure at default [EAD], and maturity [M]) that are used in the models. Under the Advanced IRB, the bank provides the probability of default [PD], LGD, EAD, and M. The range of risk weights under the Foundation and Advanced IRB approaches is greater than under the Standard Approach. Credit risk mitigation and securitization are considered under both approaches.

Bank Capital

Table 1 shows the total risk based capital ratios for all FDIC-insured commercial banks in 2002. The ratios range from 17% for the smallest banks to 12% for the largest ones. There are 80 large banks with assets greater than $10 billion, and 7,807 smaller banks. The small banks have excess capital. The capital for the large banks exceeds the 8% minimum, and provides a cushion for growth. During the 1997-2002 (4th Qtr.) period, large bank assets increased 66%. During that same period, the assets of smaller banks remained virtually unchanged.

Table 1
Total Risk Based Capital Ratio at FDIC-Insured Commercial Banks
Full Year 2002

	Less than $100 million in assets	$100 million to $1 billion in assets	$1 billion to $10 billion in assets	Greater than $10 billion in assets
12.78% Average capital ratio for all banks	17.10%	14.20%	14.53%	12.12%
7,887 banks	4,168	3,314	325	80

Source: *FDIC Quarterly Banking Profile,* Fourth Quarter, 2002, Table III-A
http://www2.fdic.gov/qbp/2002dec/cb3.html

Federal banking regulators are expected to require about twenty of the largest commercial banks to use the Advanced IRB approach. The other banks will be given a choice of using the Advanced IRB approach or continue to use the 1988 Basel Capital Accord standard. Because the smaller banks have excess capital, and less need to enter the national and international capital markets than the large banks, the 1988 Basel Capital Accord will work for them. That leaves about 60 large banks in a quandary. Which approach should they use?

One factor affecting their decision is the cost of implementing Basel II that ranges from $10 million for small banks to $150 million or more for large banks.[4] For example, Credit Suisse First Boston estimated that the initial costs of complying with Basel II would range from $52 million to $75 million, plus substantial costs for maintaining the systems.[5]

Stock market and debt market values are important too. Some bankers whose stocks are actively traded believe that they must choose the Advanced IRB approach if they want to be considered major league players by equity analysts and shareholders. Otherwise, they will be considered minor league players, and it could adversely affect the price of their stocks. The issue of whether a bank is a major league player appears to be of greater concern to equity analysts than to credit rating agencies.

Different Methods of Calculating Credit Risk Give Different Capital Requirements

Large banks will probably select the Advanced IRB method for calculating risk weighted assets because it gives them the greatest potential for reducing the amount capital that they must allocate for credit risk. Thus, a bank using the Advanced IRB method for calculating risk may have lower capital requirements for a loan than a bank using the 1988 Basel Accord standards. By way of illustration, consider a $100 commercial loan with a 1-year maturity. An FDIC study by French, Stark, Cave, and Feid (2003) revealed that under the Standard Approach – which is similar to the 1988 Basel Accord standards, the loan has a 100% risk weight and the capital charge is $8. Under the Advanced IRB approach, if the loan has an initial S&P rating of "A+," a 10% loss given default (LGD), and a 0.3 probability of default (PD), it would have a 1.72 risk weight that equates to a capital charge of $0.14 ($8 x 0.0172 = $0.1376).

The LGD, PD and EAD used in the Advanced IRB method to evaluate a particular loan may vary from bank to bank depending on the underlying assumptions, judgments, quality and quantity of the data, and the models they use. It is possible that some banks using the Advanced IRB method may understate the risks to minimize the initial risk capital required in order to price a loan below their competitors. Even if such banks don't "game" the system, the Advanced IRB typically produces lower capital requirements. To the extent that capital is taken into account in pricing loans, this creates an uneven playing field for the 7,800+ banks using the 1988 Basel Accord standard.

Real Estate

Real estate loans are singled out because they constitute a larger percentage of the loan portfolios of the larger regional banks than of the largest banks in our system. The risk weights assigned by Basel II to real estate loans

---

[4] Petrou (2003).

[5] Ervin (2003).

appear to be excessive in light of the changes that have occurred in that industry. The past and the present are discussed below.

An FDIC study, *History of the Eighties* (1997, Vol. 1), found that real estate loans were the main cause of losses at failed and surviving banks in the U.S. in the 1980s and early 1990s. An International Monetary Fund study by Lindgren, Garcia, and Saal (1996) found that real estate loans contributed to banking sector problems in Finland, France, Japan, Malaysia, Norway, Spain, and Sweden. A World Bank study by Sheng (1996) identified real estate losses with banking problems in Argentina, Chile, Columbia, Ghana, Yugoslavia, and elsewhere. Finally, Gup (1998), studying international banking crises, identified real estate loans as contributing to more bank failures than any other category of loans. The bottom line is that real estate lending can be risky. Why?

The 1985-1991 Period

In order to answer that question for real estate loans in the U.S., we examine one of the worst periods in banking history, and then contrast it to 2002. As shown in Table 2, 1,260 FDIC-insured commercial banks failed during the1985-1992 period. During this period, real estate loans expressed as a percentage of net loans and leases increased from 27% to 44%.

In order to examine the failed banks in greater detail, we focus on 1991.[6] Table 3 shows that most of the banks that failed were small: 69% had assets of less than $100 million and 23% had assets $100 million to $1 billion. Stated otherwise, 92% of the banks that failed were small, community banks. Table 3 also reveals that most of the failed banks were located in the Northeast and Southwest.

Bad real estate loans were a major factor in many of the failures. Figure 1 shows a map of troubled real estate loans by state in 1991. The darkest color on the map depicts states with 8% or more troubled real estate assets. They are located primarily in the Southwest and Northeast. Banks located in Texas, Connecticut, and Massachusetts accounted for the greatest concentration of failures. Other parts of the country fared better.

The map in Figure 1 and the data in Tables 3 provide unique insights. The real estate problems were highly concentrated in selected states. Because small banks serve their local communities, they were impacted the most by downturns in their real estate markets in the sense that they could not diversify their real estate loan risk. The same was true for the larger banks that failed. However, the composition of loans and charge-offs rates of loans differed substantially between small and large banks (see Table 5).

In the early 1990s, bank operations were restricted geographically. It was not until 1994 that the Riegle-Neal Interstate Branching Efficiency Act was passed that allowed interstate bank acquisitions.

In 1991, commercial and industrial loans accounted for 27% of total loans and leases and real estate loans accounted for about 43%. However, as shown in Table 4 – FDIC Assets in Liquidation, C&I loans exceeded real estate loans.

---

[6] 1991 was selected because the data were complete and consistent in the sources cited in Tables 2-5. Data for 1992 was not consistent.

This suggests that commercial loans also contributed significantly to bank failures, and that bad real estate loans were not the sole cause.

Table 2
FDIC Insured Bank Failures, Deposits, and Real Estate Loans

Year	Bank Failures (1,260)	Bank Deposits at Failed Banks $ bill. ($180)	Total Real Estate Loans at all banks $ bill.	Net Loans and Leases $ bill	Real Estate loans/net Loans and Leases %
1992	120	$41	$868	$1,977	43.9%
1991	124	54`	851	1,998	42.6
1990	168	15	830	2, 055	40.4
1989	206	24	762	2,004	38.0
1988	200	25	675	1,886	35.8
1987	184	6	600	1,779	33.7
1986	138	7	515	1,728	29.8
1985	120	8	439	1,608	27.3

Annual Report 2002, FDIC, p. 111; FDIC, "Real Estate Loans," Table CB12, http://www2fdic.gov/hsob/hsobRpt.asp.

Table 3
1991 Failed Banks by Asset Size and Location

Bank Asset Size	1991 Failed Banks
Greater than $10 billion	2 (1%)
$1 billion - $10 billion	9 (7%)
$100 million - $1 billion	28 (23%)
Less than $100 million	85 (69%)
Total	124 100%
Northeast	45 (36%)
Southwest	38 (31%)

"Banks Failures and Assistance," 1991, FDIC, http://www.fdic.gov/bank/historical/bank/1991/index.html

Table 4
1991 FDIC End of Year Assets in Liquidation

Asset Type	Book Value ($ billions)
Commercial Loans	$15.3
Mortgage Loans	12.8
Other Loans	1.4
Real Estate Owned	6.0
Judgments	1.9
Securities	0.3
Other Assets	5.6
Total	$43.3

Managing the Crisis: The FDIC and RTC Experience, 1998. Table 15-4.

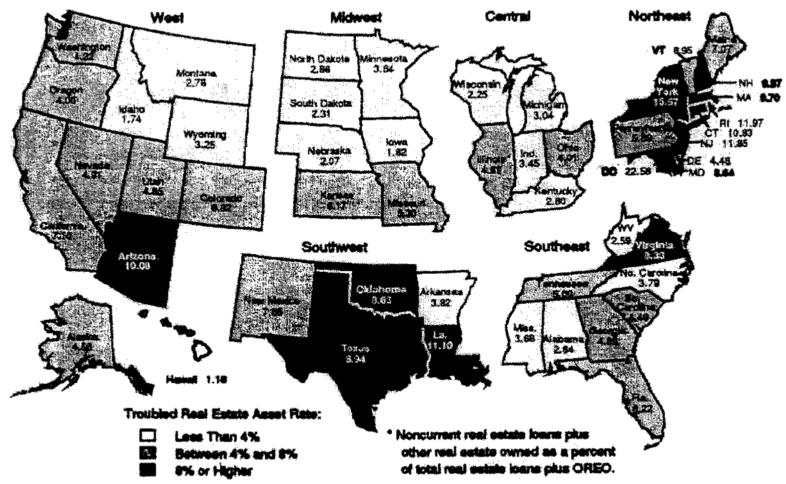
Table 5
Percent of Real Estate Loans Charged Off (Net), Yearend 1991

	All Banks	Assets Less than $100 million	Assets $100 million – $1 billion	Assets $1-10 Billion	Assets Greater than $10 billion
All Real Estate Loans	0.98%	0.26	0.45	1.02	1.54
Construction & development	3.02	0.45	1.43	3.12	4.38
Commercial	1.24	0.40	0.62	1.18	2.21
Multifamily residential	2.01	0.51	0.56	1.58	3.75
1-4 Family	0.20	0.18	0.18	0.28	0.14
Home equity lines of credit	0.14	0.27	0.11	0.15	0.10

Source: *The FDIC Quarterly Banking Profile*, Fourth Quarter, 1991, page 4.

Figure 1[7]

Troubled Real Estate Asset Rates By State
December 31, 1991



Real Estate Lending 2002

The dynamics of real estate lending have changed dramatically as a result of deregulation and changes in technology.

Geographic Diversification: As a result of the previously mentioned Riegle-Neal Act, and other laws deregulating banking activities, such as Gramm-Leach-Bliley, large banks today enjoy geographic and product diversification that allows them to limit their loan risk in specific markets. No longer is a bank limited to one city or one state. It can expand throughout the United States to obtain an optimal allocation of its loan portfolio.

Securitization: Securitization of loans benefits both the sellers and the buyers. The sellers can reduce their balance sheet risks and increase their fee income. Fannie Mae, for example, buys home mortgages and mortgage related products from banks and other financial institutions. Fannie Mae also guarantees some mortgage products. The buyers can diversify their loan portfolios by buying loans from different geographic areas, and with different degrees of risk.

Derivatives: Derivatives are widely used by about 400 banks to hedge interest rate and credit risks.[8] The *Fannie Mae 2002 Annual Report*[9] does an

[7] *The FDIC Quarterly Banking Profile*, Fourth Quarter, 1991, Chart F.
[8] "OCC Bank Derivatives Report, Third Quarter 2002," December 2002.

outstanding job explaining how this Government Sponsored Enterprise (GSE) uses derivatives to hedge interest rate and credit risk. Table 6, from Fannie Mae's 2002 Annual Report, illustrates the type of instruments used, what they are hedging, and the purposes of the hedged transactions. The annual report of Fannie Mae should be read by all real estate lenders to gain insights about how to mitigate the risks associated with such loans.[10]

Table 6
Fannie Mae's Use of Derivatives

TABLE 24: PRIMARY TYPES OF DERIVATIVES USED

Derivative Hedging Instrument	Hedged Item	Purpose of the Hedge Transaction
Pay-fixed, receive-variable interest-rate swap	Variable-rate debt Anticipated issuance of debt	To protect against an increase in interest rates by converting the debt's variable rate to a fixed rate.
Receive-fixed, pay-variable interest-rate swap	Noncallable fixed-rate debt	To protect against a decline in interest rates. Converts the debt's fixed rate to a variable rate.
Basis swap or spread-lock	Variable-rate assets and liabilities	To "lock-in" or preserve the spread between variable-rate, interest-earning assets and variable-rate, interest-bearing liabilities.
Pay-fixed swaption	Variable-rate debt	To protect against an increase in interest rates by having an option to convert floating-rate debt to a fixed rate.
Caps	Variable-rate debt	To protect against an increase in interest rates by providing a limit on the interest cost on our debt in a rising rate environment.
Receive-fixed swaption	Noncallable fixed-rate debt	To protect against a decline in interest rates by having an option to convert fixed-rate debt to floating-rate debt.
Foreign currency swaps	Foreign currency-denominated debt	To protect against fluctuations in exchange rates on non-U.S. dollar-denominated debt by converting the interest expense and principal payment on foreign-denominated debt to U.S. dollar-denominated debt.

Loan-to-Value (LTV) Ratios: The *Fannie Mae 2002 Annual Report* (page 71) states that "LTV ratio is a strong predictor of credit performance. The likelihood of default and the gross severity of a loss in the event of a default are lower as the LTV ratio decreases, all other factors held equal." This is true for both residential and commercial real estate.

The average loan to price ratio on new single family homes in the U.S. in 2002 was 77.8%, not much different from the 75.0% in 1991.[11] Data are not available for commercial and other real estate LTVs. Nevertheless, the same principal applies – high LTVs are associated with high risk.

Credit Scores: In recent years, credit scores developed by Fair Isaac & Co. (FICO scores) have become widely used as an indicator of credit quality for retail borrowers.[12] The FICO scores range from 150 to 950. Scores below 620

---

[9] See pages 61-63 in the *Fannie Mae 2002 Annual Report.*

[10] Also see Poole (2003) for a discussion of the GSEs role in the housing markets and financial stability.

[11] *Federal Reserve Bulletin*, May 2003, A 32; U.S. Department of Commerce, *Statistical Abstract of the United States, 1993,* Table 811.

[12] For additional information, see www.myfico.com.

are considered subprime. The higher the score the better, and the less likely the chance of default.

Bank Failures and Loans Charged-Off in 2002: Ten FDIC insured banks failed in 2002, the largest number of bank failures since 1994. The failures reflected slow economic growth and problems with subprime lending.
The data presented in Table 7 shows the loans that were charged off in 2002. Notice that all real estate loans had a charge-off rate of 0.15%, while C&I loans and loans to individuals had charge-off rates of 1.76% and 3.34% respectively.

This may suggest that the real estate market has suffered less than the other markets. It also may suggest that the real estate lenders have taken advantage of the risk mitigation techniques described above. In either case, it appears that real estate today is not as risky as it was during the 1985-1992 period. Accordingly, the Basel II risk weights for real estate need to be adjusted to level the playing field.

Finally, it is interesting to note that Fannie Mae and Freddie Mac, whose portfolios consist primarily of single-family and multifamily mortgage products, are required to hold far less regulatory capital (about 3%) than commercial banks (about 8%). However, the risk weight for home mortgages in the Basel II Standard approach could be a low as 40%. That risk weight translates into a regulatory capital charge of 3.2% (40% x 8% = 3.2%). The capital charge under the IRB Approach could range from 7.2% to 21.5% depending on the assumptions made about the probability of default (PD) and the loss given default (LGD).[13]

Both Fannie and Freddie make the point that the U.S. government does not guarantee their debts. Nevertheless, the capital markets seem willing to accept their low capital ratios. This suggests that the capital markets consider their real estate lending to be relatively low risk because of their portfolio management techniques they use.

CONCLUSIONS

The main point made here is that Basel II creates an uneven playing field for the large, but not the largest banks in the U.S. Bank regulators will require our largest banks to use the costly and complex Advanced IRB approach to comply with Basel II. Some of the other large banks believe that if they don't use that approach, it will have adverse consequences in the capital markets. If they want to be considered in the same league as the largest banks, they will have to comply with the same standards. And in this post-Enron, WorldCom, HealthSouth period of accounting skullduggery, stock analysts and investors will want to know which Basel II approach banks are using. The Securities and Exchange Commission Reg FD (Fair Disclosure) requires companies that disclose material nonpublic information to disseminate it broadly. Therefore, there in little doubt that all banks that are active in the capital markets should state in their annual reports which IRB method they use.

Another major point is that our largest banks are not as heavily invested in real estate loans as the large banks. For example, commercial real estate

[13] "*Basel Briefing 5*" (May 2003), p. 22.

accounts for less than 2% of the loans at Citibank and J.P. Morgan Chase while it accounts for more than 20% of the loans at Colonial and Regions banks. The fact that the Basel II risk weights on commercial real estate loans is 150% or higher means that banks holding such loans may need more than the required 8% minimum capital to make and hold such loans. One implication of this is that banks with adequate or excess capital will make such loans. Another possibility is that the bank will issue more capital. A third implication is that, banks may get out of that business because of the high capital charges.

As a corollary, we should ask if the high capital charges on real estate are necessary. The answer is yes, and no. There is no doubt that highly concentrated loan portfolios consisting of high LTV real estate loans are very risky. That was the case in the late 1980s and early 1990s in the U.S. and it still may be the case in some foreign countries. However, in the U.S. today, real estate loan portfolios can be diversified geographically and by products, hedged with derivatives, and have less risk by having lower LTVs and higher FICO scores. These techniques will make future real state bubbles less of a threat to financial stability than they were in the past. Fannie Mae and Freddie Mac provide examples of how such techniques can be used. In such cases, the Basel II capital risk weights are excessive.

One final thought concerning the statistical methodology of the Advanced IRB approach that permits each bank to have different capital charges for the same type of loan. As previously noted, the capital charge for home mortgages can range from 7.2% to 21.5% or more depending on the assumptions made about the probability of default (PD) and the loss given default (LGD).[14] Simply stated, the IRB methodology depends too much on past data to predict future losses. Looking at the real estate problems of the 1980s in Texas and Massachusetts to predict future real estate bubbles in the 21st century is analogous to driving down a steep, winding mountain road by only looking out the back window. A crash is inevitable.

Because the risk management techniques used today are dynamic, the data and the new and existing variables in the IRB models need to be updated constantly. This is a costly and time consuming process. A bank that can afford to develop models that are advantageous to them will probably have the lowest capital charges, and a competitive advantage. Stated otherwise, once again there will be *competitive inequality* in bank capital. Recall that ensuring *competitive equality* was one of the two reasons given for enacting the 1988 Basel Capital Accord.

[14] "*Basel Briefing 5*" (May 2003), p. 22.

Table 7
Total Loans and Percentage Charged-Off, 2002

	$ Billions	**Percentage of Total Loans and Leases**	**Percentage of Loans Charged-Off**
Total Loans and leases	$4,163.4	100%	1.11%
All real estate loans	2,068.0	49.7	**0.15**
Construction and development	207.4	5.0	0.17
Commercial real estate	555.8	13.3	0.15
Multifamily residential	71.9	1.7	0.07
Home equity loans	214.6	5.2	0.19
1-4 Family	945.9	22.7	0.14
Commercial and Industrial	912.0	21.9	**1.76**
Loans to Individuals	703.6	16.9	**3.34**
Credit card loans	275.8	6.6	6.38
Other loans to Individuals	427.8	10.3	1.46
Other loans and leases	479.8	11.5	0.58

Source: *Quarterly Banking Profile,* Fourth Quarter, 2002, Washington, D.C., Federal Deposit Insurance Corporation, 2003, Table V-A.

REFERENCES

Annual Report 2002, Washington, D.C., Federal Deposit Insurance Corporation, 2003.

"Banks Failures and Assistance," 1991, 1992 FDIC, http://www.fdic.gov/bank/historical/bank/1991/index.html

"Basel Briefing 5," KPMG, May 2003,

Ervin, D. Wilson, Testimony on behalf of Credit Suisse First Boston and The Financial Services Roundtable, Hearings on the New Basel Accord before the Subcommittee on Domestic and International Monetary Policy, U.S. House Committee on Financial Services, February 27, 2003.

Fannie Mae 2002 Annual Report, Washington, D.C., Fannie Mae, 2003.

Federal Reserve Bulletin, May 2003.

French, George, William A. Stark, Jason C. Cave, and John Feid, "Risk-Based Capital Requirements for Commercial Lending: The Impact of Basel II, *FYI,* FDIC, April 21, 2003, http://www.fdic.gov/bank/analytical/fyi/2003/042103fyi.html

Gup, Benton E., *Bank Failures in the Major Trading Countries of the World: Causes and Remedies*, Wesport. CT., Quorum Books, 1998.

History of the Eighties- Lessons for the Future: An Examination of Banking Crises of the 1980s and Early 1990s, Washington, D.C., Federal Deposit Insurance Corporation, 1997, Vol. 1.

Lindgren, C., G. Garcia, and M.I. Saal, *Banking Soundness and Macroeconomic Policy*, Washington, D.C., International Monetary Fund, 1996.

Managing the Crisis: The FDIC and RTC Experience, Washington, D.C., Federal Deposit Insurance Corporation, 1998, Table 15-4.

"OCC Bank Derivatives Report, Third Quarter 2002," Washington, D.C., Office of the Comptroller of the Currency, December 2002.

"Overview of the New Basel Capital Accord," Consultative Document, , Basel Committee On Banking Supervision, Bank For International Settlements, Basel, Switzerland, April 2003.

Petrou, Karen Shaw, "Policy Issues in Complex Proposals Warrant Congressional Scrutiny, " Testimony before the Domestic and International Monetary Policy, Trade and Technology Subcommittee on Financial Services, U.S. House of Representatives, February 27, 2003.

Poole, William, "Housing in the Macroeconomy," *Review*, Federal Reserve Bank of St. Louis, May/June 2003, 1-8.

Quarterly Banking Profile, Fourth Quarter, 2002, Washington, D.C., FDIC, 2003.

"Real Estate Loans," FDIC, Table CB12, http://www2fdic.gov/hsob/hsobRpt.asp.

Sheng, A., *Bank Restructuring: Lessons from the 1980s*, Washington, D.C., The World Bank, 1996.

The FDIC Quarterly Banking Profile, Fourth Quarter, 1991, Washington, D.C., FDIC, 1991.

The FDIC Quarterly Banking Profile, Third Quarter, 2002, Washington, D.C., FDIC, Third Quarter, 2002. http://www2.fdic.gov/qbp/2002dec/cb3.html

The FDIC Quarterly Banking Profile, Fourth Quarter, 2002, Table III-A http://www2.fdic.gov/qbp/2002dec/cb3.html

"The New Basel Capital Accord," Press Release, Basel Committee on Banking Supervision, Bank for International Settlements, Basel, Switzerland, January 16, 2001.

U.S. Department of Commerce, *Statistical Abstract of the United States, 1993,* Washington, D.C., 1994.

For Release Upon Delivery
10:00 a.m., June 19, 2003

TESTIMONY OF

JOHN D. HAWKE, JR.

COMPTROLLER OF THE CURRENCY

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES

of the

UNITED STATES HOUSE OF REPRESENTATIVES

June 19, 2003

Statement required by 12 U.S.C. 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Bachus, Congressman Sanders, and members of the Subcommittee, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on proposed revisions to the 1988 Capital Accord developed by the Basel Committee on Banking Supervision (Basel Committee). I welcome the efforts of the Subcommittee to focus attention on these critical issues. The health of the U.S. commercial banking system is a critical element to a strong economy. Thus, it's essential that any regulatory changes that might affect the condition and competitiveness of our banking system be fully understood and carefully evaluated by the banking industry, the U.S. Congress and the American public.

The 1988 Accord, referred to as Basel I, established the framework for the risk-based capital adequacy standards applicable to internationally active commercial banks in all of the G-10 countries, and it has been adopted by most other banking authorities around the world. U.S. banking and thrift agencies have applied the 1988 framework to all U.S. insured depository institutions.

By the late 1990s, it became evident that Basel I had become outdated. The increased scope and complexity of the banking activities of our largest banking institutions over the last decade, and the unintended consequences of various provisions of the regulations, severely undercut the utility of the Capital Accord. Basel I simply does not provide a meaningful measure of the risks faced by large, internationally active banks or the capital they should hold against those risks.

Consequently, over the past several years, the Basel Committee has been developing a more detailed and risk sensitive capital adequacy framework to replace Basel I. The Committee's first draft document, Consultative Paper No. 1 (CP-1), was issued in June 1999. It laid the groundwork for the new capital adequacy framework (Basel II), but provided few details. The Committee provided additional detail on the specifics of Basel II in its January 2001 issuance of Consultative Paper No. 2 (CP-2). Although more detailed, CP-2 still left a number of key issues unaddressed and unresolved. The Committee's most recent paper, Consultative Paper No. 3 (CP-3), which I will discuss today, was issued on April 29 of this year.

As work on these consultative papers has progressed, the Basel Committee also has attempted to gauge the impact of its proposals on the required capital levels of banking institutions through a series of quantitative impact studies. In May, the Committee published the results of the most recent assessment, the third quantitative impact study (QIS-3). While the Committee concluded that the results were generally in line with the objectives of Basel II, the QIS-3 data still do not provide a sufficiently reliable estimate of the likely regulatory capital requirements for banks subject to Basel II. More work in this area is clearly warranted and I will discuss this later in my testimony.

The Basel Committee has outlined an aggressive timeline for the remaining actions leading to the adoption of Basel II. As a consequence, the U.S. banking agencies, the agencies responsible for the maintenance of capital adequacy standards for U.S. financial institutions, are faced with a daunting task. While we will work earnestly in this effort, the timeline should be seen as a means to an end, not an end in itself. As will be highlighted in my testimony, basic principles of safety and soundness demand that the banking agencies have a more complete understanding of the consequences of this proposal on the overall capital levels of affected institutions, the competitive effects on our financial system, and associated compliance costs and burdens before moving forward to finalize this proposal.

Our current primary focus in this effort is the development of U.S. implementing regulations and policies. As I will discuss later, the OCC and the other U.S. banking agencies will soon issue for comment proposed revisions to U.S. risk-based capital regulations to reflect the primary components of Basel II. Let me be absolutely clear about the integrity of this rulemaking process – the OCC, which has the sole statutory responsibility for promulgating capital regulations for national banks, will not begin implementing a final Basel II framework until we have conducted whatever cost-benefit and impact analyses that are required, and fully considered all comments received during our notice and comment process – as we would with any domestic rulemaking. If we determine through this process that changes to the proposal are necessary, we will not implement proposed revisions until appropriate changes are made. We made this point quite clearly to our Basel Committee colleagues before we agreed to go forward with CP-3.

Indeed, many of them will also have to go through their own internal domestic processes before they can adopt the Basel II framework.

Current Basel Proposal

The Basel Committee deserves considerable credit for its articulation of Basel II in CP-3. The proposal is still exceedingly complex, but CP-3 is a clearer presentation of inherently difficult material than its predecessors. This is an important step, since regardless of the complexity of the proposal, it is important that the industry and other interested parties have a clear understanding of the proposed Accord.

The attachment to this written statement provides a summary of the substantive provisions contained in CP-3. As before, this iteration of the proposed new Accord has three mutually reinforcing "pillars" that comprise the framework for assessing bank capital adequacy. The first pillar of the new Accord is the minimum regulatory capital requirement. The Pillar 1 capital requirement includes a credit risk charge, measured by either a standardized approach or one of the new internal ratings-based (IRB) approaches (foundation or advanced), an operational risk charge, and a market risk charge. Again, the attached document provides a more detailed description of the various components of the Pillar 1 charge.

Pillar 2 addresses supervisory review. It is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy, and, subject to national discretion, provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 should also be seen as a way to focus supervisors on other means of addressing risks in a bank's portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the Committee is proposing a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies, such as the Advanced IRB approach, the new Accord will require a significant increase in the level of disclosure. In essence, the tradeoff for greater reliance on a bank's own assessment of the building blocks of capital adequacy is greater transparency.

U.S. Implementation Actions

It is important to recognize that the Basel Accord is not self-executing in the U.S. Even when adopted by the Basel Committee, Basel II will not apply to U.S. institutions unless and until the U.S. banking agencies adopt regulations to implement it. In accordance with the Administrative Procedure Act, 5 U.S.C. 551, *et seq.*, the U.S. banking agencies must publish notice and seek comment from all interested persons on any such proposal, and must fully consider those comments, before adopting a new capital regulation in final form. Obviously, the OCC and the other federal banking agencies intend to comply fully with these requirements. The importance of this rulemaking makes this comment process particularly critical to our success. Thus, we welcome this process as a means for positive contribution to this deliberative effort. We believe that the solicitation and assessment of comments is a critical step in determining the feasibility, effectiveness, and expected consequences of Basel II and related domestic capital regulations.

Next month, the U.S. banking agencies expect to jointly issue an Advance Notice of Proposed Rulemaking (ANPR) soliciting comment on proposed revisions to the existing domestic capital adequacy regulations that would implement Basel II. The ANPR will be largely based on CP-3, and will provide a description of proposed revisions to current capital regulations, while seeking comment on outstanding or contentious issues associated with the proposal. The ANPR will also request information on the cost of implementing the proposal, and will seek comment on the competitive implications in both domestic and international markets for banks of all sizes. In conjunction with the ANPR, the banking agencies will also issue for comment draft supervisory guidance articulating general supervisory expectations for banks seeking to implement Basel II-compliant methodologies for the Advanced Measurement Approach (AMA) to operational risk and Advanced IRB for corporate credits. Recognizing that CP-3 is a complex document, we understand the importance of providing U.S. banks an opportunity to review and comment on U.S. implementing documents as soon as practicable. By describing these concepts within the context of our existing regulatory and supervisory regime, the ANPR and draft guidance will provide a meaningful forum for a full discussion of Basel II.

After assessing comments generated during the ANPR process, the U.S. banking agencies will consider a complete cost analysis in accordance with applicable rulemaking requirements, including the standards of Executive Order 12866, discussed below, and will develop specific regulatory language for a joint Notice of Proposed Rulemaking (NPR). Again, the banking industry and other interested parties will have an opportunity to comment on this fully articulated proposal before any revisions to our capital regulations are finalized.

Let me now focus on two important, unique features of the U.S. regulatory capital regime that will be highlighted in the ANPR and NPR – the scope of application of Basel II and the content and structure of the proposed revisions to the capital adequacy regulations. First, the U.S. expects to set forth in the ANPR proposed criteria for identifying which banks in the U.S. will be subject to the new Accord. Despite language in the 1988 Capital Accord that permitted a more limited application, U.S. banking and thrift agencies applied the Basel framework to all U.S. insured depository institutions. As we will highlight in the forthcoming ANPR, the U.S. agencies have determined to apply Basel II concepts more narrowly. Specifically, consistent with the focus of the Basel Capital Accord on banks that compete in the global market place, we will propose applying Basel II concepts on a mandatory basis only to large, internationally active institutions that compete on a significant global basis with other financial service providers. Other institutions will have the opportunity to voluntarily opt into the Basel framework upon application to, and approval by, their primary federal supervisor.

Preliminary analysis by the U.S. agencies suggests that under the narrow approach we are proposing, there are currently fewer than a dozen U.S. banks that would be mandatorily subject to Basel II-based regulatory capital requirements. Of course, the approach of requiring only a small population of banks to comply with Basel II will be subject to notice and comment in the

ANPR and will be definitively resolved only after the U.S. rulemaking process has been completed.

Second, in developing revisions to existing capital adequacy regulations, U.S. banking agencies recognize that the revised regulation, and interagency implementation policies, need not follow the literal structure and language of Basel II. While consistent with the objectives, general principles and core elements of the revised Basel Accord, the language, structure and degree of detail of U.S. implementing documents may be very different from Basel II. These implementation differences are reflective of the particular statutory, regulatory and accounting structures and practices in place in the U.S. It is important to note that U.S. implementation actions do not contemplate changes to many fundamental aspects of our regulatory/supervisory process, including a focus on regular on-site supervision, our prompt corrective action rules, and our minimum leverage ratio for capital adequacy. As described more fully in the attachment, the U.S. agencies will propose for notice and comment a Basel II-based regime incorporating only the Advanced IRB approach for credit risk, the AMA for operational risk, and the internal models approach for market risk.

We are also very cognizant that in connection with this, or any rulemaking, existing requirements may compel preparation of detailed analysis of the costs, benefits, and other effects of our regulations, depending on threshold determinations of whether the rulemaking in question triggers the substantive requirements of particular statutes or Executive Orders. Relevant requirements are set forth in the Regulatory Flexibility Act (RFA), the Unfunded Mandates Reform Act of 1995 (UMRA) and Executive Order 12866 (EO 12866). Issuance of the ANPR will help us identify and determine costs, benefits, and other effects of the proposed rulemaking, for purposes of complying with these requirements.

Timing

As I noted early on in my testimony, the Basel Committee timeline presents a daunting task to both the U.S. banking agencies and the banking industry. While it is clearly necessary to move forward in addressing the acknowledged deficiencies in the current Basel Capital Accord, the banking agencies must better understand the full range and scale of likely consequences before finalizing any proposal. The list provided below identifies the milestones the OCC must meet under the current Basel II timeline. Each step is critical in a prudential consideration of Basel II in the U.S.:

- *Consideration of comments received by the Basel Committee on CP-3*. The comment period on this document concludes on July 31.
- *Finalization, issuance and consideration of comments on the U.S. ANPR*. Based on current estimates, the notice and comment period will run from July to October.
- *Finalization, issuance and consideration of comments on supervisory guidance on Corporate IRB and AMA methodologies*. Based on current estimates, the notice and comment period will run from July to October.
- *Development, issuance and consideration of comments on supervisory guidance on other substantive aspects of Basel II-based regulations, especially including retail IRB*. Based on current estimates, the agencies hope to commence solicitation of comment on this guidance by year-end 2003.
- *Participation in the Basel Committee's consideration of Basel II*. Under the current timeline, the Committee is to consider approval of Basel II in December of this year.
- *Development, issuance and analysis of results of additional agency efforts to evaluate the prospective effects of Basel II implementation*. EO 12866 may compel the OCC and OTS to undertake such analysis prior to the issuance of an NPR. Even without regard to this requirement, however, it is essential that we have a reliable estimate of the impact of Basel II on the capital and competitive position of U.S. banks.
- *Development, issuance and consideration of comments on the U.S. NPR*. This document would only be issued after the Basel Committee finalizes its consideration of Basel II. If the existing timeline is maintained, solicitation of comment on the NPR would commence no earlier that the first quarter of 2004.
- *Development and issuance of a U.S. final rule and supervisory guidance*. Again, assuming the present timeline is maintained, our best estimate for the issue date of a final rule implementing Basel II is the third or fourth quarter of 2004.
- *Completion of all necessary supervision-related steps to implement Basel II-based regulations in advance of the presently proposed December 2006 effective date*. Most

significantly, the agencies need to determine whether each bank subject to Basel II-based regulations has appropriate systems and procedures in place to qualify for using the A-IRB and AMA.

H.R. 2043

Mr. Chairman, you and some of your colleagues have introduced H.R. 2043, a bill that would establish an interagency committee, the United States Financial Policy Committee (USFPC). The USFPC would be chaired by the Secretary of the Treasury, and its other members would be the Comptroller of the Currency, and the Chairmen of the Federal Reserve Board and the FDIC. Broadly speaking, the purpose of this Committee would be to develop uniform U.S. positions on issues before the Basel Committee and require the banking agencies, in consultation with the Secretary of the Treasury, to evaluate the impact of the proposed Accord taking into account certain specific factors, including the costs associated with implementation of the Accord and its competitive effects. In cases where a uniform position could not be reached, the position of the Secretary of the Treasury would be determinative.

Mr. Chairman, we understand – and we share – your desire to make sure that the banking agencies adopt a uniform approach and that the impact of Basel II is well understood before it is adopted. However, we do not believe legislation is needed to compel that result. As I have already discussed, the next key step in the United States is the rulemaking process. That process is subject to requirements, including those contained in the statutes and the Executive Order that I mentioned earlier, that we believe will address the key concerns underlying the proposed legislation.

In this regard it is important to note that the rulemaking process is already an interagency process involving all the banking agencies in joint rulemaking. While we have not all agreed on every issue, the interagency approach has been very collaborative, and I am confident we will be able to work out any remaining differences in pursuit of our mutual objective.

As noted earlier, we are under an obligation to consider the costs and competitive effects of proposals like Basel II. This evaluation of the impact of Basel II involves factors similar to that proposed under H.R. 2034. Specifically, EO 12866 requires the OCC and OTS to provide specific information to OMB's Office of Information and Regulatory Affairs (OIRA), including an assessment of the costs and benefits of the regulatory action, if the agency or OIRA determines that a proposed regulation is a "significant regulatory action." A "significant regulatory action" is defined to include a rule that may have an annual effect on the economy of $100 million or more, or have a material adverse effect on the economy, a sector of the economy, productivity, jobs, or several other factors. The RFA requires an agency to consider whether a rule will have a "significant economic impact" on a "substantial number" of small businesses, including, of course, small banks. The UMRA requires an agency to prepare a written statement if a proposed or final rule includes a "Federal mandate," that is, a Federally imposed requirement that may, among other things, result in private sector expenditures for compliance of $100 million or more in any one year. If a written statement is required under the UMRA, it would include a qualitative and quantitative assessment of the anticipated costs and benefits of the Federal mandate and, to the extent feasible, estimates of its effect on the international competitiveness of United States goods and services.

Status of Basel Proposal – Outstanding Issues

In commencing an objective assessment of the status of Basel II, it is important to reiterate and reaffirm the commendable work of the Basel Committee, and in particular, the strong and intelligent leadership of its former Chairman, William McDonough. The OCC firmly supports the objectives of Basel II. These objectives constitute a sound conceptual basis for the development of a new regulatory capital regime and should continue to serve as a useful benchmark to gauge our progress in this effort. Nonetheless, much of that conceptual basis has not been tested in practice in any manner approaching the magnitude of Basel II. We continue to be concerned about the potential for unintended or unanticipated consequences of the Basel II proposals.

Implementation Challenges

At its foundation, the Basel II proposals permit qualifying institutions to calculate their minimum risk-based capital requirements by reference to their own internal systems and methodologies. While it is the hallmark of Basel II, a greater alignment of internal risk assessment with minimum regulatory capital derived through internal models represents a radical departure from our existing regulatory capital framework. As we will highlight in the ANPR and accompanying guidance, this reliance on internal risk assessment systems mandates changes in the way we structure our capital regulations and, in certain important respects, how we conduct our supervisory activities. The fundamental question for the banking agencies in assessing Basel II is the issue the OCC has previously identified – whether the regime will work in practice, as well as theory, as the basis for a regulatory capital regime.

For bank supervisors and other external stakeholders to be in a position to rely on a bank's internal process in the establishment of regulatory capital requirements, there must be a high degree of confidence that regulators can establish and enforce appropriate risk measurement and management standards consistently across the banks subject to a Basel II-based regime. The challenge for supervisors is to create a verifiably accurate system that appropriately balances the need for flexibility, to promote continued improvement in risk management practices, with the need for objective standards, to ensure consistency in application across institutions and supervisors, both foreign and domestic.

The capital rule we implement must respect the evolutionary nature of risk management. As regulators, we must acknowledge that we are still in the relatively early days of model-based credit and operational risk measurement and management, and we must recognize the inevitability of further innovation and improvements in this area. This respect for the evolutionary nature of this discipline must then be reconciled with the need for objective standards to ensure consistency in application. Much of the detail and complexity within Basel II derives from the need to establish more objective expectations for bank rating systems, control mechanisms, audit processes, data systems, and other internal determinations of risk by individual banks. In many cases, this has led to the establishment of supervisory standards in areas previously left to management discretion or supervisory judgment.

Not surprisingly, the regulatory community has struggled with the establishment of these standards. Failing to achieve the proper balance for these often conflicting objectives while moving forward with the radically different Basel II-based regime can have dramatic consequences. If our regulation and supervisory process is overly flexible, bank internal calculations of capital adequacy may prove insufficient, non-comparable, or both. If we err on the other extreme, we establish an excessively prescriptive supervisory regime that stifles innovation, imposes undue regulatory burden and inappropriately narrows the role of judgment.

This need to carefully balance dramatically opposed objectives, together with the significant uncertainties that still exist about the practical feasibility of these proposed changes to the Capital Accord, raise doubts about the achievability of the timeframe established by the Basel Committee.

Competitive Equality

A stated goal of the Basel Committee in developing Basel II was that "the Accord should continue to enhance competitive equality." Realistically, we are not yet in a position to assess definitively the full range of consequences from the implementation of Basel II, including its effect on competitive equality in the global financial marketplace. There are risks that Basel II may create or exacerbate relative advantages between domestic banks and foreign banks; between banks and non-banks; and between large domestic banks and mid-size/small domestic banks. It is imperative that the U.S. banking agencies remain sensitive to these concerns and assess, to the extent possible, any unintended consequences resulting from the implementation of Basel II.

One of the primary objectives of the Basel Committee itself is the reduction of gaps and differences in international supervisory coverage by national supervisory agencies, especially as it relates to large internationally active banks that compete on a significant global basis with other financial service providers. This principle of competitive equality and a level playing field for international banks is an admirable one, and an appropriate goal of the Committee's efforts. Yet, the very complexity of the rules themselves calls this objective into question. Bank supervision varies significantly from one country to another in approach, intrusiveness, and quality. Is it realistic to think that an enormously complex set of rules will be applied in an evenhanded way across such a broad spectrum of supervisory regimes? For example, the OCC has as many as 30 to 40 full-time resident examiners in our largest banks. They are intimately involved as supervisors in assessing the banks' operations and judging the banks' compliance with a myriad of laws, rules, and guidelines. Some other countries may send examiners in once a year to a comparably sized institution, or may examine such an institution thoroughly only every five years, or may put heavy reliance on the oversight of outside auditors.[1]

It's fair to ask, I think, in which type of supervisory regime detailed, prescriptive capital rules are more likely to be robustly and reliably enforced. The Basel Committee has not undertaken to set standards of supervision for member countries. Yet the attainment of competitive equity among internationally active banks is a bedrock principle of Basel II. Can we really achieve competitive equality without addressing disparities in supervision, particularly when we are operating on the assumption that the complex new rules we're writing will be applied in an evenhanded way throughout the world?

Another principle source of competition for many banks is not other insured depository institutions, but non-banks. This situation is especially pronounced in businesses such as asset management and payments processing. As you are aware, however, regulations implementing Basel II-based concepts in the U.S. will apply only to insured depository institutions and their holding companies. While differences in regulatory requirements for banks and non-banks exist today, many institutions have voiced concern that implementation of Basel II may unduly exacerbate the current differences. These concerns have been mainly focused on the effects on competition from the application of the operational risk proposal and the enhanced disclosures required under Pillar 3.

[1]See, Daniel E. Nolle, "Bank Supervision in the U.S. and the G-10: Implications for Basel II," *RMA Journal*, June 2003.

Finally, there is concern about the potential effect of Basel II on the competitive balance between large and small banks. As implemented in the U.S., Basel II would result in a bifurcated regulatory capital regime, with large banks subject to Basel II-based requirements and small and mid-sized banks subject to the current capital regime. This structure is premised on the belief that, to the extent possible, regulations should reflect the size, structure, complexity, and risk profile of banking institutions. The Basel II framework was developed to address the unique risks of large internationally active institutions. Mandatory application of such a framework to small banks, with its associated costs, was deemed inappropriate. In fact, the banking agencies sought comment from the banking industry, especially smaller institutions, on the development of a simplified capital framework specifically for non-complex institutions.[2] Industry comments were overwhelming negative on the proposal – most institutions felt that the cost of adopting a new regulatory capital regime outweighed any potential benefits. Accordingly, the banking agencies tabled the proposal.

With that said, the banking agencies need to continue to assess the competitive effects of a bifurcated regulatory capital regime, and it is one of the areas on which we will seek guidance in our ANPR. There are several concerns in this regard. First, banks using a Basel II-based regime may have a lower minimum capital requirement, allowing those banks to grow and compete more aggressively with smaller banks for both assets and liabilities. To be sure, banks subject to the new Basel II requirements will incur very significant systems and compliance costs in preparing for the new regime. These concerns are discussed in more detail in the "Calibration" section below. Moreover, banks using a Basel II-based regime may have significantly higher or lower marginal regulatory capital charges than non-Basel banks for some types of loan products, resulting in potential pricing differentials. While Basel II might enable larger banks to compete more effectively for high quality credits, it could also result in larger concentrations of lower quality credits in smaller institutions. Finally, the potential implications on industry consolidation are simply not known. The banking agencies must continue to assess this situation

---

[2] See Advance Notice of Proposed Rulemaking, Simplified Capital Framework for Non-Complex Institutions, 65 FR 66193 (November 3, 2000).

and, if warranted, take steps to mitigate adverse effects on the competitive balance between large and small banks. We would be seriously concerned if, as an unintended consequence of the implementation of Basel II, we significantly alter the structure of banking in the U.S.

Calibration

The first objective of the Basel Committee in embarking on the Basel II effort was to calibrate minimum capital requirements to bring about a level of capital in the industry that, on average, is approximately equal to the global requirements of the present Basel Accord. That calibration was to be designed to provide an incentive to banks to develop and maintain sophisticated and risk-sensitive internal ratings-based systems.

In order to gauge its success in meeting that objective, the Basel Committee attempted to measure the impact of its proposals on the required capital levels of banking institutions through several quantitative impact studies. On May 5, 2003, the Committee published an overview of the results of its most recent assessment, the third quantitative impact study (QIS-3). On the basis of QIS-3 results, the Committee concluded that the aggregate results were generally in line with the objectives established for Basel II.

Unfortunately, the QIS-3 data do not provide a reliable estimate of the likely regulatory capital requirements for banks subject to Basel II. Banks encountered several practical impediments to providing accurate estimates of the effect of the proposals on their measured ratios; thus, the estimated risk-based capital ratios were subject to a substantial margin of error. For example, in many cases, existing bank systems were not able to produce the data requirements necessary for inputs required by the new Accord. In some areas, the QIS-3 instructions were not sufficiently clear or were misinterpreted, and in other cases, the proposals were still in flux as banks were completing the survey. Most important, QIS-3 was completed without the rigorous supervisory validation and oversight that would occur when the proposal actually takes effect.

A key concern is that focusing on the overall results of the QIS-3 exercise masks the wide dispersion of results for individual institutions. In the U.S., measured against current risk-weighted assets, the use of advanced approaches yielded results that ranged from a decrease in regulatory capital requirements of 36% to an increase of 43%. Similarly broad dispersions are found in a great many of the underlying components that make up the total capital requirement. While some dispersion of results in a truly more risk-sensitive framework would be expected, we are not convinced that the wide ranges indicated by QIS-3 can be explained by relative differences in risk among institutions; it appears that comparability of QIS-3 results among different institutions may be severely lacking.

Finally, the quantitative studies that have been done to date have been based on unilateral inputs from the participating banks. We and other supervisors have had only very limited ability to review the veracity of the results. I want to be clear that we have no reason to believe that U.S. banks did not make every effort to provide results as accurate as possible given the constraints they were operating under. Nonetheless, it is certainly conceivable – I would say highly likely – that the results might change significantly, and not necessarily in any particular direction, when all the intricacies of real-world implementation come into play. It seems fair to assume that banks will have fewer incentives to take conservative stances and greater incentives to exploit any loopholes or gray areas in the final rules; the extent to which these effects might be offset (or exceeded by) greater supervisory oversight is unknown.

Notwithstanding the significant uncertainties noted above, it presently appears that the required capital levels of some U.S. institutions could drop significantly, even taking into account the temporary minimum floor capital requirements, discussed in the attachment. The OCC does not believe that some reduction in minimum regulatory capital requirements for certain institutions is, in and of itself, an adverse feature of Basel II. Such a result is only acceptable, however, if the reduction is based on a regulatory capital regime that appropriately reflects the degree of risk in that bank's positions and activities. Given the fact that relevant bank systems and procedures are still in development, the OCC is not yet in a position to make that determination as it relates to Basel II. As such, the OCC is not yet comfortable allowing national banks to materially lower their current capital levels simply on the basis of the output of the currently proposed Basel II framework.

The OCC expects that an additional quantitative study will be necessary after the Basel Committee's work on Basel II is completed. Ideally, this should take the form of another global study by the Basel Committee itself – i.e., a QIS-4. However, even if the Basel Committee does not undertake such a study, I believe that it is absolutely essential that the U.S. agencies do so prior to the adoption of final implementing regulations. I strongly believe that we cannot responsibly adopt final rules implementing Basel II until we have not only determined with a high degree of reliability what the impact will be on the capital of our banks, but we have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the U.S.

Conclusion

As I have indicated, the OCC firmly supports the objectives of Basel II – a more risk-sensitive and accurate capital regime. However, in light of the issues that been identified with the current iteration of Basel II, the U.S. banking agencies must now determine how best to proceed on this critically important issue. I believe the following are essential elements in the agencies' consideration of Basel II implementation within the U.S.

First, the agencies need to move forward with the solicitation of comments on a Basel II-related ANPR and associated guidance. That is the most effective mechanism to a have full and complete consideration of the proposal from all interested parties. The solicitation of comments on a proposed regulatory and supervisory structure for Basel II implementation will also permit supervisors to tangibly assess the feasibility of the proposal.

Second, the agencies need to undertake additional steps to evaluate the costs, benefits, and other effects of the proposal before moving forward with any final regulatory action. Frankly, we simply need additional information to reasonably address the numerous issues, concerns and uncertainties associated with Basel II implementation. We must better understand the likely consequences of this proposal on overall capital levels of affected institutions, the competitive effects on our financial system, and associated compliance costs and burdens. In determining the appropriate additional steps, the agencies should consider the obligations imposed under EO

12866, the other statutory requirements for consideration of costs and impact, lessons learned from QIS-3, and perhaps, a U.S. version of QIS-4.

Third, as I have consistently reiterated, if we determine through this process that changes to the Basel II proposal are necessary, the U.S. agencies must pursue those changes, both domestically and in the Basel Committee. In this regard, the U.S. agencies should not foreclose consideration of alternative proposals that address the acknowledged deficiencies of the 1988 Accord but that do not constitute such a radical departure from our existing regulatory capital framework.

Fourth, the overarching consideration for supervisors in moving forward on Basel II is the need to act in accordance with our primary mission – to ensure the continued maintenance of a robust and safe and sound banking system. We need to incent banks to continue to better measure and manage the full panoply of risks they face and to make use of new and evolving risk management practices. We must also ensure that prudential consideration of safety and soundness principles remain paramount.

As I said in the beginning of my statement, the OCC, the agency to which Congress has committed the authority to define capital requirements for national banks, will not sign off on implementation of a final Basel II framework until we have fully considered all comments received during our notice and comment process. Given the importance of this proposal, the significant issues that remain unresolved, and the prospect that whatever emerges from this process is likely to govern the financial landscape for years to come, we need to take whatever time is necessary to develop and implement a revised risk-based capital regime that achieves the stated objectives of the Basel Committee in both theory as well as practice.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

Attachment

Summary of Basel II: The Proposed New Accord
Office of the Comptroller of the Currency

The Basel Committee (the Committee) has been developing the new Accord over the past five years. During that time, three full-scale consultative papers (June 1999, January 2001 and April 2003) and numerous working papers supporting various elements of the new Accord have been released to the industry for comment. This summary is intended to convey a general idea of the structure and substance of the proposed new Accord, and does not attempt to provide a complete analysis. It is based on the most recent publications from the Basel Committee, notably the New Basel Capital Accord (Consultative Document) which is out for comment until July 31; the document can be found on the Committee's website at http://www.bis.org/bcbs/index.htm.

The new Accord will include menus of approaches for measuring the capital required for credit risk, market risk, and operational risk. For credit risk and operational risk, each of the proposed approaches is described briefly below; capital charges for market risk are unchanged in the new Accord and are not discussed here. Some of the approaches described are unlikely to be implemented in the U.S. and have been noted as such. Moreover, based on preliminary analysis by the U.S. agencies, currently there are less than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. While other banks would be permitted to opt in to the Basel rules (subject to meeting prudential qualification requirements), the U.S. capital rules will remain in place for the vast majority of U.S. banks that either are not required to or do not opt to apply the Basel II framework. Of course, any issues regarding U.S. implementation of the new Accord will be definitively resolved only after the U.S. rulemaking process has been completed.

The current structure of the Accord has been influenced by the results of several quantitative impact studies (QIS), the most recent of which was completed in December 2002. Approximately 20 US banks participated in the QIS exercise in December and the results have been factored into the most recent version of the Accord. Changes were made in several areas including the treatment of retail credits, specialized lending, securitization, and operational risk.

General Structure of the Proposed New Accord

The new Accord has three mutually reinforcing "pillars" that make up the framework for assessing capital adequacy in a bank. The first pillar of the new Accord is the minimum regulatory capital charge. In order to calculate the capital charge under Pillar 1, banks will have to determine the individual charges for credit, market, and operational risk. The new Accord offers a series of options for calculating credit and operational risk. Market risk will remain unchanged from a 1996 amendment to the Accord. The new options for credit and operational risk were designed to be available to a wide range of banks, from relatively simple to very complex. For credit risk, the Pillar 1 capital requirement includes both the standardized approach, updated since the 1988 Accord, and the new Internal Ratings-Based (IRB) approaches (foundation and advanced). Pillar 1 has been the focal point of much of the discussion and comment from the industry on the new Accord.

Pillar 2 covers supervisory review and banks' obligation to hold sufficient capital vis-à-vis their risk profile. The pillar is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy. It provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 is also a way to focus supervisors on other means of addressing risks in bank's portfolio, such as improving risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the new Accord proposes a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies for market and operational risk, the new Accord will require a significant increase in the level of disclosure. In essence, the tradeoff for greater reliance on a bank's own assessment of capital adequacy is greater transparency. This pillar has been subject to numerous changes as the Committee has worked to balance the need for robust disclosure with a recognition of the proprietary and confidential nature of some of the information.

Capital for Credit Risk

Under Basel II, banks must select one of three approaches to determine their capital for credit risk. The three approaches, from simplest to most complex are: the standardized approach, the foundation IRB and the advanced IRB.

Standardized Approach

The 1988 Accord introduced the standardized risk-bucketing approach for setting the minimum regulatory capital requirement, which is still used in the U.S. today. The approach has been subject to criticism that it lacks sufficient risk sensitivity. The revised standardized approach under Basel II enhances the 1988 Accord by providing greater, though still limited, risk sensitivity.

Key changes to create a more risk-sensitive framework include the refinement and addition of risk buckets, the introduction of external credit ratings, and a wider recognition of credit risk mitigation techniques. Risk weights are still determined by category of the borrower—sovereign, bank or corporate—but within each of these categories changes have been made to make the capital more reflective of the riskiness of the asset category. For example, the risk weight on mortgage loans has decreased from 50% to 35% and the risk weight on certain retail credits has moved from 100% to 75%. Risk weights for externally-rated corporate credits, currently 100%, will range from 20% to 150%. Sovereign risk weights are no longer dependent upon whether a country is a member of the Organization for Economic Cooperation and Development (OECD), but rather on the external rating identified for the country.

The standardized approach is not likely to be implemented in the U.S. U.S. supervisors believe that credit risk measured under the standardized approach of Basel II would generally not be appreciably different than that measured under current rules for most U.S. banks, and the marginal changes in capital requirements would not justify the cost of implementation.

Internal Ratings-Based Approach (Foundation and Advanced)

The IRB approach represents a fundamental shift in the Committee's thinking on regulatory capital. It builds on internal credit risk rating practices used by some institutions to estimate the amount of capital they believe necessary to support their economic risks. In recent years, as a result of technological and financial innovations and the growth of the securities markets, leading banking institutions throughout the world have improved their measurement and management of credit risks. These developments have encouraged the supervisory authorities to devote greater attention to introducing more risk-sensitive regulatory capital requirements, particularly for large, complex banking organizations.

Banks must meet an extensive set of eligibility standards or "qualifying criteria" in order to use the IRB approach. Because the requirements include both qualitative and quantitative measures, national supervisors will need to evaluate compliance with them to determine which banks may apply the new framework. The requirements vary by both the type of exposure and whether the bank intends to use the simpler foundation IRB framework or the more advanced IRB framework. The requirements are extensive and cover a number of different areas, including rating system design, risk rating system operations, corporate governance, and validation of internal estimates. A brief sample of actual criteria include:

- The board of directors and senior management have a responsibility to oversee all material aspects of the IRB framework, including rating and probability of default (PD) estimation processes, frequency and content of risk rating management reports, documentation of risk rating determinations, and evaluation of control functions.
- A one-year PD estimate for each grade must be provided as a minimum input.
- Banks must collect and store historical data on borrower defaults, rating decisions, rating histories, rating migration, information used to assign ratings, PD estimate histories, key borrower characteristics, and facility information.

As mentioned above, the requirements that a bank must meet are partially dependent upon which of the two IRB approaches a bank will use. The first methodology, called the foundation approach, requires fewer direct inputs by banks and provides several supervisory parameters that, in many cases, carry over from those proposed for the standardized approach. For a variety of reasons, the U.S. does not plan to introduce the foundation approach in its regulations. The second approach, the advanced IRB approach, allows banks much greater use of their internal assessments in calculating the regulatory capital requirements. This flexibility is subject to the constraints of prudential regulation, current banking practices and capabilities, and the need for sufficiently compatible standards among countries to maintain competitive equality among banks worldwide.

There are four key inputs that are needed under IRB, for both the foundation and advanced approaches. The first element is the PD of a borrower; the bank is required to provide the PD in both the foundation and the advanced approaches. The second input is the estimate of loss severity, known as the loss given default (LGD). The final two elements are the amount at risk in the event of default or exposure at default (EAD) and the facility's remaining maturity (M). LGD, EAD, and M are provided by supervisors in the foundation approach, but must be provided by banks operating under the advanced approach (subject to supervisory review and validation). For each exposure, the risk weight is a function of PD, LGD, and EAD.

The IRB approach envisions internal rating systems that are two-dimensional. One dimension focuses on the borrower's financial capacity and PD estimates that quantify the likelihood of default by the borrower, independent of the structure of the facility. The other dimension takes into account transaction-specific factors such as terms, structure, and collateral. These characteristics would determine the second dimension, i.e., the LGD. Implicit in this treatment is the assumption that when a borrower defaults on one obligation, it will generally default on all its obligations. (This assumption is relaxed with the IRB treatment of retail portfolios.)

Calculating the capital charge under the IRB approach involves several steps. The first of these steps is the breakdown of the bank's portfolio into five categories: corporate (including commercial real estate), retail, bank, sovereign, and equity. The IRB rules differ to varying degrees across these portfolios. As a result, the IRB capital charge is calculated by category, with the PD, LGD, and EAD inputs potentially differing across these categories. Supervisory approval is needed before banks can use the IRB approach for any of the five categories. The minimum requirements described above were written to apply across these five types of exposures.

Another important step is the determination by the bank of the PDs for its loan grading categories. The PD of an exposure is the one-year PD associated with the borrower grade, subject to a floor of 0.03% (excluding sovereigns). The determination of PDs for borrowers supported by guarantees or credit derivatives is more complex. Banks under the advanced approach would use their internal assessments of the degree of risk transfer within supervisory defined parameters, while those under the foundation approach would use the framework set forth in the new credit risk mitigation provisions. Overall, the PD must be "grounded in historical experience and empirical evidence," while being "forward looking" and "conservative." A reference definition of default has been developed for use in PD estimation and internal data collection of realized defaults.

Once the PD has been established, banks must then establish the dimensions of LGD based on collateral and M. Under the foundation approach, M is assumed to be 2.5 years. There are several options that may be selected for the advanced approach, but in general, M is defined as the greater of one year or the remaining effective maturity in years.

After the bank determines the PDs and LGDs for all applicable exposures, these combinations can be mapped into regulatory risk weights. The risk weights, which are calibrated to include coverage for both expected and unexpected losses, are expressed as a continuous function. The minimum capital charge is then determined by multiplying the risk weight by the amount expected to be outstanding at the time of default (EAD), and by 8%.

A final step in this process involves the ongoing review by the supervisors of the systems used to develop the IRB capital charge. Periodically, supervisors will need to validate these systems and review the internal controls that provide the foundation for the IRB approach. In addition, supervisors will also have to consider, under Pillar 2, whether the amount of capital generated by the IRB approach is commensurate with the bank's risk profile.

Implementation of the IRB Approach

In addition to the requirement that a bank meet the qualifying or eligibility criteria, the new Accord requires that banks using the IRB approach run parallel systems for one year before implementation. This means that a bank planning to implement the IRB approach in December 2006, will actually have to begin calculating results as of December 2005, while continuing to run its current systems.

Adjustments to the Capital Charge for Credit Risk

There are additional considerations that banks may have to factor in when determining the capital charge for credit risk. These additional considerations will further adjust required capital, outside of the requirements of the different approaches to credit risk. The two primary adjustments that might be made to the credit risk charge are for credit risk mitigation and asset securitization.

Credit Risk Mitigation

The new Accord provides a measure of capital relief for certain qualifying risk-mitigating techniques used by banks. However, it is important to note that most of the credit risk mitigation proposals in the new Accord are only directly relevant to the standardized or foundation IRB approaches, which are not likely to be used in the U.S. In the advanced IRB approach, credit risk mitigation must meet certain qualitative requirements, such as legal certainty. In addition, specific proposals related to maturity mismatches and backtesting requirements of certain model results are applicable to the advanced IRB approach. Otherwise, it is assumed that any credit risk mitigation efforts will be factored into the PDs and LGDs assigned by the bank.

With that caveat in mind, the section on credit risk mitigation in the new Accord attempts to provide rough approximations of the risk reduction attributable to various forms of collateralized credit exposures, guarantees, credit derivatives, and on-balance sheet netting arrangements. The Committee has proposed a conceptual approach to these risk mitigation techniques that, while recognizing their risk reduction benefits, attempts to capture the additional risks posed by such transactions.

The credit risk mitigation proposal provides both a simple and a comprehensive approach to dealing with collateral. The proposal expands the range of eligible collateral from that recognized in Basel I. It also discusses the appropriate treatment for maturity mismatches between the credit risk mitigant and the underlying credit exposure. The proposal introduces haircuts, which the bank may estimate, to cover the market price and foreign exchange volatility that may be inherent in collateral. The proposal allows banks to greatly reduce the capital requirements for exposures with large amounts of high quality collateral. There are strict quantitative and qualitative factors that must be met in order for a bank to be permitted to use its own haircut estimates. The proposal encourages the use of credit risk mitigation by expanding the type of collateral, guarantors, and transaction structures that are recognized for capital reduction. Different types of credit risk mitigation techniques pose different levels of additional risk; the proposal incorporates flexibility that recognizes these differences and adjusts the capital treatment accordingly.

Asset Securitization

Asset securitization is clearly an important issue in the U.S., as the securitization market is significantly greater than the securitization market of any other Basel-member country. The Committee believes that it is important to construct a more comprehensive framework to better reflect the risks inherent in the many forms of asset securitizations, including traditional and synthetic forms.

The securitization framework in the new Basel Accord applies generally when there is a transaction that involves the stratification or tranching of credit risk. The Committee has developed securitization approaches for both standardized and IRB banks. The level of complexity is significantly higher for IRB banks. The framework tries to focus on the economic substance of the transaction, rather than its legal form.

Under the proposal for the treatment of securitizations by standardized banks, the capital charge is generally determined by multiplying the amount of the securitization exposure by the risk weight mapped to the long- and short-term rating categories. Off-balance sheet exposures are subject to a conversion factor before the appropriate risk weight is applied. The proposal does allow for some recognition of credit risk mitigants provided on securitization exposures, but that recognition is permitted only when the bank meets a series of stringent criteria.

Banks that adopt the IRB approach for credit risk are generally required to use one of two methods for determining capital requirements for securitization exposures. One method is the Supervisory Formula Approach (SFA), under which capital is calculated through the use of five bank-supplied inputs: the IRB capital charge on the underlying securitized exposures (as if held directly on the bank's balance sheet); the tranche's credit enhancement level and thickness; the pool's effective number of loans; and the pool's exposure-weighted average loss given default (LGD). The second method is known as the Ratings Based Approach (RBA). Under this approach, capital is determined by multiplying the amount of the exposure by the appropriate asset-backed security risk weights, which depend on external rating grades, short- or long-term. Granularity of the pool and the level of seniority of the position are also considered.

The securitization proposal is one of the newest pieces of the Accord and its potential impact on the industry is still being assessed. In the December 2002 QIS exercise, banks were asked for the first time to provide data on the relative impact of the proposals. The QIS results did not provide entirely reliable results. However, the Committee has responded to some of the concerns raised during the QIS process by making changes to the securitization framework. One key change was the introduction of a simpler approach for liquidity facilities.

Operational Risk

One of the most significant changes in the new Accord is the proposal for an operational risk charge. It is expected to represent, on average, 10-15% of the total minimum regulatory capital charge. The framework is based upon the following operational risk definition: the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. This includes legal risk, but excludes strategic and reputational risks.

The Committee has proposed three approaches to calculate the operational risk charge, which represent a continuum of increasing sophistication and risk sensitivity. The Basic Indicator Approach (BIA) is the simplest of the three approaches; the capital charge is determined by taking an alpha factor decided by the Committee and multiplying it by an indicator, gross income. The next approach is known as the Standardized Approach and is similar to the BIA, but breaks out gross income into business lines. The Committee has introduced an Alternative Standardized Approach to address some of the concerns raised by the results of the December 2002 QIS exercise; this is not a separate approach, but rather a modification to the Standardized Approach. Because there is no compelling link between these measures and the level of operational risk, the U.S. does not plan to utilize the BIA or the Standardized Approach (including the Alternative Standardized Approach) to determine the capital charge for operational risk.

The Committee has made the most significant changes to the advanced approach since it was originally introduced in January 2001. At that time, the Committee envisaged a single, very prescriptive advanced approach for operational risk, similar to credit risk. However, after numerous comments from the industry, the Committee made substantive changes in the proposal to reflect the evolutionary nature of the operational risk framework. The Committee recognized that, unlike credit risk, there are very little data and no internal systems specifically designed to target operational risk; instead, banks and supervisors rely primarily on internal controls to deal with a myriad of banking risks that cannot be as readily quantified as credit and market risks.

The Committee considered the comments and analyzed the state of the art of operational risk and developed what is known as the Advanced Measurement Approaches (AMA). Rather than prescribing one methodology, the AMA will allow banks the option of designing the operational risk measurement framework that best suits their institution, subject to some broad criteria. The criteria will be the key to achieving a certain level of consistency and comparability among institutions, as well as providing a margin of comfort to supervisors who must assess these differing systems. The criteria currently identified in the new Accord include the need for internal and external data, scenario analysis, and consideration of business environment and internal control factors. Banks may also, under the AMA, consider the impact of risk mitigation (such as insurance), again subject to certain criteria set to ensure that the risk mitigants act as an effective capital-replacement tool.

Temporary Capital Floors

Two floors that have been established for the Basel II framework. In the first year of implementation, an institution's required minimum level of regulatory risk-based capital cannot be less than 90 percent of the minimum level of capital that would be required under the Agencies' general risk-based capital rules. In the following year, an institution's minimum level of regulatory risk-based capital cannot be less than 80 percent of the minimum amount required under the Agencies' general risk-based capital rules.

STATEMENT OF

DONALD E. POWELL
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on the

NEW BASEL ACCORD

and

H.R. 2043, "The United States Financial Policy Committee For Fair Capital Standards Act"

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

10:00 AM
June 19, 2003
Room 2129 Rayburn House Office Building

Thank you, Mr. Chairman and members of the Subcommittee. I welcome the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on the development of revised international capital standards (Basel II), the status of the implementation of the standards in the United States, and H.R. 2043, "The United States Financial Policy Committee For Fair Capital Standards Act."

Since my testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, on February 27, 2003, there has been good progress on the domestic implementation efforts. The federal banking and thrift regulatory agencies are working hard to issue an Advance Notice of Proposed Rulemaking (ANPR) for comment this summer. The ANPR will identify those aspects of Basel II that will be proposed for adoption in the U.S. for application to a small group of large banking organizations. At this time, we are addressing various technical issues, developing interagency guidance, and conducting industry outreach. Specifically, we have conducted outreach sessions to banking institutions of varying size at meetings held in Chicago, Atlanta and New York.

My testimony will discuss the FDIC's assessment of the status of Basel II and its application to U.S. banking institutions in light of the principal concerns detailed in our February 27, 2003, testimony. Also, I offer the FDIC's views on H.R. 2043.

Introduction

Basel II would change bank capital regulation in the United States in at least three important ways. First, rather than emphasizing simple pre-set minimum numerical capital ratios, Basel II would allow qualifying banks to use their own internal risk estimates as inputs to regulator-supplied formulas with the supervisors providing oversight and evaluation of the banks' ability to measure risk. Second, the new framework would formally adopt a "bifurcated" capital system in the U.S.: one set of rules for the large, complex and internationally active institutions, and another set for the balance of banks in the country. A third key change is that the total minimum regulatory capital charge under the new framework will include an explicit charge for operational risk. For those large institutions that qualify, the new framework may lead to reduced credit risk capital requirements for certain asset classes with additional capital held based on a flexible operational risk charge.

The FDIC supports the overall goal of Basel II, which is to create regulatory capital standards that are more sensitive to the economic substance of risks taken by these large banks, to limit their opportunities for regulatory capital arbitrage and to encourage sound risk management.

Over the years that Basel II has been under development, the Basel Committee and the U.S. federal supervisors have reached out to the industry and the public for comment on how to more closely align the proposed new framework with the ways that large banks measure risk. There have been quantitative impact studies to assess the potential impact on capital levels. We have been engaged in roundtables and discussions. Over this time, various aspects of the new framework have been refined and changed. Today, these refinements are reflected in CP3, which the Basel Committee recently released for additional comment.

The work in this country continues. The agencies intend to issue an Advance Notice of Proposed Rulemaking (ANPR) that will suggest how CP3 will be proposed for adoption in the U.S. and will seek additional comment on all facets of Basel II. As in the past, it can be anticipated that further changes to the framework may be required. The FDIC is committed to an interagency process to achieve the overall goals of Basel II and to fully understand its possible impact on bank capital levels and competitiveness.

The goal of more closely tying regulatory capital to banks' own internal assessment of risk is a good one. This goal is reached in part by using regulatory capital formulas that are based on ways of measuring credit risk and allocating internal capital that, to some degree, are already in place in large banks. The term "economic capital" is often used to refer to the amount of capital that should be allocated to an activity according to the results of a numerical loss analysis. Banks use models based on historical data and economic analysis to estimate future losses and the amount of income, reserves and capital needed to ensure their portfolios conform to management's target level of risk.

These calculations produce different results for different bank activities. For example, the measured risk on residential mortgages might be much less than the measured risk on construction loans. The bank might use the economic capital measures to compute its risk-adjusted returns on the two activities and to assist its pricing decisions. This is a disciplined approach to risk management, and Basel II establishes firm expectations for banks to be rigorous in this respect. Basel II expands these risk management expectations beyond the area of credit risk and into the realm of operational risk.

Tying capital requirements closer to risk and increasing the incentives for disciplined risk management have the potential to improve the safety and soundness of the U.S. financial system. The FDIC supports enhancing the incentives for the largest banks in the U.S. to strengthen risk management processes. Tying regulatory capital closer to risk would reduce the incentives for banks to make uneconomic decisions designed to reduce regulatory capital.

At the same time, the domestic impact of Basel II has not been determined. Given current analysis, it seems likely Basel II will confer some degree of regulatory capital benefits on the limited number of banks that qualify, in exchange for their substantial investments in systems and infrastructure intended to improve risk management. The critical issue for the safety and soundness of our financial system is whether the improvements in risk management systems, and the resulting bank risk profiles, would justify the level of capital reductions that banks might ultimately realize.

It is virtually impossible to quantify at this time the potential changes in capital under Basel II. Basel II proposes floors by which risk-based capital would be allowed to decline by at most 10 percent the first year of implementation, and at most 20 percent the second year. After the second year, Basel II does not impose a floor on the minimum risk-based capital requirement. A quantitative study conducted in the fall of 2002 showed a wide range of changes in capital requirements for 19 large U.S. banks under the Advanced Internal Ratings Based (A-IRB) approach, with an average reduction in capital requirements for credit risk of 17 percent. In this study, the reduction in capital was offset by the operational risk capital charge, which was substantial. However, the amount of this operational risk charge was by necessity estimated using an approach that will not be used in the U.S.

The agencies understand that the results to date of the impact studies do not provide a full picture of the possible impact of Basel II. There are many moving parts to the proposal and the banks' participation in the study was on a best efforts basis. Moreover, in the U.S., leverage ratio floors and the demands of the marketplace would act as a constraint on the potential reduction in actual capital.

Still, these initial estimated results show that the Basel II formulas are potent instruments for affecting risk-based capital requirements in the U.S. This is a matter of great interest to the FDIC and we are committed to working with the other banking agencies as we move forward to more accurately assess the impact of the proposed new standards.

A significant business challenge for the banking and thrift agencies would be how to achieve interagency consistency in the application of these complex rules. Required capital charges will depend heavily on the ongoing judgments of banks and regulators about a variety of specific risks.

In addition to understanding the impact of Basel II on capital levels, we must also understand the significance of mandating two tiers of regulatory capital standards -- a bifurcated framework that will offer competitors different regulatory capital charges for similar assets. The critical issues in terms of the competitive playing field are whether the direct competitors of a core group of about ten large banks would feel forced to opt-in to the new framework for competitive reasons, and whether banks in the tier below those able to opt-in would be at substantial competitive risk.

To resolve these fundamental issues satisfactorily, much hard work remains. Given the magnitude of the issues, we must proceed carefully.

Capital Adequacy

The U.S. banking system has weathered the last ten years better than the banking systems of some other countries for a number of reasons. One significant reason is strong capital levels. Bank capital is subject to federal legislation and regulation because of its critical importance to the health and well-being of the U.S. financial system. An adequate capital cushion enhances banks' financial flexibility and their ability to withstand periods of adversity. As insurer, the FDIC has a vital stake in the adequacy of bank capital—as do our fellow regulators and all U.S. taxpayers. Congress recognized this important principle when it established the Prompt Corrective Action (PCA) requirements in the Federal Deposit Insurance Corporation Improvement Act. A critical aspect of the existing PCA regulations is the minimum leverage capital requirement. To be considered well-capitalized, a bank must have a ratio of Tier 1 capital-to-total assets (the leverage ratio) of at least five percent. Banks with leverage ratios under four percent are considered undercapitalized. The agencies agree that maintaining the minimum regulatory capital standards as reflected in the current PCA legislation and existing implementing regulations is important.

Capital is not the only thing needed for safety-and-soundness. The strong risk management that Basel II promotes is also essential. There is no denying that banks with good risk management and a lower-risk profile should be able to operate with somewhat less capital than more-risky banks. But there is also no denying that when the unexpected happens, the hard-earned benefits of risk management can evaporate overnight without adequate capital.

The sophistication of the measurement of economic capital can make it easy to lose sight of the fact that, in reality, no one knows the range of potential future losses for a given activity, or the associated probabilities. Certain risk management practitioners express great faith in the calculation of economic capital, and believe that the regulatory capital standard should in all instances be less than the economic capital amount. The idea behind this philosophy is that banks tend to be forced out of low-risk activities where regulatory capital requirements exceed economic capital requirements. It is this belief that gives us concern about a clash of expectations about Basel II between a number of prominent risk management practitioners on the one hand, and the FDIC and our fellow bank regulatory agencies on the other.

As the regulators move forward to finalize our views on Basel II, we need to proceed cautiously. Where a proposal seems to run counter to established U.S. supervisory practice, we need to ask whether the established practice should be re-examined in light of the proposed new rules, or whether the new rules need to be re-examined for U.S. purposes.

Basel II is the object of intense scrutiny and comment. Changes have been and will be suggested by banks in many areas, including the treatment of commercial real estate, credit cards (and the related issue of future margin income), mortgages, securitizations, and capital recognition of certain risk-mitigating activities. The potential for many moving parts could make it difficult to evaluate the capital impact or the competitive impact of Basel II. Yet, we believe that we must achieve a better understanding of these issues before the bank regulatory agencies commit the U.S. to the new framework.

Interagency Consistency

Basel II would provide banks and supervisors some flexibility to determine what capital would be held on an ongoing basis. The degree of conservatism to apply to a particular situation would often be a judgment call. Is the loss given default on a secured commercial loan likely to be 20 percent or 40 percent? Capital for that loan would double, or be cut in half, depending on the answer -- and the answer could well depend on a mix of historical data, the specific underwriting methods used by individual banks and the specific analytical techniques banks use to make their case. Supervisors would need to validate – uniformly and consistently across banks – the answers to such questions. In this new framework, regulators must be prepared to challenge the modeled outputs of sophisticated risk measurement systems of the largest U.S. financial institutions, a difficult and demanding task. It will require courage and discipline to respond to this new challenge.

Much progress has been made by the regulators and the industry in deciding how this validation might be done. Interagency guidelines are being drafted and implementation approaches are being discussed. The FDIC has an active interest in the development of a sound approach to ensure the consistent and uniform review of bank risk measurement systems under Basel II.

A Level Playing Field

Capitalism, with its inevitable winners and losers, is about competition. It is the job of the regulators to make certain that the competition is fair. In our capitalist system, one of the key functions of regulation is to ensure the rules do not display favoritism and that the competitive struggle is carried out on equal terms. We need to evaluate Basel II against this standard before committing to implement it in the U.S.

The proposed agreement raises important questions. The fundamental question is what are the economic benefits of the regulatory capital relief some banks might realize under Basel II? Conversely, what are the costs of additional capital they might be required to hold for certain activities? Would small or mid-sized regional banks, unable to qualify for the new framework, become acquisition targets of Basel II banks whose reduced capital has boosted their returns on equity? Would a large credit card bank that must hold capital for unused credit card lines be at a disadvantage to a non-Basel bank that faces no such requirements? Would a securitizing regional bank that is forced to deduct most of its retained interests from capital be at a disadvantage to a Basel bank whose deductions from capital would now be capped? What would be the ramifications of significantly reduced capital requirements for Basel banks on specific assets held by banks of all sizes, such as mortgage-backed securities issued by the federal government-sponsored enterprises?

The Basel II formulas are designed to work for large diversified portfolios, and the capital requirements they produce might be too low for most small banks. The Basel framework also requires significant systems investments at a level likely beyond the reach of – and not essential for – small institutions. Therefore, it is not practical to think that any competitive concerns that may exist could be resolved simply by allowing all banks access to the Basel framework.

To a large extent, the banking system in the U.S. is already a two-tier system, with large financial institutions possessing the vast majority of U.S. bank assets. Still, we must evaluate thoroughly whether Basel II will unnecessarily disturb this current, albeit divided, field of competition. Even though the industry may already be divided between the large and complex and the small and less complex, banking supervisors must understand fully whether Basel II adds significant additional competitive pressures or would trigger additional industry consolidation. The ANPR will seek input from all interested parties, including banks that believe they will be competitively harmed if they cannot embrace the Basel II framework.

H.R. 2043

Generally, H.R. 2043 would impose a Congressional review procedure and add new responsibilities to the current interagency decision-making process regarding the implementation of Basel II and other international regulatory matters.

The FDIC appreciates the goal of H.R. 2043, and shares Congress' desire to ensure that uniform U.S. positions are developed and communicated to the Basel Committee. As our testimony indicates, we are working with the other regulatory agencies to develop interagency positions regarding the domestic application of Basel II. The agencies are jointly preparing an ANPR and detailed implementation guidance that sets standards for those banks that adopt the advanced approaches embodied in Basel II. The bank regulatory agencies are actively engaged in an almost daily dialogue on issues and concerns. We will take whatever time is necessary to seek input from all interested parties prior to the final adoption of the new framework in the U.S., especially the concerns of banks that may feel they will be disadvantaged in competing with Basel II banks.

We also share Congress' concern that the impact of Basel II on U.S. bank capital levels and competitiveness, and on the U.S. bank supervisory process, be fully understood before we finally implement these new standards. As we move cautiously forward to analyze these issues and accomplish these tasks, we will keep Congress apprised of developments.

However, we do not believe H.R. 2043 is the best means to accomplish this end. The legislation would, in effect, move the important task of capital regulation away from the agencies with decades of experience in this arena to the U.S. Treasury Department. This could compromise the independence of the Federal banking regulators and impair our ability to handle an important function of prudential regulation at a particularly sensitive time. Thus, we strongly urge the Congress not to enact H.R. 2043.

Without question, we understand and embrace the sponsors' desire for transparency in the rulemaking process. The development of capital regulations for U.S. banking organizations demands a full vetting of issues, congressional and industry input, and interagency coordination. In this decision-making process, which includes the administrative rulemaking, notice and comment process, we commit to you that all comments will be considered carefully. We will work with Congress to better resolve the underlying problem -- transparency in the development of capital standards and more coordinated decision making.

Conclusion

An Advance Notice of Proposed Rulemaking will be issued this summer and will reflect the U.S. banking and thrift agencies' views on how Basel II would be adopted in the U.S. More importantly, it will present issues and concerns, and raise questions to the industry and the public. The comments will provide invaluable insight to many of the key concerns being raised by the agencies, and by Congress.

Given the importance of these issues, it is vital that we treat the implementation of Basel II in the U.S. as we would any other proposed regulation—with a dose of skepticism, a willingness to entertain the discussion of options, and a commitment to fully explore potential costs and benefits before reaching a final decision. We need to listen carefully to comments that will be received in the rulemaking process to ensure we address these threshold issues.

It also is important that the financial services industry, the Congress, and the banking agencies have a full opportunity to review the response to the ANPR and achieve a better understanding of the impact of this proposed agreement before we commit the U.S. to the Basel II approach. The FDIC has no interest in delaying the agreement and its implementation beyond what is necessary to address the issues we have raised and to understand the impact of this new system of capital regulation.

I have full confidence that this interagency process will work and will arrive at an appropriate outcome. The FDIC will continue to remain fully involved in this process and will work to ensure that the goals of Basel II and of Congress are being met as the process moves forward.

Thank you for the opportunity to present the views of the FDIC.

Testimony of

Independent Community Bankers of America
on

"The New Basel Accord—In Search of a Unified U.S. Position"

before the

Subcommittee on Financial Institutions
and Consumer Credit

of the

Financial Services Committee

of the

United States House of Representatives

June 19, 2003

Karen M. Thomas
Director of Regulatory Affairs and
Senior Regulatory Counsel
Independent Community Bankers of America
Washington, DC

Mr. Chairman, Ranking member Sanders, and members of the Committee, my name is Karen Thomas and I am Director of Regulatory Affairs and Senior Regulatory Counsel for the Independent Community Bankers of America ("ICBA")[1]. I am pleased to appear today on behalf of the ICBA to discuss Basel II and its implications for community banks in the United States.

"Basel II" refers to the proposed new, highly complex regulatory capital accord under development by the Basel Committee on Banking Supervision. Basel II is proposed to replace the existing 1988 Accord (Basel I) with a more risk sensitive framework in order to improve safety and soundness in the financial system. The structure of the new accord is built around three pillars: minimum capital requirements, supervisory review process and market discipline/disclosure.

The Basel Committee's third consultative paper on the new accord was issued for public comment several weeks ago. The U.S. agencies plan to outline their preliminary proposals for how Basel II will be implemented in this country next month in an Advance Notice of Proposed Rulemaking.

In this regard, the ICBA applauds the U.S. regulators for their announced intention to limit the scope of application of Basel II in the U.S. and not to apply Basel II to non-complex community banks. In fact, U.S. regulators plan to require only the largest ten or twelve U.S. banks to comply with the Advanced Internal Ratings Based approach for credit risk and the Advanced Measurement Approach for operational risk. This group of banks is both large in scale and is engaged in significant international activities. After the first round of final Basel II rulemaking, the banking regulators expect that another ten or so of the largest banks that can meet the qualifying internal infrastructure standards for risk measurement and management will also elect to comply with Basel II, due to competitive or market pressures.

ICBA hopes that in the future U.S. banking regulators will continue to require only the largest, internationally active U.S. banks to apply Basel II and to exempt "second tier banks" and non-complex community banks. There are several reasons for recommending this. First, methods of assessing capital adequacy must be appropriate to the size and complexity of operations of the bank. Bank consolidation in the United States continues to move the industry towards a barbell shape with a few large, complex, globally active institutions on

[1] ICBA is the primary voice for the nation's community banks, representing some 4,600 institutions with 17,000 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold more than $526 billion in insured deposits, $643 billion in assets and more than $402 billion in loans for consumers, small businesses and farms. For more information visit www.icba.org.

one end, and thousands of smaller, non-complex, community-focused institutions on the other. In our view, capital adequacy regulations must recognize the increasing differences between these two ends of the spectrum.

Second, since an important objective of Basel II is cross-border competitive equality, it is not necessary to require smaller banks that do not compete in international markets to apply Basel II. Only a handful of the largest banks account for most of the international banking activities conducted by U.S. banks. Collectively, the regulators estimate that the 20 or so banking organizations that will comply with Basel II account for about 99 percent of the foreign assets held by the top fifty domestic U.S. banking organizations, and for approximately two-thirds of the domestic assets of U.S. banking organizations.

Third, on average community banks historically have tended to maintain higher capital ratios than larger institutions. Because of their smaller size, and limited access to capital markets, they have few alternatives for augmenting capital—particularly in times of stress—other than through retained earnings. For this reason and others, they generally maintain a strong capital position, in excess of regulatory minimums. According to the Federal Reserve, more than 93 percent of the banks that are outside of the top 20 banks have risk-weighted capital ratios in excess of 10 percent, which is 2 percentage points or 25 percent higher than the minimum 8 percent required by Basel I. For the 8,800 banks with less than $1 billion in assets at year-end 2002, the numbers were particularly striking. Banks with less than $100 million in assets had an aggregate risk-weighted capital ratio of 16.6 percent; and banks with assets of $100 million to $1 billion had an aggregate risk-weighted capital ratio of 13.8 percent, according to FDIC data. For banks with more than $10 billion in assets, the figure was 9.14 percent.

Fourth, the goals of Pillar II (supervisory review) and Pillar III (disclosure) of Basel II have been effectively achieved in the U.S. The U.S. banking regulators already do a very effective job supervising banks and reviewing their capital positions. Furthermore, U.S. banks already disclose significant amounts of financial information, including their capital ratios, through their Call Reports and, if they are publicly held institutions, in their annual and quarterly reports.

Minimum Capital Requirements (Pillar I)

The proposed Basel II accord would make significant and far reaching changes to minimum capital requirements. Basel II would allow banks to use one of three approaches. The Foundation Internal Ratings Based approach and the Advanced Internal Ratings Based approach use sophisticated internal credit risk rating models and systems to measure capital adequacy (the IRB approach). The Standardized approach would substantially refine the current accord and incorporate external credit ratings and credit risk mitigation elements in the risk-weight framework.

The changes to the current capital adequacy framework contemplated in Basel II are unduly complex and costly and unnecessarily burdensome for U.S. community banks and could result in higher minimum capital requirements for these institutions even though there is no increase in their risk profiles. As ICBA told U.S. regulators and the Basel Committee in 2001, we believe that Basel II is overkill for non-complex community banks, and that the costs and burdens of adhering to Basel II would outweigh the benefits, if any, of moving to the new accord. Both the IRB approach and the Standardized approach make changes that are inapplicable and/or inappropriate for most community banks.

The IRB approach is appropriately applied only to a small number of large banks. This approach is simply infeasible for community banks, and will remain so in the future. Community banks do not have the resources to use sophisticated internal risk rating models—which are overly complex and too costly for their needs—that meet the accord's requirements. A community bank is not likely to have a sufficient volume of credits to maintain a sophisticated, statistically valid model with the requisite degree or range of meaningful risk refinement to justify the high costs associated with the extensive data collection, record keeping, and maintenance of the model.

As for the Standardized approach, community bank credits consist mostly of retail credits—loans to consumers and small businesses, which will have a risk weight of 75 percent (versus 100 percent under Basel I). Loan secured by certain residential real estate will have a 35 percent risk weight (versus 50 percent under Basel I). Community banks generally do not lend to externally rated corporate entities and will have a smaller proportion of loans that qualify for lower capital charges under the credit risk mitigation provisions of Basel II.[2]

The Standardized approach—despite its additional complexity, risk buckets and incorporation of external risk ratings—may not materially affect a non-complex bank's minimum capital requirements, when the additional charge for operational risk required under Basel II is taken to into account. But, as with any change, the Standardized approach would present the burdens of learning and mastering a new scheme, changing systems and software, and retraining management, boards, and employees—with little corresponding benefit to justify the costs for community banks.

---

[2] The credit risk mitigation provisions of the Standardized approach will be of limited use to many community banks because the definition of eligible collateral is restricted mainly to financial asset collateral, such as cash, highly-rated securities and gold. As providers of retail credit, the most common form of collateral for community bank loans is physical collateral such as real estate, automobiles, equipment, inventory, livestock and crops. Community banks may have a small percentage of loans that are guaranteed by the U.S. government or an agency thereof, through special programs administered by the Small Business Administration, Federal Housing Administration, etc.

In light of the robust system of capital adequacy requirements already in place in this country, U.S. regulators rightly concluded that the costs of applying Basel II to the entire population of U.S. banks would greatly outweigh any benefits.

ICBA had expressed these views directly to the Basel Committee during a meeting the Committee held with representatives of small and medium-sized banks around the world in July 2001. At that meeting, U.S. regulators, with our full support, said they did not intend to apply the new accord to non-complex banks. They stressed that because of the distinct attributes and structure of the banking systems in various countries, each country's supervisors must have flexibility to determine the scope of application of the new accord in their own country. The U.S. diversified financial system, which includes thousands of smaller community banks, is unique.[3]

Competitive Concerns

Even though community banks are pleased with the decision regarding the scope of application of Basel II in the U.S., that does not mean that we do not have concerns about the impact Basel II will have on community banks. In particular, community banks are concerned that Basel II may place them at a competitive disadvantage as Basel II will yield lower capital charges for residential mortgage, retail, and small business loans.

Larger banks that have the resources and capability to apply Basel II will choose it over Basel I if they perceive it to be in their best interests to do so. Under the IRB approach, various types of credits will enjoy much lower risk-weights and correspondingly lower capital charges than under the Basel I accord. The Basel Committee intends the lower minimum capital requirements associated with the more sophisticated methods to provide an incentive for banks to adopt the costly, more advanced risk assessment and management techniques.

Thus, banks using the internal ratings-based approach can be expected to use Basel II to keep their capital levels very tight. This would result in community banks having relatively higher minimum capital thresholds, which could put them at a potential competitive disadvantage.

A review of the Basel Committee's Quantitative Impact Study 3 (QIS3) heightens our concern. Analyzing Basel II's impact on more than 300 individual banks, QIS3 compares the average risk weights and capital charges for various

[3] At year-end 2002, there were 9,354 FDIC-insured institutions in the U.S. Approximately 8,800 had assets of less than $1 billion (4,700 with assets of less than $100 million); 550 had assets of more than $1 billion (106 with assets greater than $10 billion).

credit portfolios required by the current Basel I accord with those required under Basel II. Average risk weights and capital charges for some types of credit and asset portfolios would increase. But for retail credits, including mortgage and non-mortgage loans to individuals and small businesses—the very credits where community banks compete with large banks—the risk weights and capital charges would significantly decrease. For example, total retail credit capital charges under the Advanced IRB approach are estimated to decrease by 50 percent (60 percent for mortgages, and 41 percent for non-mortgages) among the banks in the G10 market area.

There is a cost to a bank for maintaining capital, and regulatory capital is a key factor in profitability and return on equity. The lower capital requirements may result in a cost advantage, and correspondingly a pricing advantage, in retail credits for large banks that are subject to Basel II.

One key factor is whether a bank's overall capital requirements, and not capital allocated for individual portfolios, will govern pricing decisions. Once operational risk charges are added to regulatory minimums, the overall change in minimum required capital may be relatively small. The QIS3 result was an aggregate 2 percent reduction overall using the Advanced IRB approach, although the experience of individual banks will vary widely. Particularly for a bank with a large percentage of its portfolio in low-risk weight retail credits, its overall minimum capital requirements will drop significantly, perhaps as much as 30 percent by some estimates. In addition, in the U.S., the "prompt corrective action" requirement to maintain a leverage capital ratio of 5 percent in order to be considered "well-capitalized" may act as a floor on how low regulatory minimums can go.

ICBA urges U.S. regulators to examine the question of competitive impact closely, and carefully review the expected practices of Basel II banks, as they consider implementation of Basel II. Because of the important role small and medium-sized institutions play in the economy by providing credit to consumers and small and medium-sized businesses, it is imperative to consider the competitive impact Basel II will have on second tier and community banks, and their customers.

If competitive inequities can be expected between Basel I and Basel II banks, a suitable response should be to consider whether some adjustments for Basel I banks, such as additional risk buckets to increase risk sensitivity and help balance the inequities, are appropriate. In addition, regulators should consider whether to allow second tier banks and community banks to opt to apply the Basel II Standardized approach in order to avail themselves of its lower risk weights for retail credits.

Challenges for Regulators in Applying Basel II

Regulators must be mindful of the conflict of interest inherent in using internal capital allocation models to both optimize profitability and increase returns on the one hand, and determine adequate capital levels on the other. Institutions using the IRB approach will have incentive to understate risk and losses in order to reduce capital requirements and increase return on equity. To guard against this, methods of ensuring accountability on the part of institutions using the IRB approach must be part of Basel II.

Under the IRB capital scheme, regulators will ultimately be responsible for ensuring institutions maintain adequate capital levels and must be very careful to assure the suitability and validity of IRB models, which may prove to be a daunting task. Only those institutions that are truly qualified to use the IRB approach should be permitted to do so. Mistakes or faulty judgments will have far reaching implications as regulators face the challenges of supervising large, complex banking organizations whose failure or disruption of operations present systemic risk to the domestic and global financial system and economy.

Conclusion

Methods of assessing capital adequacy should be appropriate to the size and complexity of operations of the bank. In this regard, ICBA strongly supports the intention of U.S. bank regulators not to require application of the Basel II capital accord to "second tier" and community banks in the U.S. Basel II is unduly complex and unnecessarily burdensome for U.S. community banks. The Basel I accord has worked well and generally remains well suited to assess capital adequacy for these banks.

At the same time, the ICBA is concerned that the Basel II changes and lower minimum capital requirements will result in a competitive and pricing disadvantage for Basel I banks, particularly with respect to residential mortgage, retail, and small business loans. We urge careful examination of this issue and its implications not only for Basel I banks, but for their customers as well. To address any competitive inequities, regulators should consider appropriate adjustments for Basel I banks, such as additional risk buckets or changes in risk weights to increase risk sensitivity.

Thank you for the opportunity to provide ICBA's views on this important subject. At the appropriate time, I will be glad to answer any questions you or members of the Committee may have.

ARTUR DAVIS
7TH DISTRICT, ALABAMA

208 CANNON HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
(202) 225-2665
FAX (202) 226-9567

COMMITTEES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY
COMMITTEE ON THE BUDGET

Congress of the United States
House of Representatives

May 2, 2003

Honorable Alan Greenspan
Chairman
Federal Reserve Board
20th and Constitution Avenue, NW
Washington, DC 20551

Dear Chairman Greenspan:

At last week's hearing before the Financial Services Committee you provided a brief, though timely, discussion of the status of the proposed Basel II Capital Accord. I say timely because the Basel Committee on Banking Supervision released its third consultative paper last week as well. I write in response to that paper as well as your discussion before the Financial Services Committee.

At the hearing, you stated that you believed the Basel II agreement would be less burdensome on our financial institutions than their current capital requirements. Further, you stated that you did not intend to accept a set of Basel II rules that would be detrimental to U.S. financial institutions. I applaud you for your efforts in this regard.

While I concur that there must be an appropriate emphasis on risk management, I am concerned over the potential impact the proposed Accord could have on smaller institutions, particularly regional banks with significant commercial real estate portfolios. As you may be aware, Alabama, and the Seventh Congressional District in particular, is the headquarters location for a number of major regional banks, and these banks are significantly engaged in commercial real estate lending as a result of the growth nature of the southeastern market. I am particularly concerned about the potentially negative impact the proposed Accord could have not only on these institutions, but also upon the availability of capital in my district and other growth areas of the southeast.

In other words, I am concerned about the impact of the proposed Accord in terms of credit availability, as well as the impact it could have on major institutions in my state. These institutions would be affected in several ways. First, were they to continue to meet the credit needs of this region, they would face serious capital costs. Second, as a result of these capital costs, they would be at a competitive disadvantage *vis-a-vis* the largest financial institutions in the country which do not engage in commercial real estate lending to the same degree as regional and smaller banks. This competitive disadvantage would

BIRMINGHAM OFFICE
1728 3RD AVENUE NORTH, SUITE 400 B-2
BIRMINGHAM, AL 35203
(205) 254-1960
FAX (205) 254-1974
TOLL FREE 1-868-285-0007

TUSCALOOSA OFFICE
TUSCALOOSA COUNTY FEDERAL COURTHOUSE
1118 GREENSBORO AVENUE, SUITE 336
TUSCALOOSA, AL 35401
(205) 752-5380
FAX (205) 752-5899

LIVINGSTON OFFICE
205 NORTH WASHINGTON STREET
UWA STATION 40, WEBB HALL, SUITES 236-237
LIVINGSTON, AL 35470
(205) 652-5834
FAX (205) 652-5935

SELMA OFFICE
908 ALABAMA AVENUE
FEDERAL BUILDING, SUITE 112
SELMA, AL 36701
(334) 877-4414
FAX (334) 877-4489

DEMOPOLIS OFFICE
102 EAST WASHINGTON STREET
SUITE F
DEMOPOLIS, AL 36732
(334) 287-0860
FAX (334) 287-0870

be particularly acute in terms of the treatment the respective institutions would receive in the capital markets.

I am told that there is data reflecting that real estate loan losses can be correlated to the level of equity provided by the borrowers. Thus, what thought, if any, was given to setting capital levels for commercial real estate loans based on loan to equity ratios, as opposed to the arbitrary capital charge now proposed under Basel II?

Before the third consultative paper was released, the Committee conducted qualitative impact study 3 (QIS 3) – its "field test" of the Basel II framework. I note that 350 banks in 40 countries participated in that study. I also note that dialogue with industry participants was a critical component of developing this third consultative paper. I would like to know in some detail the characteristics of the U.S. banks that participated in QIS 3 and that were engaged in dialogue by the Committee. For instance, how many banks would be considered "regional" or mid-sized U.S. banks? Did QIS 3, or any other impact study, assess the competitive advantage or disadvantage that such banks would experience based on the treatment of commercial real estate in Basel II? In this regard, I would note that such banks have a much higher level of such lending when compared to the largest institutions in the United States. Thus, to the extent that they have much higher capital charges with respect to their type of lending, they will be disadvantaged as compared to the larger banks in the United States. If so, what changes, if any, have been made to the Accord based on these studies?

On a related topic, I would like to know whether either the Federal Reserve Board or the Basel Committee on Banking Supervision has conducted any studies on the impact the proposed treatment of commercial real estate will have on availability of credit for commercial real estate projects in the United States and abroad.

Finally, I would appreciate your thoughts on another matter. Some have suggested that the proposed Accord would not affect any but a handful of the largest U.S. banks. Specifically, it has been said that ten or so banks would be required to come under the new Accord and approximately another ten banks would do so voluntarily. On the other hand, I understand that a very distinguished professor of banking has estimated that the capital markets, as a practical matter, will force the top 80 U.S. financial institutions to utilize the advanced internal ratings-based approach of Basel II. These institutions hold roughly two-thirds of the banking assets in the U.S. I would appreciate your thoughts on these differing points of view. If you disagree with the professor in terms of likely market reaction, I would appreciate your stating the basis of your disagreement and the degree of confidence you have that he is incorrect.

As I mentioned previously, I commend your efforts to improve the capital adequacy framework for banks and other financial institutions. In so doing, I would urge you to ensure that the framework is improved for all banks, not simply the largest banks and financial institutions. Further, I would hope that you and the Board would avoid taking any step that could unnecessarily restrict growth in the southeast and elsewhere. I look forward to hearing from you soon.

Sincerely,

Artur Davis

Artur Davis
Member of Congress

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

May 20, 2003

The Honorable Artur Davis
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Thank you for your letter of May 2 regarding Basel II. Your letter focuses on issues regarding the Basel II treatment of commercial real estate and its implications for regional banks. My response will focus on these two broad issues, as well as the issues of competitive equity and credit availability you raised.

In the United States, we currently plan to implement only the most advanced versions of Basel II. For a small set of large, internationally active banks, this approach will be mandatory; for other U.S. banks that meet certain stringent risk management standards it will be voluntary. All other banks will remain under the current (Basel I) requirements.

I appreciate the concerns that you and others have raised regarding the Basel II treatment of commercial real estate lending. The newest Basel proposal, released on April 29 (the third Basel Consultative Paper or CP3), would allow banks using the Advanced Internal Ratings Based approach, to estimate their own inputs to the capital formula for all commercial real estate loans. This is a major new modification that U.S. regulators, including the Federal Reserve, fought for and won in the most recent round of negotiations. This means that banks, as you suggest, would be able fully to take into account such factors as borrower equity when developing these inputs to the capital formula. Prior to this modification, banks were understandably concerned that capital requirements for some commercial real estate loans would increase under Basel II, while none could decline below the current 8 percent standard. Under the new approach, we anticipate that capital requirements on high-quality commercial real estate loans will decline below the current level.

The new proposal would allow regulators in each country to differentiate a subset of commercial real estate loans from commercial and industrial lending by applying a different capital formula for all Basel II banks making loans in that national jurisdiction. This reflects the tentative judgment that *some* types of commercial real estate lending may be more risky in the sense that whatever defaults occur tend to happen at the same time.

The U.S. authorities had been considering, based on the empirical information available to us, using that discretion to impose higher capital requirements on loans for certain in-place commercial real estate. However, the continued analysis of the empirical data we developed and received from others has not been fully supportive of that position. We will soon publish a White Paper that will provide the available data and our analysis for public comment. But our analysis of the data has now led us to the view that commercial real estate loans on in-place properties should be treated like commercial and industrial loans, and not be subject to the alternate formula and the resulting higher capital requirements.

We do believe, however, that banks will need to employ prudent and conservative practices in estimating the loss given default (LGD) inputs for such loans. And we still believe that loans for acquisition, development, and construction (ADC) should be subject to the higher capital formula unless the borrowers have themselves committed substantial equity or have already leased or sold the majority of the assets under development. We will clearly flag all these issues (loans on in-place properties, LGDs, and ADC loans) in the upcoming Advanced Notice of Proposed Rulemaking (ANPR). As demonstrated by our change in position on commercial real estate loans on in-place properties, in the end, the final framework will be guided by the best available evidence.

Your letter refers to the third Quantitative Impact Study (QIS 3) that was undertaken by the Basel Committee. In the United States, more than twenty banks participated, including a number of large regional banks, some of them located in the Southeast. Despite being based on the more conservative approach to commercial real estate proposed *before* CP3, the aggregate QIS 3 results for these banks were not materially different from that of the other U.S. banks in the study. With the changes in the proposal under CP3 noted above, we anticipate that banks' commercial real estate portfolios would have lower capital charges than implied by QIS 3. We intend to meet with each U.S. QIS 3 participant individually to discuss their results and any remaining concerns.

At present, we do not believe there will be a significant competitive disadvantage or a reduction in credit availability from the commercial real estate proposals, but we remain open to any evidence to the contrary. The key objective of Basel II is to have a more risk-sensitive capital requirement that builds on banks' own measurement and management of their risk. That is why the changes in CP3 are so important in giving each bank subject to Basel II the scope to use its own risk measures to establish its capital on commercial real estate and other loans. If, as we intend, the regulatory framework is broadly consistent with strong risk-management practices by banks themselves, there should be no issue of competitive disadvantage or credit availability simply because capital requirements better reflect a bank's risk exposure. Moreover, a large number of factors other than minimum regulatory capital affect competitive positions and credit availability. Banks tend to hold buffer capital to receive better funding costs, to retain flexibility under duress, and to qualify to become a financial holding company. Moreover, if the *regulatory* capital charge on a certain credit does exceed the charge the market would apply, banks can securitize the credit, as we have seen under Basel I. To the extent that capital charges are more risk sensitive under Basel II, banks should have less reason to securitize.

Of course, if a truly risk-based capital system and improved risk-measurement systems are adopted, the result would surely be a higher regulatory capital requirement for banks whose risk exposures are greater than the norm. Greater risk requires greater capital to protect the guarantor of that bank's insured deposits--the Federal Deposit Insurance Corporation, and ultimately the taxpayer--not to mention, in some cases, the financial system.

Based on our discussions with rating agencies and other market observers, we do not believe that a large number of banks, and certainly not the top 80 banks in the country, will be under severe pressure to adopt Basel II in the near term. We understand that there are market observers that believe there will be such pressure and we continue to explore this matter. The regulators, however, will not be pressing additional banks to adopt Basel II because we believe the benefits for regional banks and for the financial markets do not outweigh the costs. Over the longer term, independent of the adoption of Basel II or its scope of application, there will probably be evolving pressures from counterparties, those that deal with and fund banks, for the adoption of more sophisticated risk-management techniques by the regional banks.

Whatever such pressures may be, it is important now that Basel II, particularly as it will be implemented in the United States, reflects the input of banks that might choose to operate under it in the future. We do not want Basel II to include features that would discourage regional banks from adopting it and we believe the upcoming ANPR process will provide a valuable opportunity for feedback from such institutions. In addition, over the next month the banking agencies have organized a series of roundtable meetings with regional banks. These discussions are to share information about Basel II and encourage participation in the ANPR process.

I hope this is responsive to your questions.

Sincerely,

June 25, 2003

The Honorable Carolyn Maloney
House of Representatives
Washington, DC 20510

Dear Congresswoman Maloney,

At the Subcommittee hearing on June 19th, you asked for a letter from Vice Chairman Ferguson confirming his answer to your question about the resolution of any possible conflicts between the time schedule for Basel II and the need to take whatever time is necessary to evaluate relevant public comments and also to develop a consensus among the federal banking agencies. Reflecting the close coordination among the federal banking agencies on the Basel process, all of us, as indicated by the signatures below, join in this response.

As background, you should be aware that any Basel Accord is a document that reflects a consensus position of participating central banks and supervisors. It is not legally binding or self-implementing in any country and, as a consensus document, it would be subject to change as new information and perspectives develop. In addition, each financial institution's application of Basel II would be subject to regulatory approval and continuing oversight by one of us.

We want to make clear the steps that would have to be taken before the federal banking agencies implement a final Basel Accord. These prerequisites are, first, that the agencies have sufficient time to analyze all timely U.S. public comments on both the Basel third consultative paper and the agencies' upcoming Advance Notice of Proposed Rulemaking; second, that we have thereafter developed a unified U.S. position; and third, that we have achieved an agreement in Basel that is acceptable to the agencies as the basis for taking the next step in our domestic process, namely the issuance of a Notice of Proposed Rulemaking. We will also continue to make clear to the Basel Committee that the adoption of a final rule in the United States would be contingent on the results of the comments received on this Notice of Proposed Rulemaking and a Quantitative Impact Study (QIS), both of which we anticipate developing in 2004. Even after the subsequent adoption of a final rule in this country, the agencies would still reserve the right to revise that final U.S. rule on the basis of the results of additional QIS reviews and any other information developed in future years.

The Honorable Carolyn Maloney
June 25, 2003
Page 2

We should also note that market realities require that the principles underlying the U.S. rules on capital must be applied consistently at each of the regulatory agencies for the depository institutions under their respective jurisdictions. Therefore, consensus and agreement among the regulatory agencies are required before any change as fundamental as Basel II could be adopted for depository institutions in this country. That is simply the practical reality, and we are committed to work together and support each other in the process.

We hope you find these observations helpful.

Sincerely,

John D. Hawke, Jr.
Comptroller
Office of the Comptroller of the Currency

Roger W. Ferguson, Jr.
Vice Chairman
Board of Governors of the Federal Reserve System

Donald E. Powell
Chairman
Federal Deposit Insurance Corporation

James E. Gilleran
Director
Office of Thrift Supervision

Copies to:

Chairman Oxley
Ranking Member Frank
Chairman Bachus

Chairman Shelby
Ranking Member Sarbanes

KeyCorp

June 16, 2003

The New Basel Accord

TESTIMONY OF KEVIN M. BLAKELY

On behalf of

KEYCORP

Hearings on Basel Capital Reforms
House Financial Institutions and
Consumer Credit Subcommittee
June 19, 2003

Testimony of Kevin M. Blakely
Hearings on Basel Capital Reforms
House Financial Institutions and
Consumer Credit Subcommittee
June 19, 2003

Introduction

I was invited to testify in person at today's hearing, but had to decline the opportunity due to a schedule conflict. However, I appreciate the opportunity to submit my written testimony for the record on behalf of KeyCorp, the 11th largest banking company in the United States. KeyCorp has total assets of approximately $85 billion, and spans the northern half of the U.S. from Maine to Alaska. While the vast majority of our business is domestically based, we do have a modest level of international business activity.

KeyCorp is not one of the institutions included in the definition of "top ten most internationally active institutions". Accordingly, under the present regulatory guidance, we will not be required to comply with Basel II when it becomes effective in 2006. Nonetheless, it is our intent to qualify as an advanced practice institution. We simply believe that it is good banking practice to develop the risk management tools that are the foundation of Basel II: if that qualifies us as an advanced practice company under the new accord, so much the better.

I believe my testimony today provides a rather unique perspective on the issue of whether or not Basel II is good for the banking industry. For the first 17 years of my professional career I was a bank regulator with the Office of the Comptroller of the Currency (OCC). Much of my time with the OCC was spent dealing with problem and failing institutions. During my last several years with the OCC, I was Deputy Comptroller for Special Supervision. That's a nice way of saying I was responsible for the department that dealt with severely troubled and failing financial institutions.

My tenure in the Special Supervision department ran from 1986 through 1990, a time when a significant number of banks failed in the U.S. I was able to see first hand the myriad of reasons that caused banks to get into trouble. Not the least of these was the inability to appropriately identify and manage their risks.

I left the OCC in 1990 to join the deeply troubled Ameritrust Corp. in Cleveland, OH. Ameritrust was a $12 billion company that had encountered difficulties arising from its loan portfolio. I was part of the new management team focused on turning the company around. Over an 18-month period, Ameritrust lurched from one crisis to another, but we eventually were able to stabilize the company. During the interim period I lived, first hand, through the effects of a firm that had little in the way of risk management practices and tools.

My experience with OCC's failing banks division and the Ameritrust debacle convinced me that there had to be a better way of managing risk in the banking industry.

In 1992, Ameritrust was acquired by Society Corp., the precursor of today's KeyCorp. I was placed in the position Executive Vice President of Credit Policy & Risk Management. In this capacity, I was given the opportunity to explore and experiment with new risk management tools that were beginning to bud in the industry. I was encouraged to do so by our CEO who expressed a desire to have a system whereby he could understand the totality of risk that our company faced on a daily basis.

Our CEO envisioned a process that could tell him how much aggregate risk the company was taking, including the risks that emanated from our credit, market and operational activities. He wanted a system that could allow us to increase, decrease or maintain our risk position as circumstances warranted. Neither of us realized it at the time, but he was describing a process that is today commonly called "enterprise-wide risk management".

In 1993 I commenced the first step of his vision by installing a Value-at-Risk (VAR) system in our company's trading floor. VAR was a highly complex model designed to measure risk in the bond, equity and foreign exchange trading we undertook on a daily basis. Due to the complexity of a VAR model, I had to engage several PhDs to help us implement it. During the course of their engagement, I happened to mention my frustration in finding an enterprise wide system that could aggregate the risk of each of our banking activities. One of the PhDs suggested that I look into the concept of economic capital allocation, now commonly known as "risk based capital".

Once I investigated the premise of risk-based capital allocation, I concluded I had discovered a powerful risk management tool. Implementing such a model at KeyCorp would enable us to allocate capital to our lines of business based on the amount of risk they took. Each line of business would be charged for the amount of credit risk, market risk and operational risk they encountered. Using the aggregate of that capital charge as the denominator, and the revenue they generated as the numerator, we could determine which lines of business were getting appropriately paid for the risk they took. For the first time, we would be able to put all our lines of business on an apples-to-apples comparison basis. Hence: the ability to know our level of risk and whether or not we would be paid for the risk being taken. Further, we would be able to aggregate the total amount of capital being allocated to all our lines of business to understand the totality of risk our company was taking. It was the enterprise-wide solution we had been looking for.

KeyCorp commenced building an economic capital allocation program in the mid 1990s because we firmly believed it was the right thing to do. It has taken us a nearly a decade to build it, and we are still not finished with it. Nonetheless, even after nearly 10 years we remain convinced that it is the best way to run our company. No regulator has told us that we must do this.

We are pleased to note that this powerful risk management tool, economic capital allocation, is now the underlying driver of Basel II. Our company was highly critical of the initial version of Basel II and publicly stated as much. We felt that it failed to address the sophistication and complexity that our industry routinely operated in. We felt it was inadequate and little better than the original Basel I. Put simply, it did not adequately address risk sensitivity. However, over the next several years we were pleasantly surprised to see how Basel II became a much better document. The regulators working on the new accord have been genuinely receptive to hearing the concerns that KeyCorp and others have raised. We haven't always gotten our way, but at least we have been heard.

We believe that Basel II is now on the right track. Financial institutions will need to develop more sophisticated risk management tools to support the risk based capital premise upon which it is built. This is a good thing. In today's world of complex financial markets, tools such as value-at-risk, two-dimensional loan grading systems, enterprise data warehouses and operational loss databases are not a luxury; they are a necessity. In order to understand their risk positions, banks should be calculating risk based capital and using these tools to do so. While models are no substitute for human judgment, they certainly create a more informed human with whom to make the decision.

One of the benefits we see in the Basel II proposal is that we will finally be free to price our products and services commensurate with the risk they entail. As previously mentioned, Basel I provides very little in the way of risk sensitivity. One of the perversities of this shortcoming is that it has driven high quality borrowers away from the banking industry. These clients can access providers of credit not subject to the costly level of capital that banks are currently required to hold. In essence, banks are forced to overprice for this business, and they lose it to other cheaper, non-regulated providers. Conversely, Basel I's simplistic 8% capital requirement has allowed banks to hold less capital than they should against borrowers that are high risk. This has resulted in banks underpricing such credit. It should be no surprise, then, that Basel I has chased high quality credits away from banks, while attracting low quality credits to them.

If banks are allowed to calculate the proper level of capital to be held based on a realistic stratification of credit risk, this serious problem will largely disappear. This is one of the tenets that Basel II is based upon: you hold the level of capital necessary to support the risk, and price for it accordingly.

I would now like to address some of the criticisms that have been leveled against Basel II. These would include its cost, complexity, inflexibility and propensity to foster pro-cyclicality. I would also like to provide a few comments on the merits of Basel II's Pillar 1 versus Pillar 2.

Cost

Much has been said about the cost of building the models necessary to comply with Basel II. At KeyCorp, we wonder how anyone can afford not to build them. We, ourselves, have painfully learned the cost of not having them. In 1996, our risk based capital process was still in its embryonic stage: in truth it didn't begin to take hold until 2000. In '96 we were still calculating profitability measures utilizing the primitive 8% capital standard stipulated by Basel I. On this basis, one of our loan portfolios, leveraged lending, was producing an eye-popping return on equity close to 30%. As a consequence, we unfortunately pursued expansion of leveraged lending over the next several years. At the end of 1998, the quality of this portfolio began to collapse and we have written-off many millions of dollars since.

We have looked retrospectively on our experience with this portfolio. We believe if we had had our risk based capital model in place (the kind proposed by Basel II) our anticipated return would have been in the single digit range. Such knowledge would have caused us to avoid this particular lending activity and to seek other opportunities that offered better risk/reward ratios.

Through this experience, we have learned an important lesson from which others can benefit. The entire cost of the nearly 10-year effort to implement our economic capital model (the same kind proposed by Basel II) pales in comparison to the cost of not having it in place.

We have read that others estimate the cost of compliance with Basel II to be staggeringly high. We are not convinced this is the case, and it certainly has not been so at KeyCorp. Yes, we have spent multiple millions of dollars over the years investing in risk management tools and models, but we've done so because we believe those tools are necessary to conduct our business in a safe and sound manner. Frankly, they will also make us a better competitor. The more we understand our risk, the better we will be at managing and pricing for it.

Some have criticized the cost of auditing and back-testing the accuracy of the models that Basel II is based upon. We view such activities as nothing more than good common sense. Auditing and back-testing of outputs is critical to ensuring that the model is producing reasonable numbers. Auditing/back-testing serve as the tuning devices necessary to modify the models' calculations. For example, auditing and back-testing of VAR models is an accepted practice in the industry now: everyone knows their benefit. We view auditing/back-testing as necessary investments needed to create a better model. Better models create better understanding of risk and the ability to better manage it. Better management of risk results in lower losses to banks. We believe the cost of auditing/back-testing is inconsequential compared to the losses that can occur due to inferior risk management processes.

Before one accepts the large figures attributed to Basel II compliance, one must subtract the costs of building the risk management systems that a good financial institution would invest in, regardless. We do not believe the gap between the two is significant.

Complexity

We cannot deny that Basel II is a complex document. It is. Yet, it needs to be. Banking is a complex business that needs complex solutions to the issues it faces. We should not run from complexity but instead be willing to face it and manage our way through it.

I have previously mentioned that KeyCorp installed a VAR system for its trading floors in the early 1990s. At that time, many were saying VAR systems were exceedingly complex, expensive and too mathematically driven. Yet, today VAR systems are widely recognized as the standard by which to manage risk in their trading books. VAR is a superior risk management tool that never would have come to be had the financial services industry been intimidated by its complexity. I reiterate: when VAR first surfaced, it was accused of being too complex, costly and mathematically driven, the same crimes Basel II stands accused of today. Yet, VAR has become the industry standard.

Inflexibility

Some fear Basel II will trap the industry with year 2000 era risk management tools and stifle creation of new ones. We believe this concern is overstated. The 1988 Basel Accord was a woefully inadequate document from the start. Its simplistic approach mandated a specific capital level and made no provisions to the contrary. Yet, over the past 15 years, the financial services industry has continued to develop new risk management tools never envisioned by the '88 accord. These would include: VAR models, two-dimensional loan grading systems, economic capital models and enterprise-wide data warehouses. The fact that such tools were not contemplated by Basel I did not interfere with the industry's pursuit of them. We anticipate a similar situation with Basel II – banks will continue to pursue a better risk management mousetrap. We will acknowledge, however, that regulators must be willing to consider the new tools as they are developed, and work with the industry to accommodate them as their effectiveness is demonstrated.

Pro-cyclicality

We have frequently heard that regulators are concerned that Basel II might allow substantial capital to escape from the banking system. We believe the whole premise of pro-cyclicality is evidence that such concerns may be overstated. Basel II capital levels represent the *minimum* level of capital that an institution is to hold. The premise of pro-cyclicality assumes that banks operate at or near the minimum capital level. We believe it is highly unlikely that any banking company worth its salt will allow their capital to sink to the lowest acceptable level.

Some argue that under Basel II, economic downturns will cause financial institutions to become more reluctant to lend when liquidity is most needed. Banks would be placed in a position of making a difficult choice: immediately raise new capital or stop lending. In truth, there is a third choice that most banks will probably follow: retain a buffer level of capital to accommodate cyclical changes in risk that everyone knows will inevitably occur.

We also believe that even in times of economic stress, banks genuinely desire to make new loans to drive their own revenue streams. Our current economic situation is a prime example: banks are anxious to lend money. The demand simply isn't there.

Pillar 1 versus Pillar 2

One of the basic principles of Basel II is to make risk transparent so that it is comparable from one institution to another. Pillar 1 encourages a formulaic based system that will enable this to occur. Consistency of methodology is critical to empower investors, regulators and depositors with the information they need to gauge the risk of the institution with whom they are dealing. Without Pillar 1's consistency of approach, a Tower of Babel syndrome can occur.

Pillar 2 relies more on flexible judgment as to how much capital is warranted at an institution. We acknowledge and accept that regulators must have the flexibility to invoke their authority to ignore the results of Pillar 1 when circumstances so dictate. However, completely abandoning Pillar 1 in favor of Pillar 2 yanks any comparability benefit away from investors and depositors. The invisible hand of the market will be impeded in its ability to quickly discipline a wayward institution.

For example, much has been said about the need to place operational risk under a Pillar 2 approach. In this regard, the individual regulator that happened to be examining a particular bank would largely determine the adequacy of capital held for its operational risk. This lends itself to varying assessments, interpretations, methodologies and enforcements. An investor attempting to compare the level of capital held for operational risk at multiple banks must assume that different examiners will utilize the exact same thinking in their operational risk assessments. That simply doesn't happen. A more formulaic approach, where all banks are using the same scorecard, lends itself much more to consistent comparability.

The mere presence of a Basel II draft has caused many in the industry to start contemplating new ways of tracking operational risk. This would include KeyCorp. We have commenced building an operational risk database that will give us better information regarding the source, size and amount of operational losses. This database will ultimately serve as the system that feeds our operational risk model. We believe it can be supplemented by exchanging information on operational risk losses with other financial institutions. This will help us build the critical mass necessary to create reliable, predictive loss forecasting models. I will readily admit that we have a way to go in this particular area, but the presence of Basel II over our heads encouraged KeyCorp and others in the industry to get moving on building the databases sooner.

In conclusion, KeyCorp believes that Basel I is hopelessly broken and that a new accord needs to be implemented. Basel II is a major step forward and we applaud its approach. It is not perfect now, nor will it be perfect when implemented, nor perfect 10 years after implementation. Regardless, it is light years ahead of Basel I as well as any other proposal we have seen to date. It should be supported.

We acknowledge it is complex, but banking is a complex business. A simple solution to complex issues is probably not the right medicine. As an industry, we should not shy away from the remedy simply because it is complex. Instead, we should work collectively with the regulators to find the right solution, not the easy one.

We have our doubts as to the high cost figures attributed to Basel II. Our own experience to date has proven to the contrary. Further, we believe many Basel II costs are simply expenditures we should otherwise be making as a matter of sound banking practice. Good risk management costs money, but it is intended to help avoid even bigger costs that arise from bad risk management.

We do not believe adoption of Basel II will trap the financial services industry in a time warp. Banks will continue to develop better methods of managing risk regardless of what Basel II requires. However, regulators must be open and responsive as these new tools are developed.

We believe there is substantial merit to including as much as we can in Pillar 1 versus Pillar 2. One of the greatest benefits that Basel II promises is that it will utilize the invisible hand of the market to discipline wayward institutions. In order to do that, investors must have adequate information to compare the risk of one institution against another on an apples-to-apples basis. Pillar 1 is the best vehicle for ensuring that banks report on a consistent basis.

Mr. Chairman, KeyCorp appreciates the opportunity to share our views on Basel II. We want to make sure our industry operates within a safe and sound environment. We know this is the goal of the committee as well as our friends in the regulatory world. While Basel II is far from perfect, it certainly moves us further down the path.

O