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AN UPDATE ON THE NEW BASEL CAPITAL ACCORD

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

THE RECENT DEVELOPMENTS REGARDING THE IMPLEMENTATION OF BASEL II AND BASEL IA AND THE CONCERNS RAISED ABOUT THE BASEL II REGULATIONS PROPOSED BY FEDERAL BANKING REGULATORS

TUESDAY, SEPTEMBER 26, 2006

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AN UPDATE ON THE NEW BASEL CAPITAL ACCORD

TUESDAY, SEPTEMBER 26, 2006

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:06 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

Today we will continue our oversight of the new Basel II Capital Accord and the proposed revisions to existing capital requirements, known as Basel IA. After years of development and consideration, we are now entering into a critical phase for the implementation of Basel II and Basel IA. Federal banking regulators recently approved the Notice of Proposed Rulemaking for Basel II and are expected to issue shortly the Notice of Proposed Rulemaking for Basel IA.

During the public comment period for these regulations, Federal banking regulators will consider whether any modifications are necessary before the regulations become final. The decisions Federal banking regulators make over the next few months will have profound consequences for the long-term stability of the U.S. economy.

Capital requirements play a key role in ensuring the safety and soundness of our banking system and protecting U.S. taxpayers from the cost of bank failures. We only need to look at U.S. economic history to see how thinly capitalized banks have in the past made our financial system vulnerable to unanticipated economic shocks and how a crisis in the banking system quickly infects the rest of our economy. And due to the existence of Federal deposit insurance, in the end, taxpayers pay the cost of bank failures attributable to a lack of capital.

The risks posed by undercapitalized banks are heightened by the rapidly increasing sophistication of our financial system. In the world of derivatives and off-balance-sheet transactions, it is vital that banks utilize advanced risk management practices to effectively monitor and control their financial exposures. Accordingly, Basel II and Basel IA must be implemented within the utmost care and diligence. There is little margin for error when it comes to capital requirements. Yet concerns have been raised about the Basel II NPR.

At the Committee's last hearing on Basel II, we heard testimony that questioned whether Basel II would leave banks sufficiently capitalized and whether regulators possess the expertise necessary to implement Basel II. Furthermore, several banks have requested that they be allowed to choose the Standardized Approach for setting their capital requirements. Currently, banks adopting Basel II in the U.S. will be permitted to use only the Advanced Approach. Before Basel II and Basel IA go forward, I believe we must have a clear picture of how they will change our financial system. We must also know that our banks will hold the appropriate amount of capital, that our regulators will be able to implement a regime as complex as Basel II, and that our small banks will not be placed at a competitive disadvantage.

I look forward to hearing the witnesses' testimony on these important questions today. At today's hearing we will have two panels.

The first panel will consist of the Honorable John Dugan, Comptroller of the Currency; the Honorable Susan Schmidt Bies, Governor of the Federal Reserve Board of Governors, a member of the Federal Reserve; the Honorable Sheila Bair, Chairman of the Federal Deposit Insurance Corporation; the Honorable John Reich, Director of the Office of Thrift Supervision; and the Honorable Diana Taylor, Superintendent of the New York State Banking Department, on behalf of State Banking Supervisors. We will just go to the first panel first.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Well, thank you very much, Chairman Shelby. I want to commend you for holding not just this hearing but a series of hearings on the status of Basel II. There have been very important developments since our last hearing. I am sure this hearing today will help us to understand those.

As people know, and let me just say at the outset, I am very skeptical of proposals that would reduce bank capital requirements or threaten to do so in the future.

Like others on this Committee, I have been around long enough to remember the difficult years of the late 1980s and early 1990s when our banking system became undercapitalized. Some banks and thrifts had negative capital and were closed. Most others were forced to increase their capital, and in that period, the American taxpayer paid an enormous cost to make good on the promises of deposit insurance. We were here together, I think, in those days, Mr. Chairman.

Chairman SHELBY. Dark days.

Senator SARBANES. I do not think anyone on this Committee would want to go through an experience like that again.

When banks are forced to rebuild their capital, they make fewer loans to the riskier startup businesses that are important to job creation. But we managed through legislation and regulation to get our banking system back on a firmer footing. Many experts believe that the U.S. economic performance was much better than the Japanese performance in the late 1990s because our banking system had successfully recapitalized and the Japanese banking system had not. Strong bank capital protects taxpayers and promotes healthy and stable economic growth. And, furthermore, it does not appear to have hurt the profitability of our Nation's banks. They are earning record profits and are doing much better than their competitors abroad, even though, it is constantly pointed out, the foreign banks have lower capital requirements.

Many experts welcomed the original Basel I in the 1980's as an unprecedented accord among bank regulators in the U.S., Europe, Japan, and Canada to raise bank capital requirements. Over the years, it has been updated many times, but in the late 1990's it was decided to develop a new agreement, Basel II. Basel II was finalized in 2004. It provides for three different approaches for capital regulations: standardized, foundational, and advanced internal ratings-based.

The Federal Reserve has taken the lead in long maintaining that the Advanced Approach should be mandatory for our largest banks. My concern with this is that the Advanced Approach under Basel II may indeed end up threatening the safety and soundness of our banking system.

Last year, a year after the terms of Basel II were settled, we learned the likely effect of the Advanced Approach on bank capital requirements. The so-called QIS–4 study of 26 of our largest banks found that the capital requirements in one instance for one of those banks would plunge nearly 50 percent and the capital requirements for half of the banks would fall at least 26 percent.

Seeing these results—in fact, we had been constantly assured in testimony before this Committee that there was not going to be a substantial reduction in bank capital. Seeing these results, the four bank regulators wisely agreed—I gather with some internal dissension—that they should maintain the leverage ratio, slow the decline in any one bank's capital, and limit the decline in overall capital in the banking system.

I have yet to hear a single outside expert on our banking system argue that our banks today are overcapitalized. In fact, Bill Isaac, who will be testifying on the second panel, says in his statement, and I quote him, talking about the original premise behind Basel II about developing these mathematical capital models while broadly maintaining the overall level of capital: "The models—incomprehensible to mere mortals, such as boards of directors and senior management of the banks"—and Members of Congress. That is my addition, not his. He is very polite to the Members of the Congress. He left us out of this problem.

Chairman SHELBY. At least here.

Senator SARBANES [continuing]. "Would measure the risks in these institutions' assigned capital to cover those risks."

"This original premise was somehow transferred into an expectation that large banks would be offered the carrot of reduced capital in exchange for developing the models. Let us pause right here"—this is Isaac—"and think about the proposition that the largest banks have excess capital and should be allowed to reduce their capital materially."

"Does anyone really believe in that notion—particularly anyone who lived through the two decades in banking from 1973 to 1993? Thousands of banks and thrifts failed during that period—many more, including most of the largest banks, would have failed but for very strong and costly actions taken by the FDIC and the Federal Reserve to maintain order. It was a very scary period that nearly careened out of control."

"For any regulator to accept the premise that the world's largest banks as a group have significant excess capital is unfathomable to me, yet that is the glue holding Basel II together."

Now, I also worry about the complexity and potential conflict of interest in the structure of the Advanced Approach. For many of these reasons, the limits on capital reduction allowed under the Advanced Approach makes a lot of sense.

Now, over the summer, a new proposal emerged that would allow all banks to use the Standardized Approach. This proposal has won the endorsement of large and small banks, bank associations, and State bank regulators. The four bank regulators recently decided to seek public comment on this proposal in their Notice of Proposed Rulemaking.

The Standardized Approach appears to have the merit that it would apparently not lead to large reductions in required bank capital. I have been concerned about this effort to achieve large reductions in capital requirements, and I know that some in the banking industry pushed for this Advanced Approach, but without the restrictions on how low their capital could go.

The Standardized Approach also addresses the concerns that the Advanced Approach would favor the largest banks at the expense of smaller banks.

So, Mr. Chairman, this is a very important hearing, and again, I commend you for scheduling it. I want to just close by again quoting Bill Isaac, who, of course, had the distinguished service as a former Chairman of the Federal Deposit Insurance Corporation. At the close of this statement he says, and I quote him, "This is by far the most important bank regulatory issue in front of us today. If we get this one wrong, our Nation and taxpayers will almost certainly pay a very big price down the line—a price that will make the S&L debacle seem like child's play."

Thank you very much.

Chairman SHELBY. Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Chairman Shelby and Ranking Member Sarbanes, thank you for holding today's hearing on Basel II Capital Accord. One of the most important duties of this Committee is to ensure the safety and soundness of our financial system, and oversight of Basel II is a critical element of that responsibility.

As we consider the state of Basel II, I would urge the regulators not to lose sight of three main goals.

First, all banks deserve a level playing field. I am pleased that we seem well on our way to solving the domestic competitiveness concerns that confronted us last year, and I would like to thank the regulators for taking those concerns seriously. I look forward to reviewing the forthcoming Basel IA proposal, and I also support offering all banks of whatever size the internationally negotiated Standardized Approach. Small community banks remain the lifeblood of many of our communities, and Basel II must not impair their ability to compete.

Ironically, though, we appear now to be on the verge of placing large internationally active U.S. banks at a serious disadvantage against foreign competitors, and even against U.S. consolidated supervised entities. I would urge the regulators to review the U.S. banking Notice of Proposed Rulemaking to avoid duplicative requirements and to take great care before piling on a host of new requirements that diverge from the international version of Basel II.

Second, risk-based capital should remain a priority. Clearly, our main concern must be the safety and soundness of U.S. financial institutions. However, it has been well established that more capital is not always better. In fact, the recognition that more is not always better is largely why we embraced the Basel negotiations in the first place. The current system, which fails to peg capital to risk, perversely encourages risk-taking. Basel II recognizes that when risk and regulatory capital are aligned, capital is adequate but not excessive, and banks are forced to internalize their risks. We all benefit from the right balance.

The challenge, of course, is identifying the optimal balance. Under our risk-based system capital is meant to change depending on the risk of the underlying asset or activity, as well as underlying economic conditions. In reviewing the impact of any proposed rule, it is important to keep in mind that not all capital drops are bad. Of course, some may well be bad, and that is the point of Pillars 2 and 3.

Third, international harmonization should be a goal. In reviewing the newly published NPR, I am very concerned that we are undervaluing the creation of uniform international capital standards. The marketplace for products and services is increasingly global; therefore, it is critical that everyone plays by the same rules and U.S. banks are not disadvantaged. Of course, we need to make sure that the system works and banks are closely monitored. But the number of significant changes to the international text, which would apply only to U.S. banks, strikes me as a strange and unwanted result given our original goal of international harmonization.

Mr. Chairman, I think we would all agree that we have some way to go on Basel II to get it right. Clearly, all of the regulators have devoted considerable time, energy, and resources to ensuring the safety of our institutions and the vitality of our economy, and I value that dedication. I urge you in the coming months to continue working together to achieve the necessary balance in Basel II. I also urge the regulators to keep an open mind to giving all banks of whatever size the option of implementing the international version of the Standardized Approach.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Well, thank you, Mr. Chairman. I really want to thank you for holding this timely hearing. We are fighting to remain competitive in the financial markets. I think every American wants us to stay No. 1, but no one more than those of us who represent New York City, which is our financial capital. And we have a tremendous dilemma here and not just in this area.

As the world economy becomes internationalized and financial markets become one, you run the tension between having a system of regulation—which with this country has worked extremely well. I think in the last quarter of the 20th century, we achieved quite an exquisite balance. I have always said I like people who are both pro-business and pro-regulation, and I think there is no contradiction between the two. Those on the left wing who just want to regulate, regulate, regulate, and tie the hands of an entrepreneurial system, that makes no sense. And those on the right wing who just say do whatever business wants have not learned the lessons of history, plain and simple.

So there is a balance and we achieved it, but now it has sort of been thrown up in the air because of internationalization. And you can run into the problem of lowest common denominator. In other words, the place with the least regulation, that is where people will go, because regulation is a public good and it does not affect the individual making the deal unless the whole system collapses. You know, there is a book by Mancur Olson, "The Logic of Collective Action," which is very relevant here, which talks about that.

Well, I have to disagree with some of my Democratic colleagues who say we must keep every regulation in place because they have worked in light of the international challenge. But I disagree with saying let's get rid of them all as well. We have to find that balance, and this hearing is an attempt to do it.

Now, let me make some comments here. We have all heard about IPOs, only one of the top 24 being registered in the U.S., four in London. But listen to this: London already accounts for 70 percent of global bond trading, 40 percent of derivatives, 30 percent of foreign exchange activity, and 30 percent of cross-border equities.

As Senator from New York, these are the kinds of things that keep me awake at night, and I know they keep our great banking superintendent, Diana Taylor, who is here, awake as well. Hi, Diana. Nice to see you.

Ms. TAYLOR. Hello. Thank you.

Senator SCHUMER. Now, with respect to Basel II, I was there when Basel was—you know, I was involved as a Congressman on the Banking Committee when Basel started up. We all thought it was a great thing. We had seen the banking crisis, the S&L crisis, and we knew that capital standards, rather than strict regulation, were the way to go. Plain and simple.

Now we have not had a banking crisis for 15 years, so the need to have capital standards sort of declined a little bit. But we need them.

The problem is, again, when other countries say we are going to do much less, the imperative of New York companies, American companies to their stockholder says, well, if we can be more profitable doing it over there, we should. That is the dilemma we face, and if we are too rigid, we will lose all the business, and we will have no regulation and no business. If we are not rigid enough—I mean, if we are too flexible, we will have the kinds of crises we saw before.

So, as I said, we need to look at this carefully. Everything is interconnected. One failure is going to lead to the failure of many, and it is going to hurt taxpayers. So we have to be careful. We have to be careful.

But we should not fool ourselves into thinking a bigger capital cushion always means a safer system. Advances have occurred in risk management. Management makes it possible to use capital requirements to make banks internalize their risk, and if a bank takes a calculated risk, obviously it should have more capital in those investments than the ones that do not. But if they have to hold onto too much capital against safe activities, that is where we are losing out, and I think that is the nub of this problem that we have to look at.

So a number of Members have discussed these issues, but I have to say candidly I am concerned that at a time when we are struggling to maintain our stature as the world's economic center, this Notice of Proposed Rulemaking can hurt our ability to compete with France, Germany, and Japan, and particularly London. And make no mistake about it, London is making a strong effort to replace New York as the financial capital. Their regulators are here. They actually go solicit companies, which we are not doing. And, in fact, I formed a little group along with Mayor Bloomberg to discuss what we should do, and we are going to be examining that very seriously in the next few months.

So let me say here I believe in giving all banks access to the international Standardized Approach, and that is an important step and I support it. At least banks will have one option that allows them to follow the same rules as the rest of the world. And with respect to the Advanced Approach, I am a little less optimistic. I take pride in representing the world's financial capital. I want to make sure that our noble intentions do not backfire, and we need to keep the system safe and strong. We need to give New York banks a fair shot.

By the way, they are not New York banks anymore. They are in New York, but they are international banks, and they could locate somewhere else very quickly. And that is their job. I would get mad at them if they do it. I would fight less hard for them if they did it. But their first obligation is to their stockholders. And so this is a real dilemma.

Senator SCHUMER. And one other point, Mr. Chairman. There would be value if the GAO were to look at how any differences in the bank proposal could affect U.S. banks. So I am going to ask the GAO to conduct an expedited impartial analysis to report on the differences between the U.S. and foreign implementation of Basel II to determine which differences could have an adverse competitive consequence on U.S. banks and an adverse consequence on safety and soundness.

And with that, Mr. Chairman, I really thank you for holding this timely and important hearing.

Chairman SHELBY. Thank you, Senator Schumer. Comptroller Dugan, we will start with you. All of the written testimony will be made part of the hearing record in its entirety. A lot of you are not strangers here, so you proceed.

STATEMENT OF JOHN C. DUGAN, COMPTROLLER OF THE CURRENCY

Mr. DUGAN. Chairman Shelby, Senator Johnson, and Senator Schumer, I appreciate this opportunity to discuss the U.S. banking agencies' proposals to enhance our regulatory capital program under Basel II.

The U.S. implementation of Basel II is, at its core, the effort to move away from the simplistic Basel I capital regime for our largest internationally active banks. The inadequacies of the current framework are pronounced with respect to these banks, which is a matter of great concern to the OCC because we are the primary Federal supervisor for the five largest. These institutions, some of which hold more than $1 trillion in assets, have complex balance sheets, take complex risks, and have complex risk management needs that are fundamentally different from those faced by community and mid-sized banks.

Because of these attributes, Basel II is necessarily complex, but it would be mandatory for only a dozen large U.S. institutions. The new regime is intended not only to align capital requirements more closely to the complex risks inherent in these largest institutions, but, just as important—and this is a total departure from the existing capital framework—it would also require them to substantially improve their risk management systems and controls. This would be accomplished using a common framework and a common language across banks that would allow regulators to better quantify aggregate risk exposures, make more informed supervisory decisions, disclose more meaningful risk information to markets, and make peer comparisons in ways that we simply cannot do today.

Earlier this month, the agencies took a critical step forward in this process by approving a notice of proposed rulemaking. In addition to establishing the basic Basel II framework in the United States, the NPR addresses two key issues about implementation.

The first concerns the reliability of the framework itself. As you know, last year's quantitative impact study of the potential impact of an earlier version of Basel II predicted substantial drops and dispersions in minimum required capital. These QIS–4 results would be unacceptable to all the agencies if they were the actual results produced by a final, fully supervised and implemented Basel II rule. But they were not. Some changes already made in the proposed rule—and others that will be considered during the comment period—should mitigate the QIS–4 results. More important, we believe that a fully supervised implementation of a final Basel II rule, with examiners rigorously scrutinizing the inputs provided by banks, is likely to prevent unacceptable capital reductions and dispersions.

We cannot be sure, however, and that is why the proposed rule will have strict capital floors in place to prevent such unacceptable results during a 3-year transition period. This will give us time to finalize, implement, supervise, and observe "live" Basel II systems. If during this period we find that the final rule would produce unacceptable declines in the absence of these floors, then we will have to fix the rule before going forward, and all the agencies have committed to do just that.

The second issue concerns optionality. The NPR asks whether Basel II banks should have the option of using a simpler approach. This is a legitimate competitive question, given that the largest banks in other Basel II countries have such an option, although, as a practical matter, all such foreign competitors appear to be adopting the Advanced Approaches. We are very interested in comments about the potential competitive effects of providing such an option to U.S. banks.

The OCC has been a frequent critic of many elements of the Basel II framework, and we have worked hard to make important changes to the proposal that we thought made sense. But at critical points in the process, the OCC has supported moving forward toward implementation, and our reason for doing so is simple. An appropriate Basel II regime will help both banks and supervisors address the increasingly complex risks faced by our very largest institutions. While we may not yet have all the details right, and we will surely make changes as a result of the public comment process, I fully support the objectives of the Basel II NPR for the supervision of our largest banks. Likewise, for non-Basel II banks, I fully support our interagency effort to issue the so-called "Basel IA" proposal in the near future as a way to more closely align capital with risk without unduly increasing regulatory burden.

In closing, let me emphasize that, as we move forward with these proposals, the agencies will continue to foster an open process, consider all comments, heed good suggestions, and address legitimate concerns.

Thank you very much.

Chairman SHELBY. Chairman Bair.

STATEMENT OF SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you, Chairman Shelby, Senator Sarbanes, Members of the Committee. I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation concerning the Basel II International Capital Accord.

At the outset, I would like to emphasize that we all support moving ahead to the next step in the Basel II deliberative process. The FDIC Board of Directors recently voted to publish the Basel II Notice of Proposed Rulemaking for public comment. U.S. bank and thrift regulators also are developing a more risk-sensitive capital framework for non-Basel II banks, known as Basel IA, which we hope to publish for comment in the near future.

While it is important to move ahead with the process, there is also agreement that we must not do so in a way that will result in significant reductions in capital or in the creation of wide disparities in capital among different types of insured depository institutions.

The agencies' most recent QIS study suggested that the Basel II Advanced Approaches would result in a substantial reduction in risk-based capital requirements. The results also showed wide variations in capital requirements for similar risks. The agencies found these results unacceptable, and as a result, included a number of important and essential safeguards in the NPR to address them.

I look forward to the comments on the NPR, and I will approach those comments with an open mind. I particularly look forward to comments on the question of whether the regulators should allow alternatives to the Advanced Approaches. We have had a number of requests to allow any U.S. banks to use the Standardized Approach to capital regulation that is a part of the Basel II Accord. The U.S. is the only country proposing to make the Advanced Approaches mandatory for any group of banks.

The Standardized Approach includes a greater array of risk rates than the current rules. It is simpler and less costly to implement than the Advanced Approaches. In addition, because there is a floor for each risk exposure, it does not provide the same potential for dramatic reductions in capital requirements.

On the other hand, there is the argument that only the Advanced Approaches would provide an adequate incentive for the strengthening of risk measurement systems at our largest banks. Whether our largest banks should be required to use the Advanced Approaches is a fundamental issue, and as I just mentioned, I look forward to public input on this question.

Before concluding my remarks on Basel II, I would like to say a few words about the leverage ratio. The FDIC has consistently supported the idea that the leverage ratio, a simple capital-to-assets measure, is a critically important component of our dual capital regime. I am pleased that all the bank regulators have expressed their support for preserving the leverage ratio. I appreciate that banks in most other Basel Committee countries are not constrained by a leverage ratio and that effective capital standards around the world vary widely as a result. Indeed, if large European banks were subject to the U.S. Prompt Corrective Action standards, several would be considered as undercapitalized.

For this reason, I believe that the United States should ask the Basel Committee to initiate consideration of an international leverage ratio. The leverage ratio has provided U.S. supervisors with comfort that banks will maintain a stable case of capital in good times and bad. Similarly, the establishment of an international leverage ratio would go far in strengthening the liquidity and stability of the international banking system and help limit the consequences of reduced risk-based capital levels with Basel II implementation.

In conclusion, it is important that we improve the current risk-based capital rules without significantly reducing capital requirements. In addition, we should not allow ourselves to be drawn into a debate about lowering capital ostensibly as a means of promoting international competitive advantage. The U.S. has always had high capital standards, and this has been a source of strength, not weakness, for our banking system.

I will support implementing the Advanced Approaches only if I can develop a comfort level that strong capital levels will be preserved. To this end, I will review with an open mind the possibility of allowing the U.S. version of the Standardized Approach as an alternative option for implementation of Basel II.

In addition, as I indicated, the Basel Committee should consider an international leverage ratio as a way to promote liquidity and ensure a baseline of capital for safety and soundness throughout the global banking system.

I look forward to working with my fellow regulators to achieve a consensus on an outcome that is in the public interest. I appreciate the opportunity to testify regarding Basel II and look forward to answering any questions the Committee may have.

Thank you.

Chairman SHELBY. Thank you.

Governor Bies.

STATEMENT OF SUSAN S. BIES, GOVERNOR, FEDERAL RESERVE BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Ms. BIES. Thank you, Mr. Chairman, and I appreciate the attention of the Members of the Committee.

First of all, I think holding this hearing at this time recognizes the major events that have occurred in the last month, where we have issued the Basel II NPR and also the market risk NPR which will, for the first time, provide similar capital treatment for securities and banking firms in the United States. It implements a global accord between the Basel Committee on Banking Supervision and IOSCO, and I think that also is a major step forward in getting a more level playing field.

Let me focus today in my remarks on Basel II and where we are. As has already been mentioned, Basel II and our NPR are proposing that the core banks, who we define as the very largest and internationally active banks—it would be about a dozen—would have to adopt the most Advanced Approaches, the A–IRB for credit risk, and the Advanced Measurement Approach, the AMA for operational risk.

The U.S. proposed framework has been compared with the Basel framework other countries will implement where there are a variety of options in the Basel II framework. One point I would like to make, though, is in many countries Basel I goes away when that country adopts Basel II. We have made the choice in the United States to maintain Basel I for the vast majority of our banking institutions. For those countries where Basel I goes away, banks in those countries who are both small and large, therefore, need a variety of approaches. And so some of the Standardized Approaches were designed by the Basil Committee with the smaller, simpler organizations in mind when Basel II was drafted. And I think that is one of the questions we will want to get comments on in the NPR, of how that would apply in the United States.

The other point I would like to make is that we do know that while there is large variety, the largest globally active banks at this time are indicating that all of them are going to adopt the Advanced Approaches, and that has been stated most recently in a public format in the Basel Committee's report on QIS–5. The United States did not participate, but the other major countries did, and that is what the large international banks indicated at that time.

Chairman SHELBY. Does that include the Japanese banks?

Ms. BIES. Yes.

We also have focused so much attention on Pillar 1, I hope people also recognize that Pillar 2 is there. Pillar 2 involves processes to address the kinds of risks that aren't captured in credit or operational risks in Pillar 1. It can require additional capital if there are those other risks, and it is part of the supervisory process that makes the Basel II Framework so effective.

Finally, in looking at alternative approaches under Basel II, we also hope we get comment on what the implications are for Pillar 3. Pillar 3 is the public disclosure standard of the Basel II Capital Accord. One of the challenges here is that we had envisioned in the U.S. NPR to have the very complete disclosure of risk that the more sophisticated models would entail. The question then is: will the disclosures under a Standardized Approach to Pillar 1 be sufficient to give good disclosure of how risks are managed so we have market discipline about risk-taking of the largest organizations.

We continue to believe at the Fed that Basel I is inadequate for the largest, most complex U.S. banking organizations because they cannot fully capture the array of risks that these institutions face. Basel I does not recognize operational risk embedded in many services, and in our Basel I NPR that we are working on, as we did in the A–NPR, we do not anticipate an operational risk. Now there is a question that has been added about how to deal with operational risk if we provide a standardized credit risk approach.

Basel I also does not differentiate the riskiness of assets within asset types, and we have learned that the large organizations have quite a variety of the kind of risk exposure even though they have similar asset types.

Basel II draws upon many of the economic capital models that the banks use for their own risk management. But one of the challenges that we have seen is understanding the validity that these models have because they have different approaches. Already through the working in QIS–4 and –5, regulators are understanding that by requiring a more standardized framework, it allows us more effectively to have transparency into how those models work and gives us an ability to assess and identify weaknesses in risk management models. And for that reason, we also think that it is an important goal to support Basel II.

We will continue to work on QIS–4 questions. We have strengthened Basel II in the NPR, and I would note that some of the things that we have strengthened, the Basel Committee in QIS–5 also noted as areas that need further attention by the Basel Committee. And so many of the things we already have put in our NPR I think create timing differences and will be addressed on a global basis as the regulators worldwide work to completion of the Basel II.

Finally, I would say, as the central bank, the Federal Reserve has responsibility for maintaining stable financial markets and ensuring a strong financial system, and that mandates that we require banking organizations to operate in a safe and sound manner with adequate capital that appropriately supports the risks they choose to take.

And for that reason, the Federal Reserve will continue to work to make sure that Basel II is implemented in an effective and safe and sound manner.

Thank you.

Chairman SHELBY. Thank you, Governor Bies.

Director Reich.

STATEMENT OF JOHN M. REICH, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. REICH. Thank you, Chairman Shelby. I appreciate the opportunity to present the views of the Office of Thrift Supervision. I feel compelled to state that I began my banking career 42 years ago, in 1964, and I grew up with a generation of bankers who believed in two principles: one, you cannot have too much capital; and, two, you cannot have too much in loan loss reserves. And I hold those principles today as a member of the banking regulatory——

Chairman SHELBY. I think you are a wise man. We all do. [Laughter.]

Mr. REICH. When I testified before this Committee last year, I reported on the progress with the other Federal banking agencies on the development of the Basel II Framework, including the then recently completed QIS–4. At the time, I noted that a number of the concerns with the results of QIS–4. This week, the agencies are publishing an NPR on Basel II. I believe the NPR addresses a number of the issues that are raised by QIS–4, but questions obviously remain, and there is still work to be done between now and full implementation scheduled for 2012.

I do believe the addition of various prudential safeguards that are included in the NPR go a long way toward ensuring the safety and soundness of Basel II in the United States.

Challenging policy issues remain, and we are committed to working to resolve these issues based on comments received and to be received from the industry and other interested parties. I believe that our longer implementation period in the United States will provide the opportunity and the time to make whatever changes are necessary to implement Basel II, but this is in part predicated upon our receipt of ample and detailed comments from institutions that may be directly or indirectly affected by the proposal.

In my written statement, I detail the various challenges presented by the Basel II Advanced or models-based approach. While this approach attempts to level the playing field for banks around the world and provide a more accurate system of bank capital based upon risk, it is also complex and costly to implement, and it presents a number of policy and operational hurdles.

As we develop a more sophisticated risk-based capital framework, it is also important that we consider the Standardized Approach, the less complex alternative to the Basel II models-based approach.

The Basel II NPR requests comment on this alternative, and I believe it is important for the Federal banking agencies to consider whether a Standardized Approach could achieve a number of the same goals as the models-based approach, but at a lower cost and with greater clarity and transparency.

A critical aspect of the Basel process for U.S. regulators is ensuring that Basel II rules do not competitively disadvantage U.S. institutions that may choose to continue operating under the Basel I-based approach. In addition, to address competitive equity concerns, as well as to modernize capital rules for institutions other than the core institutions that are expected to operate under Basel II, the banking agencies are also working on modernizing the existing Basel I rules, and we expect to release the Basel IA NPR in the near future.

Before my time as the Director, OTS was an early advocate of comprehensively revising and modernizing Basel I. We strongly support amending the existing Basel I standards simultaneously or in close proximity to Basel II to improve the risk sensitivity of the current capital framework without unduly burdening affected institutions.

Finally, while Basel IA is intended to increase risk sensitivity and minimize potential competitive inequities from Basel II, many highly capitalized institutions have indicated that they will likely prefer to continue operating under the rules of Basel I. I am particularly dedicated to the proposition that we should not unduly burden these institutions, and I support this flexibility consistent with balancing safety and soundness with regulatory burden concerns.

The Federal banking agencies anticipate issuing the Basel IA NPR within the next month, and as with the Basel II NPR, we encourage comment on the flexibility of this system operating parallel with Basel and Basel II-based standards.

OTS supports the goals of Basel II, and we are prepared to make whatever changes may be required during the next few years of transition in order to make Basel II work satisfactorily for U.S.-based institutions. We look forward to continuing the dialog on Basel II and the parallel implementation of the Basel IA rulemaking, and we will continue to work with this Committee, with the industry, and with our fellow Federal banking regulators.

Thank you.

Chairman SHELBY. Ms. Taylor.

STATEMENT OF DIANA L. TAYLOR, SUPERINTENDENT OF BANKS, NEW YORK STATE BANKING DEPARTMENT

Ms. TAYLOR. Good morning, Chairman Shelby, Ranking Member Sarbanes, and distinguished Members of the Committee. Mr. Chairman, before I begin my oral statement, I would like to pay tribute to Senator Sarbanes for his many dedicated years of service on the Senate Banking Committee. Senator Sarbanes has been a wonderful person to work with. He has been a true friend to the States and a staunch protector and defender of States rights, and we will miss him.

Adoption of Basel II clearly has potential domestic implications that could affect our banking system and our economy. Specifically, we must understand the impact of these regulations on safety and soundness and competitive equity.

CSBS is fully supportive of the original objectives and goals of Basel II to better align regulatory capital requirements to underlying risks and to provide incentives to banks to hold lower-risk assets in their portfolios. However, the changes that would be implemented by Basel II must be well understood and must not have unintended consequences that may prove harmful to our valuable banking infrastructure which has served us so well for so many years.

Therefore, before we decide to move ahead with the implementation of Basel II's Advanced Approaches, I believe we need to address a number of important issues.

First, the results of QIS–4 in the United States showed a drastic drop in required capital. My fellow State supervisors and I have traditionally been vigilant with regard to capital requirements because of the pivotal role capital plays in ensuring safety and soundness and in stimulating economic growth. It is our responsibility to ensure that changes in capital requirements are prudent, do not unduly benefit one type of bank over another, and that any transition to a new calculation of capital is carefully managed. In fact, a major concern of mine as a State banking supervisor is that if Basel II goes into effect as currently constructed, the result could be a further erosion of the dual banking system and our Nation's broad and diverse financial industry.

Second, in order to successfully implement regulations such as Basel II in the United States, I believe State supervisors must have a more substantive role in the drafting and implementation process. We are very appreciative of Governor Bies' willingness to provide regular briefings to State supervisors on the status of Basel I and Basel IA. However, despite our status as the primary supervisor for most institutions, we have not been included in the drafting process of either Basel II or the Basel IA NPR.

Third, CSBS is pleased with the inclusion of several safeguards that have been incorporated into the Basel II NPR. Primarily, the maintenance of the current leverage ratio is crucial in preserving safety and soundness in the domestic banking system. We commend Chairman Bair for initiating a dialog on the need for an international leverage ratio. This would be a significant step to strengthening the international banking system.

I am aware of the criticism of the so-called conservativism of the U.S. approach to Basel II and the concern about international competitiveness. I do not believe we should be basing competitive equity on reduced capital. Also, this is an unfounded criticism. U.S. banks currently hold more capital than international institutions, yet our banks are generally more profitable than their international counterparts and remain highly competitive.

I agree that our banks must remain internationally competitive, but our first priority must be preserving the safety and soundness of the system and then ensuring a level playing field for our domestic institutions.

We now have the opportunity and the responsibility to make sure that when Basel II is implemented in the U.S. it will meet the objectives first put forth in 1999. I propose that we consider simpler Basel II options until we better understand the consequences of adopting Basel II's Advanced Approaches. Therefore, CSBS recently requested that the Federal agencies seek public comment on offering the Standardized Approach in the United States. The agencies have included such a question in the Basel II NPR, and we commend them for doing so. In my opinion, it is possible that adopting the Standardized Approach could allow us to increase the risk sensitivity and comprehensiveness of current risk-based capital requirements and establish uniform capital requirements across all institutions. Our domestic financial system could benefit from a less complex, more risk sensitive approach to monitor risk-based capital requirements.

Ultimately, the intention of Basel II is to produce a stronger international system that does not weaken our domestic dual banking system. The objectives put forth in 1999 must be met as we implement Basel II in the coming years. In our rush to improve safety and soundness and competitive equity in the international system, we absolutely cannot afford to weaken safety and soundness and competitive equity in our domestic institutions. As U.S. regulators, our first priority must be to our domestic institutions.

I commend you, Chairman Shelby, Ranking Member Sarbanes, and the distinguished Members of the Committee for addressing this matter. On behalf of CSBS, I thank you for this opportunity to testify, and I look forward to any questions.

Chairman SHELBY. Thank you.

I will address this first question to Chairman Bair and Governor Bies. For capital requirements to be effective, regulators must have a reasonable approximation of what the proper level of bank capital should be. Using that approximation, they can then determine whether capital requirements are too strict or too lax. A key question for Basel II is whether the expected declines in capital will leave U.S. banks undercapitalized.

Would you comment, starting with you, Ms. Bair, on whether U.S. banks are sufficiently capitalized at the present time or whether they are over- or undercapitalized? And then explain how you arrive at your conclusion. And how confident are you about what capital levels will be under Basel II? Do you have an estimate of the number of Basel II banks whose capital will fall enough to hit the floors of the Basel II NPR?

That is a mouthful.

Ms. BAIR. A long question. [Laughter.]

Well, I am very comfortable with current capital levels, yes, and I would repeat——

Chairman SHELBY. Do you believe that our banking system is in good shape today?

Ms. BAIR. Absolutely. The banking sector is healthy. All indications are that it continues to be healthy, even though we are seeing some softening in certain areas. I think our capital standards are relatively high vis-a-vis other non-U.S. jurisdictions. That plays a crucial role in the health of our banking system.

I would like to note, when Basel—I was not around when Basel II started, but going back and reading the materials of the Basel Committee itself and its pronouncements, consistently you will see that the Basel II process was not supposed to be about lowering capital. It was supposed to be about making the risk-based capital framework more risk sensitive, not about lowering capital. So it is frustrating to me—go ahead.

Chairman SHELBY. But the lowering of capital has gotten into the equation.

Ms. BAIR. It certainly has.

Chairman SHELBY. OK.

Ms. BAIR. That is a frustration to me because I see a healthy banking sector now, one that has been healthy for many years, and I see, as others have testified, banks, if anything, hold higher capital than their regulatory requirements. So it does not immediately suggest to me that banks themselves think their capital is too high.

I think going forward the QIS–4 results were very troublesome. We do not know if QIS–4 is an accurate predictor of what will actually happen under the Advanced Approaches. Some analysis suggests that actually the capital requirements—the risk-based capital requirements—could be even lower than suggested by QIS–4. It requires a lot more analysis.

If we go by the QIS–4 results, though, most of the banks participating in QIS–4 would be considered to be undercapitalized if that was the only constraint setting their capital. So, yes, I think that is why all the regulators viewed QIS–4 as unacceptable and why we need a lot more work and analysis before we know whether this is going to work or not.

Chairman SHELBY. Do you have an estimate of the number of Basel II banks whose capital will fall enough to hit the floors in the Basel II NPR?

Ms. BAIR. I do not know the number off the top of my head. We could provide it for you.

[The information follows:]

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

SHEILA C. BAIR
CHAIRMAN

October 18, 2006

Honorable Richard Shelby
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am writing to provide further information in response to a question you asked me during my testimony on September 26, 2006, before the Senate Committee on Banking, Housing and Urban Affairs. In particular, you sought information about the number of banking organizations participating in the agencies' most recent quantitative impact study (QIS-4) that are identified by that study as potentially being constrained by the various capital floors and safeguards included in the Basel II Notice of Proposed Rulemaking (NPR). Twenty-six banking organizations participated in the study, representing $5.5 trillion in bank assets, or 57 percent of the assets held by all FDIC-insured banks.

The NPR relies on three basic mechanisms for ensuring that minimum capital requirements do not fall in an unsafe manner. First, the NPR will impose transitional floors for each institution to limit reductions in minimum capital to 5 percent per year during the three-year transition period. Second, the NPR leaves unchanged the existing leverage ratio standards, which place hard-and-fast limits on minimum capital. Finally, the NPR indicates that regulatory changes will be made if Basel II institutions, in aggregate, exhibit a decline of more that 10 percent in minimum regulatory capital.

The U.S. agencies' QIS-4 suggested that without the safeguards contained in the NPR, most banks adopting Basel II would have their minimum regulatory capital requirements reduced to levels that would be considered unsafe and unsound. The safeguards in the Basel II NPR have been proposed to ensure these banks continue to maintain an adequate capital base. The enclosed tables provide further details.

We hope that this information proves helpful. Thank you for the opportunity to testify. Please do not hesitate to contact me if you have further questions.

Sincerely,

Sheila

Sheila C. Bair

Enclosure

Table 1	
QIS-4 Changes in Capital Requirements at Bank Holding Companies (Measured by Effective Minimum Required Capital)	
Holding Company Capital	**Number of QIS-4 Holding Companies**
Decline of more than 15 percent	17
Decline of between 15 and 10 percent	3
Decline of between 10 and 15 percent	1
Decline of less than 5 percent	1
Increase	4
Total QIS-4 banks	26

Table 1 shows that according to QIS-4 results, most banks adopting the advanced approach of Basel II would see an immediate reduction in their risk-based capital requirement of more than 15 percent.[1] The transitional floors contained in the NPR ensure that any such reductions in capital requirements for individual banks would be phased in gradually.

Table 2	
QIS-4 Capital Requirements Were Well Below Leverage Based Requirements (Minimum Tier 1 Requirements as a Percentage of On-Balance Sheet Assets)	
Ratio	**Number of Companies in Range**
Less than 2 percent	10
Between 2 and 3 percent	10
Between 3 and 4 percent	4
Between 4 and 5 percent	0
Greater that 5 percent	2
Total QIS-4 banks	26

Table 2 shows that according to QIS-4 results, at least 20 of the 26 participating organizations reported Basel II capital requirements that if implemented would make them undercapitalized under current U.S. regulation.[2] The retention of the leverage ratio will ensure that this would not occur.

[1] The results described in these tables have some limitations. First, the QIS-4 did not collect information about insured banks, only holding companies. While it is possible to draw inferences about insured bank results from the holding company data, such inferences would involve a number of assumptions. Therefore this response only estimates information provided at the holding company level. Second, the information provided does not reflect the application of the so-called 1.06 scaling factor that is contained in the NPR and the international Basel II Accord. This adjustment multiplies the capital requirements for credit risk by the number 1.06, but would not change the overall nature of the results. Third, it is important to note that all of the results presented are estimates provided on a best efforts basis at one point in time.

[2] Some bank holding companies are subject to a three percent leverage requirement and some to a four percent leverage requirement. We do not categorize the four institutions whose tier 1 capital requirement according to QIS-4 ranged between 3 percent and 4 percent of assets.

Chairman SHELBY. Can you do that for the record?

Ms. BAIR. The QIS–4 participants, which included both core and opt-in banks, most of them would have been below PCA levels.

Chairman SHELBY. Governor Bies, do you have any comments in that area?

Ms. BIES. Well, let me start by echoing what Chairman Bair just said, that none of the regulators would have accepted the state of the databases and models for any of the banks that participated in QIS–4.

Having said that, as we got in and looked at the QIS–4 information, we really did find areas where either the models as we had defined them in our regulatory framework or where the banks were in the stage of implementation made us want to include additional safeguards in the NPR to strengthen capital in a few areas. And we have done that in this NPR. And there are a lot of other areas that we hope to get some input on.

One of the interesting things is that, in the discussion about how much capital can drop under Basel II, it is important we differentiate between regulatory minimum capital and actual or total capital that banks hold. Today, banks hold way above regulatory minimums because they are driven more by the marketplace and the rating agencies and other investors who also require strong capital. So there is more than one constituency here in terms of looking at total capital.

So it is not clear to me, no matter what minimum regulatory capital does, how much that will affect banks' actual capital.

But we want to make sure, as we work through this, that there is enough capital for the different risks, both in this NPR and in——

Chairman SHELBY. Well, that is the basis of a sound banking system, is it not?

Ms. BIES. It is. And one of the challenges we have is the banks use economic capital models internally that are very similar to what we have specified. The big difference is the banks use them to manage their strategy. Long run, where are they going? What is the kind of variation they are likely to encounter? But as regulators, we want capital to be there when the banks come under stress, and so we tend to focus on downturn events and more of the tail losses than the banks do in their internal models. And that is one of the reasons we are asking for more capital—that is, higher minimum regulatory capital—than many of them have in their internal models.

Again, the comments we hope to get on the Basel II framework will help strengthen that, but we want to make sure we are comfortable that the capital is there in those stress periods.

Chairman SHELBY. Governor Bies, Senator Sarbanes brought this up a few minutes ago. But former FDIC Chairman William Isaac, who is well respected in the banking area, has raised serious concerns about the reliability of the data that banks will collect and compute to determine their capital requirements understand Basel II's Advanced Approach. In prior testimony to this Committee, former Chairman of the FDIC Isaac noted that banks do not have loss data going back far enough and that mergers and acquisitions in the banking industry have left banks without consistent data.

To what extent, Governor Bies, will these problems with data collection—knowledge, in other words—undermine the effectiveness of Basel II's Advanced Approach? Have you taken this into consideration? And, if not, will you?

Ms. BIES. We are taking it into consideration. It is one of the things that we spent a lot of time analyzing in the QIS–4 results and our foreign counterparts did in QIS–5.

When we look at the capital, we know that all of these models are providing estimates. Banks also are creating new products all the time, and one example would be the new mortgage products that some of us are very concerned about that the banks are underestimating risk. But that is why I emphasize that Pillar 2——

Chairman SHELBY. Mortgage products with no downpayments, all those kind of things.

Ms. BIES. Those negative ams and payment shocks and all those wonderful bells and whistles.

Chairman SHELBY. That should keep bank regulators up at night.

Ms. BIES. It keeps us awake at night, and that is why Pillar 2 is so important. It allows us as supervisors, where we feel either it is a new product, the model is not reliable, or it has a kind of risk that the Pillar 1 does not pick up—because Pillar 1 does not pick up all risk. We can specify additional capital the banks have to hold beyond their Pillar 1 numbers.

Chairman SHELBY. Chairman Bair, I am not picking on you.

Ms. BAIR. That is all right.

Chairman SHELBY. You just have a big portfolio here. All of you do. But in your testimony, you call for considering an international leverage ratio as a way to eliminate the competitiveness concerns presented by the retention of the leverage ratio under Basel II, as well as a way to improve global capital standards.

Could you discuss with us the idea here a little further today and whether foreign regulators would be receptive to the idea?

Ms. BAIR. Thank you, Mr. Chairman. Yes, the leverage ratio is obviously a very simple capital-to-assets ratio. There is no cost to implement it. It is a hard number; it is an easy-to-determine number.

We have had many years' experience with it. It has worked very, very well for the banking system. Canada is the only other country that has something like a leverage ratio, and the way they calculate theirs is a little different from ours. But I have been engaged in conversations at the staff level and at the principal level with other Basel country members and their representatives. I will be going to Mexico next week for the next Basel Committee meeting and hope to be talking more and will be formally pushing to have an international leverage ratio put on the agenda.

Some responsiveness, some reluctance, a lot of reticence. This obviously is new—not a concept that has been embraced heretofore. But, I think particularly as we look at the potentially dramatic drops in risk-based capital under the Advanced Approaches as we are moving forward, and it is not just U.S. banks that are seeing this, that that can make the leverage ratio more attractive as a hard baseline.

We are not sure we are getting it right with the Advanced Approaches. That is why we need more work. We are not sure that we are actually measuring risk under risk-based capital, and one of the good things that would occur through the leverage ratio is to give us a baseline, if we are not getting it right, at least providing a floor under which capital could not drop.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Well, thank you very much, Mr. Chairman, and I want to thank the panel. I know you summarized the statements, and I have been through the statements, and I appreciate the time and effort that obviously went into them.

Chairman Bair proposed that we negotiate an international agreement to establish a common leverage ratio in her testimony. In the next panel, Professor Tarullo supports that concept with the recommendation that it includes off-balance-sheet activities as well.

The first question I want to put: Is there anyone at the table who holds the position that the United States should not continue to require the leverage ratio? I take it everyone takes the position that we should require the leverage ratio. Is that correct?

All right. Now, if we continue the leverage ratio, is there any reason not to seek an international agreement on a common leverage ratio? What is the argument, if any, against at least undertaking this initiative? Basel I, after all, as I recall, was an effort to raise the amount of capital in the international banking system, which, of course, is a very deep concern of ours. And Professor Tarullo in his statement, which is coming later in the morning—I would like to get these up in front of you, because you all testify and then you up and go away, and then these other folks come on, and they make these statements, and we do not have you here to sort of respond to them. So I am trying to get the horse ahead of the cart in this respect.

He says, "The last thing many Basel Committee members want to do is to return to negotiations over international capital standards. Understandable as that sentiment may be, I would nonetheless urge our banking agencies to use the breathing space created by adoption and implementing regulations for Basel II to pursue alternatives both domestically and internationally. The problem with the A–IRB approach more than justified this response. At this juncture, the most promising approach may be a relatively simple international minimum capital rule accompanied by complementary domestic measures for achieving appropriate bank risk management and by enhanced international cooperation supervising complex, multinational banks. Specifically, I would suggest that the banking agencies raise with the Basel Committee the idea of an international minimum leverage ratio."

Then he recognizes that it is a simple rule that does not necessarily address all the complexities, but he says, "Because of its very simplicity, it is far more transparent in its application, far less easy to manipulate than more complex regulatory capital requirements. It can serve, as it does today in the U.S., as a useful warning sign to regulators and markets. Its application could be fairly easily monitored domestically and internationally."

So I come back to my question. If you all believe we should have the leverage ratio, is there any reason not to seek an international agreement on a common leverage ratio? Mr. Dugan, why don't we begin with you and go right across the panel.

Mr. DUGAN. Sure, Senator. Chairman Bair has put this issue on the table, but it is not one that we have had a chance to meet on as a group and discuss.

You have stated the issue quite well in terms of our being committed to the leverage ratio in the United States. It has worked well here. Just by way of background, other regulators have not imposed a leverage ratio in their countries and in the past have been quite adamant, in many cases, about not believing it is appropriate.

I think the concern that some of us have had is if this gets put into play internationally, what is the tradeoff? What is the potential price that we would have to pay in such a negotiation? How would such a leverage ratio be computed? Would there be a risk that our particular leverage ratio would be decreased as a matter of international harmony? Because, after all, the Basel Committee is not and never has been intended to result in identical capital requirements set by an international standard body. There has always been an element of national discretion. And, while we prefer the leverage ratio in our country, there are other aspects of the Accord that other countries prefer that we do not like. I would want to see what the entire package was before committing to it. I think those are the kinds of concerns that we need to think about as we discuss this issue.

Senator SARBANES. Are those concerns so weighty in your mind that you would not even put it on the table for discussion?

Mr. DUGAN. I think that is the discussion we ought to have as an interagency group. We really have not had any serious discussion about the pros and cons, and I would like to have that discussion.

Senator SARBANES. Ms. Bair, I already know your position, but go ahead.

[Laughter.]

Ms. BAIR. Well, I would be happy to have anytime, anywhere, even more discussions on this. I think it is very hard to argue against at least having a debate on something. And I think we all agree that any discussion of eliminating the leverage ratio is off the table domestically. I hope the representatives of the large banks sitting behind me that are concerned about competitive disparities and treatment are listening to that, because they are going to have a leverage ratio here in the United States. So it seems to me that if people are worried about competitive disparities, frankly, I am more worried about liquidity and stability in the global banking system, particularly if we see further declines internationally in risk-based capital, which right now is the only constraint for the vast majority of Basel countries. So I think getting it on the table, at least forcing people to talk about it, is very, very important. We can control where it goes. I am not going to make any significant concessions on our own standards to get the debate going, but I think that we do need to have the debate. And since we are starting with a zero baseline for most Basel countries since they have no leverage ratio, anything we can get them to do is going to raise the bar up in those countries.

Senator SARBANES. Ms. Bies.

Ms. BIES. Senator, I think we should raise the issue at the Basel Committee. As Mr. Dugan just commented, this has been raised before at other periods, and other countries have been very vocal against the idea.

I think one of the challenges we will have is the legal framework in different countries in terms of the kind of activities that go on within a bank varies, and that is why we have made more progress using a risk-based framework where similar activities are treated similarly. We would have to anticipate how to deal with that issue because that is sort of the heart of each nation's ability in terms of powers within the banks.

Senator SARBANES. Mr. Reich.

Mr. REICH. Senator, when OTS has a seat at the Basel table, I will be happy to join Chairman Bair in advocating for an international leverage ratio.

[Laughter.]

Senator SARBANES. OK. Fair enough.

Ms. Taylor.

Ms. TAYLOR. Ditto, Chairman Reich.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman. To our witnesses, welcome. It is good to see you. Thank you for joining us today.

I do not know if my Chairman and Ranking Member have ever used this before, but a lot of times issues come before us, and we are divided. We are not sure really how to go, and oftentimes we will see some of my friends are for it, some of my friends are against it, and I am for my friends.

In reading through my briefing materials for this hearing today, it looks like some banks, including some banks that have substantial operations in Delaware, are for this and some are not. And I understand we are starting a 120-day comment period so that everybody can weigh in and say what they believe is good or bad about this?

Do I understand that there are about 20 banks in this country that would be affected? Is that correct?

Mr. DUGAN. There are about a dozen core banks that, as proposed, would be mandatory, and then there is another group of banks that has talked about opting in.

Senator CARPER. And it is their choice, opt in or opt out? Why would they opt in as opposed to opting out? What is the rationale for that?

Mr. DUGAN. I think the rationale is that the Advanced Approaches are viewed as a more sophisticated system that address for large banks the kinds of risks that they would be involved with anyway. The notion is—and we heard this actually with the securities firms that testified on the other side—that it is a measure and an indicia of being a large, sophisticated player. If it became a standard, large banks would get measured against it, and they want to rise to that level, assuming it is a more rigorous way to measure risk in the system.

Senator CARPER. For the banks, especially American banks, I understand there are three or four that really like this approach, and some that are less enamored with it. But for the ones who really think this is the right thing to do, what—I think I understand the rationale, but what is it?

Mr. DUGAN. I think the idea is that there is support for tying capital more closely to risk—that is how they do it themselves—and a recognition that the current system is not a very good measure of that. Among other benefits, if there were a common way that it was done, regulators would understand better how this was computed, and there would be disclosures to markets that would reward banks that had a less risky profile according to the risk-based capital measurements of the Advanced Approaches. So there are several reasons why institutions would think this was a positive thing, if it were done correctly. The devil is in the details, as you will hear.

Senator CARPER. All right. Others, please.

Ms. BIES. Senator, I think one of the other issues that we hear as we talk to banks, not only in the U.S. but globally, the sophisticated models that banks use to run their shops day to day are very opaque to the outside world. And what Basel II, especially the Advanced Approaches, does is give them the confidence that regulators, in a common framework that we set out as requirements are confident the bank's measure of risk is within the range of the expected variance for the risk exposure and it is done in a consistent way. Today they all do it in different manners.

The additional disclosures that are required in Pillar 3 compared to what is there today would give users of financial statements and bank customers and investors better information about the nature of risk the bank is taking. And as they go through time and see what real risks are from period to period, they can look at how reliable the bank's risk management practices are and how well they anticipate the kinds of situations that could create loss for that organization.

Senator CARPER. Among the 12 or so banks that will be directly affected—they do not have a choice; they are going to be in whether they opt in or not—the folks that are less enamored with this approach, what are they saying? What are their concerns? Are they legitimate?

Mr. REICH. Too costly, too burdensome; that the regulators have added some safeguards which make it less conducive, less beneficial to them.

Senator CARPER. So it is burdensome, it is costly, it is not beneficial. But other than that, they are OK——

Mr. REICH. Other than that, it is a good thing.

[Laughter.]

Senator CARPER. Let us say that you lived in Salisbury, Maryland, or Foley, Alabama, or——

Chairman SHELBY. Tuscaloosa, Alabama.

Senator CARPER. Whatever. Or Lewes, Delaware. Why should you care about this stuff? Why is it important to folks there?

Mr. DUGAN. I had an outreach meeting with a group of community bankers last week, and I think there is a recognition that the very largest institutions are in a very different business in many ways from the community bankers, and there is a concern that if ever there were a problem with a large institution, it would affect the entire system.

So there is concern, and I get this question all the time: What are you doing to make sure you have your arms around the complex risks that the largest institutions take? And one of the answers, one of the fundamental reasons we are trying to get Basel II right, is because it is an opportunity to move toward a more sophisticated approach and to enhance risk management in a way that allows us to look across our largest institutions to help ensure that they operate in a more safe and sound manner, given the very different and very complicated types of risks that they take as they perform their function in the economy.

Senator CARPER. Ms. Bair, do you want to add anything to that?

Ms. BAIR. Yes, I would, because I think we all agree that complex banks need complex risk management tools. The question is whether you tie that to capital reductions, whether you use capital reductions as an incentive or whether under our supervisory powers, the banks under our jurisdiction, we ask them to have risk management systems that are conducive to their business model. So I think that is really where the issue is, not with regard to whether complex banks need complex risk management tools.

Also, in the sense that these models that we are requiring banks to implement in the Advanced Approaches are giving us accurate—complex as they are—risk measurements, that is a very, very key question. The QIS–4 results showed that there were wide dispersions in how large banks were measuring risk for identical exposure. So that suggests to me that these complex models need a lot more work before we can have confidence that they are really giving us precise measures that might justify reductions in capital.

Senator CARPER. My time is expired. Can I just ask one more quick question?

Chairman SHELBY. Go ahead.

Senator CARPER. After 120 days goes by and people have had a chance to comment, what happens?

Ms. BAIR. We will all come together and make a decision.

[Laughter.]

I would say I want to pay tribute to Sue Bies in particular for the leadership she has shown and her knowledge on this issue. And as you can tell, we have differing perspectives, different emphasis, different questions. But I think everybody has worked together very collegially to try to come together. We did it with the Basel II NPR. We are doing it again with the Basel IA NPR. And I think when we go to final rulemaking, it will be that same collaborative spirit.

Senator CARPER. All right. Thanks.

Ms. BIES. I would just like to add that, you know, we will be coming out next month with the Basel I NPR, and so both the Basel II and Basel IA NPRs will be out for comment, because we also care about the competitive issues within the U.S. banking system. So we want to look at all the comments from both proposals and look at how they fit together and see if we have struck the right balance and have addressed the concerns of banks of all sizes, and that we end up with a strong capital framework going forward.

Senator CARPER. Great. My thanks to each of you.

Thanks, Mr. Chairman.

Chairman SHELBY. Thank you.

I think this is a very important hearing, not just for you, the panel, but for us and the public. I will direct these questions to Comptroller Dugan, Director Reich, and Superintendent Taylor.

Basel II will not only impact the large banks that adopt it, but also smaller banks that will have to compete with those Basel II banks that will then have different and possibly lower capital requirements. Will the significant up-front costs necessary to qualify to use Basel II serve as a barrier, Mr. Dugan, to entry that will prevent banks from growing and becoming large enough to qualify for Basel II? In effect, will Basel II cement the position of the largest U.S. banks and give them a competitive advantage over all other banks?

Community banks are especially concerned about how Basel II will impact them. Could you please comment on the steps that you have taken both to address the competitiveness issues between Basel II banks and community banks and to address concerns that Basel II will reduce loans to small businesses, which could have an impact on our economy? Are there additional measures necessary?

We will start with you, Mr. Dugan.

Mr. DUGAN. Thank you, Mr. Chairman. That is exactly why we are putting Basel IA out for comment. You are right, it takes a very substantial investment in order to qualify for Basel II, and ordinarily that would be out of reach for community banks. So the question is: In the way that Basel II is structured, does it create a competitive imbalance that is serious enough that we have to worry about ways to address it? We are concerned about that, and Basel IA is an effort to address some of those issues. I cannot say it is going to be an identical rule. If it were, we would have Basel II all over again. The question is: Have we struck the right balance there?

In terms of small business lending, there was a proposal in the international version of Basel II that created a specific capital break, if you like, for small business lending that we did not include in the notice of proposed rulemaking for Basel II precisely because of this capital question. But the comparison between that treatment in Basel II and Basel IA is exactly why we need to put this out for comment and hear from people, and why we have been advocating an overlapping comment period so we get both sets of rules on the table before we get to the decisions of how to go final on both proposals.

Chairman SHELBY. Director Reich.

Mr. REICH. Well, I am very concerned about the impact on community banks with the changes that are being proposed, and I will be vigilantly defending and looking out for the interests of community banks as we go forth with Basel II and Basel IA and Basel I.

One of my greatest fears at the outset a few years back about Basel II is that it might result in accelerated industry consolidation and the disappearance of community banks from the scene. I do not want to see that happen.

Chairman SHELBY. Could that have an adverse effect on our job creation machine, small business?

Mr. REICH. Absolutely. It would have tremendous social costs to local communities.

Chairman SHELBY. Ms. Taylor.

Ms. TAYLOR. Once again, I want to say ditto to Chairman Reich. I agree with everything that he said. I am very concerned about the competitive imbalance, potential competitive imbalance between the very large banks which take the advanced IRB approach as opposed to the smaller banks. And I am very happy that the two comment periods for Basel II and Basel IA are overlapping.

Chairman SHELBY. I have a number of questions here for Governor Bies and Comptroller Dugan, and you might want to do this for the record, but we would like to have this information.

We would like to better understand your agencies' decision to request comments in the Basel II NPR on whether banks should be allowed to choose the Standardized Approach. Your agencies had previously decided that Basel II banks would only be allowed to use the Advanced Approach.

So my question is: Why did your agencies originally decide not to allow banks to use the Standardized Approach? Second, why have you now decided to re-evaluate this decision? And, third, what factors will you consider when deciding whether to allow banks to use the Standardized Approach? Given that Fed Chairman Ben Bernanke, during his last appearance before this Committee, expressed concerns about whether the Standardized Approach is appropriate for large global banks, is the Standardized Approach a realistic alternative for our biggest banks?

You might want to do that for the record. Do you want to comment on it now?

Ms. BIES. Let me just make one——

Chairman SHELBY. Because this is a mouthful here.

Ms. BIES. Right. I would like to do a written comment, but let me just put one thing in perspective.

When we chose to go with the core group of banks, about a dozen, we were focusing on the complex organizations. The complex organizations, we feel, need some risk framework that reflects the kind of positions they are taking, the sophisticated instruments they are using. But the comment letters and requests that we recently got come from small organizations, too. And the Standardized Approach, as I have commented on, is in Basel II for the countries who no longer have Basel I for their smallest organizations.

So the way the questions are teed up, you will see the way Basel IA is teeing it up, to ask how could a Standardized Approach be used, and for what institutions is it appropriate. And we want to hear comments on this because if we want to change direction we want specific input—that is why we are still in the comment period.

Chairman SHELBY. Would you give us a comprehensive answer on that for the record? Because our staff and all of us would like to closely look at that.

Mr. DUGAN. Mr. Chairman, if I could just add one point briefly?

Chairman SHELBY. Yes, go ahead.

Mr. DUGAN. We will be happy to provide an answer for the record. The Standardized Approach, the one that was adopted for the international community, has some hard risk weights that raise some concerns about whether they would be appropriate in the United States, and we will have to look at what would be an appropriate version in the United States if we were going to go down that path. That is exactly what we will be asking questions about in Basel IA, and I think that is appropriate.

Chairman SHELBY. Ms. Bair.

Ms. BAIR. I would just say I think that is a very central question, and I think key to that debate is input on, again, whether we see the need for further complex risk management, whether that can be done under Pillar 2 supervisory authorities or whether it has to be tied to capital levels.

Chairman SHELBY. I will direct this question to Governor Bies and Comptroller Dugan. How will your agencies monitor the implementation of Basel II Advanced Approach by foreign regulators?

Second, given that the implementation of Basel II will be opaque to anyone outside the banks and the regulators involved, what assurance does this Committee and, more importantly, the public at large have that Basel II will be implemented properly? Governor Bies.

Ms. BIES. Well, first in terms of——

Chairman SHELBY. Because there is a lot of difficulty here. You have all said that.

Ms. BIES. Yes, and we have been working very hard at this with our staffs now for a couple years.

The Basel Committee a couple years ago created the Accord Implementation Group that has been working under the leadership of Nick Le Pan, who heads the Canadian bank supervisory authority, to work out answers to exactly the question you are asking: How do we work internationally to get to as much comparability as we can get? Internationally, you never get exactly the same treatment. But we want to identify how we are going to rely on each other and how, what we call our home host issues will be addressed.

In addition, for the global banks—and luckily we are only talking about 50 or so that really create a lot of countries' involvement—where they are in multiple countries across the globe, we actually have created a college of supervisors around that unique institution where we already are in a couple cases testing out what are the biggest issues, how would we deal with it, how would we implement it in different countries given different legal, national requirements, and then look at the consolidated entity. So we are heavily into this, in part because Europe, as you know, goes live in January 2007 for Basel II. So we are far along in this.

In terms of opaqueness, when we issued the NPR this week, there are also some templates for additional data disclosures. Some of these will be made public because call report data today does not reflect risk-taking the way we need to for these complex activities.

There is also some additional information that will be gathered by the regulators and kept confidential that will allow us to look across organizations at comparability.

The public part of it we think will greatly give more transparency to the risk-taking of each of these organizations compared to what we provide today through today's call report definitions.

Chairman SHELBY. Ms. Taylor, I would like to direct this next question to you, if I could. State banking regulators oversee the vast majority of our Nation's financial institutions. Hence, Basel II and especially Basel IA will directly affect not only the safety and soundness of the institutions that State banks regulate, but also how State banking regulators oversee State banks.

What has been the role of State banking regulators in the process for developing Basel II and Basel IA? Have you or other State banking regulators been included at all in the drafting process for the regulations? And if not, is there a mechanism through which your input is taken into account by Federal banking regulators?

Ms. TAYLOR. No, we have not had a seat at the table.

Chairman SHELBY. You have not been consulted, basically, have you.

Ms. TAYLOR. No. We have been briefed on what——

Chairman SHELBY. Briefed? There is a lot of difference between briefing and being consulted.

Ms. TAYLOR. Yes, sir.

Chairman SHELBY. So you have not really had any input into this process, have you?

Ms. TAYLOR. No.

Chairman SHELBY. Thank you.

For the entire panel, and, Governor Bies, I will start with you, and maybe you can answer it for everybody. Where are we in the process with respect to hitting the expected starting date of the Basel II parallel run in 2008? And would delay of implementing Basel II have any implications for the competitiveness of U.S. banks and on the safety and soundness of our banking system?

Ms. BIES. Well, obviously, it is hard to anticipate what all the comments are going to be around Basel II, and I think the real issue is going to be how close we are in the NPR to what the commenters would like us to end up with. If we hear major changes in the comments, it could create time pressures because we clearly have to get the final rule out for banks to have enough lead time to start and be ready for the parallel run in January of 2008. I think we really need to see what the comment letters are, but it is a very tight timetable that we are under right now.

In terms of internationally, that could create some transitional issues. But, again, the AIG recognizes that different countries are moving at different paces. Some countries actually are moving ahead of the mid-year agreement. So some are further along already than we are. So we have been anticipating the transition issues. Further differences in timing will make those last longer, and it could create some longer-term implications. But we already are dealing with timing issues, and I think the timing issues generally are a little bit easier to deal with than the permanent differences that may happen.

Chairman SHELBY. Up to this point, a lot of our discussion here today has entirely focused on the application of Basel II on domestic firms. Let's just switch the focus for a moment and ask whether Basel II's reduced capital requirements could hurt a foreign bank, foreign firm, and the collapse of that firm or bank could then have a ripple effect that ultimately hurts our bank or our banking system. You know, the reverse. It is always possible, is it not, that a large foreign bank under Basel II, which they have adopted, doing business in a big way in the U.S., if they got in trouble, it could have a ripple effect, could it not, Mr. Dugan?

Mr. DUGAN. Yes, but the whole point of Basel II is to get onto a common scheme and to have more harmony in terms of capital requirements. The effort is to avoid exactly that result.

Ms. BAIR. And I hate to be a Johnny One-Note, but this is one of the reasons why I think it is very important to get a debate going on an international leverage ratio, if we are seeing further reductions in risk-based capital, which is the only constraint for most Basel countries. We really need to get a debate going on leverage—another nice thing about the leverage ratio is that it is a constraint on leverage so it helps promote liquidity in the global banking system. So I think your question is very much responsive to the need for an international standard of leverage.

Chairman SHELBY. Governor Bies.

Ms. BIES. Let me just comment on how we deal with differences in the strength of supervision because we have this situation today. When a foreign bank has a legal entity in the United States, where any of us might be the primary supervisor, we require within that legal entity to hold the same kind of capital and controls that we would of any domestic bank.

The additional issue, though, is when foreign bank subsidiaries are part of a global group, they may be branches here or they may rely on different control systems from the global group that are not in the United States physically, and that is where it is so important that we work with foreign supervisors. The Federal Reserve as a holding company supervisor looks at the strength of foreign bank supervisor in what we call our SOSA ratings, and we take that into account, whether we can rely or not rely on the foreign supervisors and whether we give that foreign entity the ability to operate in the U.S. on a level playing field.

We have limited expansion or prohibited expansion by banks from certain countries where there has not been strength of their domestic supervision because of the contagion effect of something happening at their parent company.

Chairman SHELBY. Mr. Reich, do you have a comment?

Mr. REICH. Well, I would agree with Chairman Bair that your question highlights the importance of an international leverage ratio.

And speaking to another part of your question, I think that getting Basel II right is more important than deadlines that currently exist, and if the deadlines need to be adjusted, as one participant at this table, I am willing to adjust them.

Chairman SHELBY. Ms. Taylor.

Ms. TAYLOR. I think it is important to get it right the first time when it goes out because it is a lot harder to fix if it is wrong going down the road than it is to fix now.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Well, thank you very much, Mr. Chairman. I know you want to get to the next panel.

Chairman SHELBY. I think this first panel is important.

Senator SARBANES. It certainly is. But I am going to try to be very quick here.

First of all, I want to again quote what I said in my opening statement, quoting Bill Isaac. "This is by far the most important bank regulatory issue in front of us today. If we get this one wrong, our Nation and taxpayers will almost certainly pay a very big price down the line—a price that will make the S&L debacle seem like child's play."

I agree with that. I think this is a very large issue. I am deeply concerned how we got down this path without fully examining a lot of the implications and consequences. It is interesting to me that four large banks came in now and want to be able to choose the Standardized Approach, which would, of course, allow them to go into Europe without a problem, which is—or to be in Europe without a problem, although you have that one issue you say you need to pay attention to.

But the consequences here are very large. I mean, we talk about the effects on smaller banks and small business. Isaac, who is coming up on the next panel, says, and I quote him, "We have already experienced a great deal of consolidation in the U.S. banking industry, with the 25 largest banking companies now controlling some 70 percent of the Nation's banking assets. I am convinced that creating a large disparity in capital standards between the large and small banks will lead to increased consolidation, leaving fewer banking choices for smaller businesses. Further consolidation in banking is inevitable, but it ought to be driven by market forces, not by capital rules that favor larger banks."

And Tarullo, when he appeared here last year, said, and I quote him, "After seeing the risk weights that will be applied to residential mortgage and small business lending under Basel II, the 9,000 U.S. banks that will not be applying the advanced rules will become concerned that they will be disadvantaged in competing with the advanced banks in those lending markets."

Second, we have talked here—the Chairman I think focused on it early on, and I think it is a very important issue—about the data. I mean, models, no matter how sophisticated, are no better than the data that go into them. The proposed Basel II rules require that the banks have a minimum of 5 years of data, but we have not had a serious recession for most lending activities in 10 to 15 years.

And Bill Isaac, in our hearing last year, said, and I quote him again, "Basel II is based on inadequate and unreliable data. It is virtually impossible to build reliable models with such a paucity of information, particularly when the decade that the available data covers is the most prosperous in banking history."

I mean, talk about a leap into the unknown. In fact, I am told that banks are being told to put a recession into their data if it is not there already. Now, that is an interesting approach. You know, we are going to, in effect, create a scenario and try to plug it into the model to cover a recessionary situation.

Now, let me address this question of the international competition, that we would be at a competitive disadvantage. Isaac, in his testimony that is going to come, says, "It is argued that large banks from other countries will have a competitive advantage unless U.S. banks are allowed to use the advanced modeling approach. I do not buy that argument. The fact is that U.S. banks are by far the best capitalized, most profitable banks in the world. They do a great job of meeting the credit needs of business and individuals and are a major reason the U.S. has the strongest economy in the world."

He says, "Other countries should emulate the U.S. system, not the other way around. The U.S. should urge other countries to impose minimum capital standards on their banks, rather than enabling U.S. banks to lower their capital to unsafe levels." Which, of course, goes to this initiative.

Is it not the case that the U.S. already has a higher capital requirement than those abroad?

Ms. BAIR. Yes.

Senator SARBANES. Now, is it the view of any regulator at the table that these higher capital requirements have put U.S. banks at a serious competitive disadvantage?

Ms. BAIR. No.

Senator SARBANES. Well, then, what is it—I mean, we are constantly hearing this argument being advanced that we are at a competitive disadvantage, we have got to lower the capital standards.

We have got the profitability of major banks, percentage of total average assets. There is the U.S. pre-tax profits, first on the list. First on the list. We seem to have been able to have better, higher, more quality capital standards and still sustain profitability.

In fact, this Advanced Approach would require the banks to spend an inordinate amount of money to try to develop these models, would it not? Isn't it an expensive proposition to develop these models?

Mr. DUGAN. Yes, it is, Senator. I do not think any of us takes the position that there is a competitive disadvantage because of the higher capital that U.S. banks hold. I think the issue is which approach will produce a more safe and sound result for the particular bank.

Senator SARBANES. All right. Now, here is what Isaac says. I bet you are all sorry I read this statement ahead of this witness.

[Laughter.]

"Models are important to large banks in managing banks and pricing risks. They are a management tool, but are very poorly suited for use in setting regulatory capital standards."

Now, the banks develop these models in any event, to some extent, and would continue to do so, as I understand it.

Mr. DUGAN. Senator, that is not quite right. We regulators have the model, the banks provide the inputs to the model, and our model then computes the capital charge.

Senator SARBANES. Isaac says this: "Nearly every professional bank supervisor with whom I have spoken believes the Advanced Approach under Basel II is fundamentally flawed. Every major industry trade group has requested that the Standardized Approach be made available as an option." And they go on to talk about its complexity and that no one would understand it. You know, it lacks transparency and so forth and so on.

It seems to me that both of these witnesses on the next panel sort of say, well, look, there is a way to work ourselves out of this box we are in. You retain the leverage ratio. You try to get it adopted internationally, which would be a significant improvement in the capital situation worldwide with respect to the banking industry. You allow the Standardized Approach, which has more sophistication than where we are right now. But you do not get into all of the problems inherent in going to the Advanced Approach. Yet, as I understand it, some of our regulators are bound and determined that these major banks will go into the Advanced Approach with all of the problems that come along with that.

It seems to me—and I know you all took an initiative. Ms. Bies, you were in the forefront of that, I guess, and the Fed pushing down that path, and now it is, I would presume, awkward in dealing with your international partners to sort of come along and say, well, you know, wait a second, there are a lot of implications here and we need to come back and rethink this.

But it seems to me, given the concerns that are being raised—very reasoned, I think, and rational concerns—that we need to say, now, wait a minute here, let's re-examine this.

I do not want some leap into the dark. And I do not want to be told that, well, you know, we can hypothetically do these models and everything is going to be OK. We have been through some rough patches up here, and we need to—and at the moment, we have got high capital standards and we are highly profitable. That seems like a pretty good combination to me.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Before we move on to the next panel, I want to associate myself first with some of the remarks of Senator Sarbanes. While I recognize that the development of Basel II required a considerable amount of time and energy, I do not think the fact that such efforts have been undertaken in and of itself justifies moving forward. We should not adopt Basel II simply to adopt Basel II. We should adopt Basel II if it is sound public policy and improves the risk management of our financial institutions, and ultimately helps our economy.

This Committee is committed to continuing its oversight of the Basel II process and to making sure that any changes in our capital requirements are prudent and proper. However, the complex and technical nature of Basel II means that the responsibility for the final Basel II regulations falls distinctly on your agencies that you represent here today. And I think this is a matter of critical importance. In fact, I believe that I can say without overstating the significance of this issue, developing and successfully implemented new capital standards will be the single most important task that each of you will undertake during your tenures in your positions.

As you move forward, I would just like to remind you of the difficult lessons learned—and Senator Sarbanes talked about it; both of us have been on this Banking Committee a long time—when thousands of thinly capitalized banks collapsed during the 1980's and early 1990's. We were here. Therefore, before you do anything, be sure that what you are doing is right, that it is the right thing to do.

I want to thank you again for testifying before us, and you are going to furnish some of the information for the hearing record.

Senator Sarbanes, do you have anything else?

Senator SARBANES. No.

Chairman SHELBY. We will call up our next panel now: Mr. James Garnett, Head of Risk Architecture of the Citigroup on behalf of the American Bankers Association; Mr. Daniel Tarullo, Professor of Law at Georgetown University Law Center, and no stranger to this Committee; Ms. Kathleen Marinangel, Chairman, President, and CEO of McHenry Savings Bank on behalf of America's Community Bankers; and, of course, Mr. William Isaac, former Chairman of the Federal Deposit Insurance Corporation, and now Chairman of the Secura Group.

I want to thank all of you for appearing here today and for sitting through this protracted hearing.

All of your written testimonies will be made part of the record in their entirety.

Mr. Garnett, we will start with you, if you can briefly sum up this before we get a vote on the floor. Your entire written testimony, as I said earlier, will be made part of the record.

STATEMENT OF JAMES GARNETT, HEAD OF RISK ARCHITECTURE, CITIGROUP

Mr. GARNETT. Thank you, Sir. Chairman Shelby, Ranking Member Sarbanes and members of the Committee, my name is Jim Garnett. Thank you for the opportunity to testify today.

I am responsible for the implementation of Basel II for Citigroup. I am here today on behalf of the American Bankers' Association. The ABA has long supported capital reform and remains committed to the implementation of Basel II in the United States.

Unfortunately, the Basel II proposal published yesterday by the Federal banking agencies would place U.S. banks at a competitive disadvantage with foreign competitors and would impose significant compliance costs on U.S. banks.

These problems are due to differences between the proposed U.S. version of Basel II and the internationally approved Basel Accord. U.S. regulators have proposed provisions that reduces the risk sensitivity of Basel II and do not apply to foreign banks. These include, for example, longer transition floors, different definitions of default and special capital restrictions triggered by all Basel II banks in the aggregate.

These new features which apply only in the U.S. frustrate the goal of aligning risk and capital and thus fail to create appropriate incentives for risk-taking. Therefore, we recommend that the U.S. version of Basel II be harmonized with the international accord. Doing so would better align risk in capital. It would prevent foreign banks from gaining a competitive advantage over U.S. banks and it would reduce compliance costs for U.S. banks.

Moreover, to attain competitive balance within the American banking industry domestically, an appropriate update of capital rules is needed for all of the community and regional banks for which the more advanced elements of Basel II may not be appropriate. We also recommend that U.S. banks be given a choice of capital compliance options, giving all American banks, large and small, a choice of options has several benefits. Choices consistent with the international accord. Choice gives banks of all sizes access to simple and transparent methods for capital compliance. Choice assures a competitive domestic marketplace and choice reduces compliance costs.

The compliance options might include Basel I, Basel IA, the Standardized, and Advanced. The Standardized Approach in particular is transparent and cost effective. It ties capital charges to factors such as credit rating of the borrower and strength of collateral. The Standardized Approach is part of the international accord and, as such, would help to achieve the benefits of harmonization.

In summary, we urge the banking regulators to harmonize the U.S. version of the accord with the international accord and to give all U.S. banks, large and small, a choice of capital compliance options. Moreover, the agencies need to move quickly to revise general risk-based capital rules that will apply to banks not adopting the Basel II Advanced Approach.

Furthermore, all options need to be implemented at the same time. This way, the entire industry can be prepared to follow standards that are competitively comparable. We also hope the Committee can support these objectives as the rulemaking process moves forward.

Thank you very much.

Chairman SHELBY. Thank you.

Ms. Marinangel.

STATEMENT OF KATHLEEN E. MARINANGEL, CHAIRMAN, PRESIDENT, AND CEO, McHENRY SAVINGS BANK

Ms. MARINANGEL. Chairman Shelby, Ranking member Sarbanes, and members of the Committee, my name is Kathleen Marinangel. I appear today on behalf of America's Community Bankers, where I serve on the board of directors. I am also Chairman, President, and CEO of McHenry Savings Bank, a community bank in McHenry, Illinois. We are a $275 million community bank focused on retail customers and small business owners. We compete head-to-head with many large national and regional banks.

Let me thank the Committee for its substantial oversight of the Basel rulemaking process. Your interest has been instrumental in the progress made to ensure that the banking industry in general and community banks in particular will be able to offer competitive services to the communities in which they do business. We also appreciate the thoughtful modifications by the agencies to the initial proposals.

ACB, however, remains concerned about competitive and safety and soundness consequences that might arise from the rulemaking if it does not remain on track. First, Basel II should not be implemented until changes are made to Basel I to address the competitive needs of depository institutions not suited to the Basel II regime. Otherwise, we believe that Basel I banks would be left at a serious competitive disadvantage and would become possible acquisition targets for Basel II banks. We are pleased that the agencies will soon release a proposal on Basel IA intended to give these institutions the option to more closely align capital with risk.

Second, we believe that an optional Basel IA standard must be designed to permit the majority of banks to more accurately manage their risks and capital requirements. This should include more risk buckets and a breakdown of some assets into multiple buckets to take into consideration collateral values, loan to value rations, credit scores, and other risk factors. We would like to stress the importance of addressing every asset on a bank's balance sheet when finalizing the proposed formula for Basel IA.

The ANPR addresses some of the assets but not all. Some of the missing assets that need to be addressed are commercial real estate loans, bank land and buildings, prepaid assets, and correspondent bank deposits. Credit guarantees and other mitigation measures also should be incorporated into the framework. In short, the system must result in banks of all sizes having equivalent capital charges against equivalent risk whenever possible.

Third, we urge that capital standards be implemented in a manner that will not add significantly to regulatory burdens to ensure that smaller institutions who do not need complex risk management systems are not subjected to unnecessary regulatory burdens. We believe it essential to allow them to maintain the current Basel I capital regime as an option.

Fourth, flexibility is key to creating a successful new capital regime. This flexibility should include the option for Basel II banks to choose between the Standardized Approach and the Advanced Approach as contemplated in the international Basel II accord.

Fifth, we strongly support the regulators' intentions to leave a leverage requirement in place. A regulatory capital floor must be in place to mitigate the imprecision inherent in internal ratings-based systems. ACB suggests that the precise level, however, of the leverage requirement should be open for discussion.

Finally, as a community banker, I strongly believe that everyone would benefit if capital requirements better align capital with risk and if more risk-sensitive options were available. Advances in technology and the availability of more sophisticated software would make implementation of a new Basel IA relatively straightforward for many community banks. For my bank, there would be little burden and a lot of benefit to my institution and the community I serve. I need an effective Basel IA in order to compete.

I thank the Committee for its attention to these important issues and I will be pleased to answer any questions.

Chairman SHELBY. Mr. Isaac, welcome back to the Committee.

STATEMENT OF WILLIAM M. ISAAC, CHAIRMAN, SECURA GROUP, LLC

Mr. ISAAC. Thank you, Mr. Chairman, Senator Sarbanes. It is really a pleasure for me to be here. I know that you want to move on quickly, so, I will just try to summarize very briefly. Plus, I think some of my testimony has already been——

Chairman SHELBY. We have been quoting you all morning.

[Laughter.]

Senator SARBANES. Professor Tarullo ought to give us the benefit of your thinking here.

Mr. ISAAC. Let me try to be quick here.

First of all, I would commend the regulators for doing a lot of hard work for a long time on Basel II. Everybody is acting on good faith and trying to get the job done. And I am not here to criticize anybody. I do not like the result so far, as you know.

In particular, the advanced modeling approach to Basel II is just not going to work. I am very concerned with it on a variety of fronts.

Chairman SHELBY. Say that again.

Mr. ISAAC. The advanced modeling approach under Basel II——

Chairman SHELBY. Is not going to work.

Mr. ISAAC [continuing]. Is not going to work, in my opinion. There are a lot of problems with it. It is fundamentally flawed. If we are going to go forward with it as an option, I believe that, at a minimum, we must maintain the leverage ratio where it is. We must maintain prompt corrective action. And I believe we should maintain the percentage limitations on reductions in capital that the regulators have already put into the advanced notice.

If Basel has enough bells and whistles on it, I do not think it can do a lot of harm. What I really worry about is that 5 or 6 years from now, or 7 or 8 years from now, when there are new leaders in the regulatory agencies who are further removed from the 1980s, they will change those safeguards. And our system could get into a lot of difficulty. That is a real concern that I have.

I think that it makes all of the sense in the world to resolve our Basel II problems. Basel II has been stuck in a quagmire for the better part of a decade. I believe the regulations should allow the Standardized Approach.

There is a huge consensus behind the Standardized Approach. It is less expensive to implement and maintain. It does not purport to deliver more reliability than can be delivered, while the Advanced Approach conveys a false sense of security and reliability. The Standardized Approach is far less intrusive than the Advanced Approach and will allow the banks more flexibility to manage themselves and update their models and not have to seek permission from regulators to change their own models.

The Standardized Approach is much more transparent and much easier for all important users of the information to understand. That would include boards of directors, senior management, customers, investors, analysts, regulators, and the media. There are a lot of users of this information, and the Advanced Approach is not something that is user friendly.

The Standardized Approach will produce a smaller disparity in capital ratios between large and small banks. Moreover, it will allow Basel II banks in the U.S. to be treated in the same fashion as Basel II banks throughout the world because the Standardized Approach is available throughout the world.

If we were to allow the advanced modeling approach and the capital ratios of the large banks were to decline, that would lead to a competitive disparity between the large banks and the small banks. It would probably lead to faster consolidation of the industry, and more of it then we would otherwise experience. And I believe that, in the end, it could be very harmful to small businesses, because it would deny them more choices for their banking needs.

I do not buy the argument that foreign banks have an advantage over the U.S. banks. We have the most profitable banks and the strongest banks in the world. If we are concerned about a competitive disparity, I endorse wholeheartedly the notion that we ought to be trying to get the countries around the world to impose a leverage ratio on their banks, rather than allowing the capital ratios of our banks to decline.

Thank you, again, for having this hearing. It is a very important topic and I am pleased to be a part of the process of trying to deal with Basel II. Thank you.

Chairman SHELBY. Dr. Tarullo, we are glad to have you back here.

STATEMENT OF DANIEL TARULLO, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. TARULLO. Thank you, Mr. Chairman, Senator Sarbanes.

In preparing for this testimony as we gather again here today on this topic, and in listening to the first panel, I thought what I would try to do is to sum up where I think things have changed in the last 10 months.

Senator SARBANES. I think if you drew the mike closer, it would be helpful.

Mr. TARULLO. Is that OK, Senator?

Senator SARBANES. Yes, thank you.

Mr. TARULLO. First, as Bill Isaac just intimated, and I think as your questioning of the first panel suggests, the big questions about the advanced internal ratings-based approach that we identified 10 months ago have not been answered in the intervening time.

We do not know what impact it would have, ultimately, on capital levels. We do not know what impact it would have on the ability of supervisors to monitor banks adequately. We do not know what impact it would have on the ability of our supervisors to monitor how supervisors in other countries are implementing it. We do not know what the impact on the competitive situation of small and medium-sized banks will be. And we do not know whether the cost of compliance for large banks is worth it.

I do not know that everyone is prepared to jettison the advanced internal ratings-based approach conceptually, but I think most people have moved closer to that position. Most people, that is, except the regulators, who are trying, actually, to implement it.

Second, how have the regulators changed in the last 10 months? Well, here I think we have seen some positive movement. And I, for one, detected a difference in tone this morning from that which we heard 10 months ago. That reflects, I think, more experience perhaps. It is definitely reflected in the notice of proposed rulemaking, where the regulators as a group have strengthened the safeguards which they will impose-precisely because of all those unanswered questions. The regulators themselves identified in the NPR the uncertainty about the effects of the A–IRB approach of Basel II. They identified the concerns that they have as a result of the fourth quantitative impact study.

I think that was the proper response. There are serious questions about the methodology as a whole, but to the degree we are going to try to learn about it, we are not going to learn about it by driving at 60 miles an hour around a hairpin turn in deep fog without knowing where we are going to come out on the other side. So we should have some rules, some limits, and some brakes applied.

Third, where and how have the banks' positions changed? Well, this is perhaps the most interesting development. I am not surprised that banks are still concerned that they be able to have lower regulatory capital levels. That is what they are usually after. They will set their own capital as they think they need to in the marketplace but, in terms of regulatory capital, their interest is almost always in having it lower.

The interesting development, though, is the proposal of the four large banks to use the Standardized Approach. I think this reflects a recognition that, with the safeguards that are necessary in the A–IRB approach, it is not clear that they will get the big capital reductions that they had counted on based on the QIS studies. Having seen that, they have quite rationally said "Let us look at the other approach that is much less costly to implement, even though it is going to produce a much smaller decline in regulatory capital, and let us go that route." And, as Bill pointed out, there are a lot of ancillary benefits for other banks that may come along with the adoption of the Standardized Approach.

I would just make one further point. The object of Basel II, as with Basel I, was to create a common minimum approach to regulation, not a common maximum, a floor and not a ceiling. I do not think we want our regulators or our representatives in the Senate thinking that any time the regulators do anything different from what the Basel accord indicates that it is somehow inappropriate, that it somehow failed to harmonize properly.

We are supposed to be providing a safe and sound banking system in the United States. We are using the Basel accord as a tool to assure at least a minimum such system in other countries, and that is the way that we should think about it. If there are problems—and I endorse Chairman Bair's to move a leverage ratio forward internationally—if there are problems with implementation overseas of Basel II, if it is too lax, our representatives in the Basel Committee should point that out and should seek the kind of strengthening that will make the entire global financial system safer.

Thank you.

Chairman SHELBY. Mr. Isaac, I will start with you.

We have received testimony suggesting that, unless U.S. banks can hold as little capital as foreign banks, U.S. banks will be placed at a competitive disadvantage versus their foreign competitor. Could you please discuss the relationship between the amount of capital a bank holds and its profitability?

U.S. banks are presently very well capitalized and very profitable. Does this suggest that strong capital requirements do not adversely affect the competitiveness of banks?

Mr. ISAAC. I believe that strong capital requirements are actually an asset. I think it is one of the great strengths of our banking system in this country.

For one thing, it makes pricing in the banking industry more sane. If you have to earn a certain amount of return on your capital and if you are required to have more capital, you are going to price your products accordingly and you are not going to take undue risks. And I believe that during the 1980s, when our banks and thrifts did not really have enough capital, they were willing to take a lot of risks because they did not have that much at stake.

Today, our banks are much saner about pricing their risks and what risks they take than they were in the 1970s and the 1980s. So, I think that having capital is a competitive advantage and it also makes our banks much more attractive partners for people around the world who need financing.

Chairman SHELBY. Mr. Garnett, in your testimony you state that the changes that banking regulators have made in the Basel II NPR mean that banks will, quote—I am quoting you—realize few, if any, of the benefits that were anticipated at the inauguration of the Basel II exercise, end quote.

Could you explain the types of benefits that banks expected to attain from Basel II but are now unlikely to realize? And if these benefits include capital reductions, how large must the capital reductions be for Basel II to be most effective for banks?

Mr. GARNETT. I think it is——

Chairman SHELBY. What did they expect in the beginning?

Mr. GARNETT. The objectives of the Basel II accord were very straightforward and simple and certainly the U.S. banks, certainly the large banks, supported those objectives. Very simply, those——

Chairman SHELBY. What were those objectives?

Mr. GARNETT. Very simply those objectives were consistency of capital regimes globally, useability, in other words, let's use as much of the internal systems as we can or develop capital requirements that, in fact, were useable to better manage risk internally. And aligning capital with risk was the primary impetus of why we are probably here today talking about Basel II. That was the primary objective.

We support all of those objectives to this day.

Chairman SHELBY. What are your concerns now?

Mr. GARNETT. Let me also make one other point regarding the issue——

Chairman SHELBY. Sure.

Mr. GARNETT [continuing]. Of our expectations of lower capital. I do not think there were any expectations whatsoever at the outset of Basel II. I think there was a lot of time spent, 6 or 7 years, with regulators trying to get the measurements to be useful and consistent and aligned with risk.

There has been a lot of talk about the decline in capital that was discovered in the QIS–4, and rightly so. We believe very strongly in a safe and sound banking system. I would caution interpreting the QIS results to the extent that perhaps conclusions have been drawn today.

First of all, that QIS study was performed in probably the most benign period, most favorably period in quite some time. When you have a risk-based capital process where risk is aligned with capital, when you are taking on less risk, as you would be, intuitively, in a very benign period, you would expect some decline in capital.

To conclude that the declines that we saw and the magnitude of the dispersions that we say in the QIS–4 would have resulted if the entirety of the Basel II process had been completed. In other words, were these models validated? Was there substance behind the data? Was there adequate stress testing to ensure that there was capital in place in the event of a weak downturn? None of these other supervisory and management practices that are employed, not only with the regulators, but internally in the banks, were ever employed.

So, we kind of did a quick look. I certainly think that the bank systems at the time were probably not in the greatest shape. A lot of work has been done since then, but, more importantly, we did not let the supervisory process play a role there.

Chairman SHELBY. Do you believe that banks are presently overcapitalized?

Mr. GARNETT. I do not know how to pick the magic number.

Chairman SHELBY. Sure.

Mr. GARNETT. We have decided that the current regime and the amount of minimum capital that is formulated from that regime, which, as I have said, we think is probably pretty broken. We are using that as a benchmark.

I, unfortunately, cannot give you a better benchmark. I will tell you that, when it comes to the capital planning process, regardless of whether or not minimum capital will go down or go up—and by the way, under the Advanced Approach, I think if you look at what happens to the Advanced Approach minimum capital during a period of just moderate economic weakness, not to mention a severe weakness, in fact, the amount of capital is higher than what it would have been under Basel I. And there have been some very interesting studies that we can certainly share with you to demonstrate that conclusion.

Capital management takes the form of a number of different factors.

Chairman SHELBY. It does.

Mr. GARNETT. Certainly, minimum capital is something that is an extremely important part of that process, but so is making sure that the amount of capital that banks hold today can provide the appropriate amount of cushion in the event of a downturn or in the event that balance sheets or risks could not be moderated or mitigated is also an important part of that process.

Chairman SHELBY. You know, I have been on this Committee a long time. I do not know, myself, of any bank that has been well capitalized and well managed and has ever gotten in trouble. Mr. Isaac might have a different view because of his background, but if you are well capitalized and well managed, you are pretty sound, aren't you?

Mr. ISAAC. Generally speaking, that is right.

Chairman SHELBY. Mr. Garnett, would you support an international leverage ratio as a way to address some of your concerns about the competitive problems raised by retaining the leverage ratio under Basel II?

Mr. GARNETT. Mr. Chairman, the concept of an international leverage ratio is something that, quite frankly, we heard very, very recently.

Since I am here today——

Chairman SHELBY. Would you explore it and talk to us about it?

Mr. GARNETT. I have not had the opportunity to talk with the members.

Chairman SHELBY. Sure.

Mr. GARNETT. It is very clear by statements that have been made by your Committee, as well as the regulators that were here about half an hour ago that the leverage ratio is probably not going anywhere soon, even though it is a difference in regimes, if you would.

So, if you will give us a little bit of time to learn more about that concept——

Chairman SHELBY. Yes. Let you learn more about it——

Mr. GARNETT [continuing]. I am sure that we would be more than happy——

Chairman SHELBY. Absolutely.

Mr. GARNETT [continuing]. To respond to your question.

Chairman SHELBY. Professor Tarullo, are the floors banking regulators have put in place on the amount capital can fall during transition periods and after implementation of Basel II sufficient to reduce the risk of proceeding with Basel II?

Do you want me to say that again?

Mr. TARULLO. Mr. Chairman, I, as you can tell, have serious doubts about the whole AIR–B approach.

Chairman SHELBY. Sure.

Mr. TARULLO. My preference would be that over time we not implement the A–IRB approach at all.

Having said that, it is part of Basel II. I agree with Mr. Garnett on the need for choice for the banks that are confronted with this new regime. Therefore, I think the regulators have done a reasonable job of putting in place—retaining, really—one safeguard, which is reflected in congressional legislation, the leverage ratio. And second, they have put in place two other kinds of safeguards, one bank specific, and the other applying to all AIR–B banks.

Might I have calibrated it a bit differently? Perhaps. But the regulators have a tough job and I think those proposals are reasonable.

Chairman SHELBY. Ms. Marinangel.

Ms. MARINANGEL. Marinangel.

Yes.

Chairman SHELBY. In your testimony, you support maintaining the leverage ratio as part of Basel II as a way to mitigate the imprecision inherent in a ratings-based capital requirement system. Would you explain why a ratings-based system is, quote, imprecise, and would you explain how maintaining the leverage ratio will help level the playing fields for community banks when they compete against banks that have Basel II, if that happens?

Ms. MARINANGEL. Any system, any internal ratings-based system is, of course, only as precise as the data that you put into the system. And, as you know, any software program that you design for risk management includes subjective input. Therefore, there would be imprecision.

The leverage ratio, I think, is important to maintain. I do not know if the current level is the right level but I think it does add stability. I would like to comment a little bit, as well, about the reduction in the required level of capital held when you risk weight assets. From a community bank's point of view, and from my point of view, even before Basel II was being introduced, I guess I was very frustrated about the fact that the capital held for the assets did not truly reflect the risk.

So, for many years I was working on trying to modify Basel I through the regulatory agencies and through the national trade groups. I actually have run the Basel IA model myself in my shop and there also is a reduction in the required capital level. And that is because some of the assets are, you know, a 90 percent loan-to-value mortgage is weighted the same as a 20 percent loan-to-value mortgage and that does not make any sense.

So, I am not too concerned about the drop in the level of capital required when you risk weight the assets. I guess from my point of view, in my small community and doing the small business loans, it would be helpful to have a reduction in the capital held for risk-based assets. It would allow me to make more small business loans, and, for example, a small business loan to a person who has a lot of collateral backing it, let's say a guarantor that has a high net worth, would allow me to risk weight that loan lower in a lower bucket and hold less capital. Let's say that you might even weight that commercial small business loan at 50 percent. It would allow me then to make more business loans in my community. And it is critical.

So, I really am not as concerned—and we have talked a lot about Basel II, but it so important to talk about Basel IA for the 9,000 community banks that will work this. And it can be Basel IA, it could be the Standardized Approach, but if I cannot risk weight those assets properly, then I am held back from making more loans.

Also in my town, just for your information, I have 28 banks in my town of 24,000. I have many national banks, Citibank, J.P. Chase Morgan. I also have foreign banks in my town, Harris, La-Salle, Bank of Scotland. So, I have to be able to compete. I can make more loans if I can risk weight my assets.

Chairman SHELBY. But if you can compete on a level playing field, you can——

Ms. MARINANGEL. Absolutely. I need to. Yes. I need to be able to.

So, I am not as upset or concerned about the lowering of the capital when you risk weight even Basel II Advanced A–IRB Approach or in a Basel IA that allows me to risk weight. You will have a drop because these assets are not being reflected properly. So, I am not as concerned about it as everybody else, as long as all of us can truly reflect the assets so I can serve my community.

Chairman SHELBY. Are a lot of your customers small businesses, startup companies, and everything?

Ms. MARINANGEL. Well, we have some startup, but we also have some pretty established customers. We do a lot of consumer lending. We do indirect financing for auto and RV and boat dealers. So, my goal had been to diversify assets so that I can reprice——

Chairman SHELBY. Sure.

Ms. MARINANGEL [continuing]. After the savings and loan—and I had been a State-chartered savings and loan, but now I am a savings bank charter.

You know, we had to be able to diversify assets for repriceability. So, a lot of the commercial mortgages and real estate loans adjust with prime, and consumer loans, a third reprice annually. So, yes, we are very diversified and we feel we can compete as long as we have a level playing field.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

I want to address these models that are being posited under Basel II. First of all, I understand the Basel II require that banks have a minimum of 5 years of data; is that correct?

Mr. GARNETT. I am sorry, were you addressing that to me, Sir? Yes, that is——

Senator SARBANES. Yes, well, I think I should go to the bankers first.

Mr. GARNETT. Yes, Sir. That is correct.

Senator SARBANES. OK.

Now, I am concerned about how confident we can be that banks have enough historical data in their internal risk-based models to provide accurate evaluation of risks. How many years of data do most banks have for building their models?

I guess I should go to you again, Mr. Garnett, because you, essentially, I guess, speaking for the banks that were engaged in the process of building the models.

Mr. GARNETT. Yes, Sir. I do not think that there is a single number I could give you. I could probably give you a range. There are banks that have as many as 30 years worth of data, other banks that may not have that much.

Senator SARBANES. Are you giving away a propriety secret if I ask you how many years of data does Citi have in its model?

Mr. GARNETT. I would prefer not to have to answer that question, if you do not mind, Sir.

Senator SARBANES. I am told that the banks were told to put recession into their data, since we do not really have a recession over the last 15 years. So, if your bank's data does not run for a period longer than 15 years, it is not factoring in a recession; is that right?

Mr. GARNETT. That could very well be the case. I am not familiar with the term, building a recession into the data. What I am familiar with, and it is a very important part of Basel II, is Pillar 2 requirements with regard to stress testing. It is clearly very important to make sure that the capital levels that are required in both good and bad times is achievable. And by looking at stress tests, it is a very important way of making sure that there is a capital planning process if we happen to be doing this exercise in a good time, to make sure that there is a flexibility and a capacity for that organization individually to meet minimum capital requirements in the even of a downturn.

Now, that could take the shape of various activities on the balance sheet. It is not just a capital, necessarily, action plan. But stress testing is an extremely important part of Basel II. And it gets at the point that--I agree 100 percent with you. You cannot simply assume that if we are operating with data that has been, you know, in very good times, that that will necessarily be the best predictor of what happens tomorrow. That is why Pillar 2 and Basel II are extremely important.

Senator SARBANES. Well, let me ask you and Ms. Marinangel. Were you taken aback by the results of the fourth QIS, which showed these very substantial reductions in capital for some of the major banks? Did you expect that the models would produce that kind of result?

Mr. GARNETT. Well, because——

Senator SARBANES. Let me preface that by underscoring the concern here because the regulators, from the very outset, in presenting their efforts on Basel II, and we have been following it for quite a while, but at the very outset said that this was not going to lead to any significant reduction of capital in the banking system. We were repeatedly told that.

Ms. MARINANGEL. If I could answer first on this.

I was not taken aback by that because I believe that, as I said before, assets are not risk weighted properly. I am also not as concerned. I feel that.

Senator SARBANES. Well, let me just interrupt you right there on the weighting of the assets and evaluating the risk.

As I understand it, the regulators now are considering issuing guidance to the banks with respect to commercial real estate. They are concerned about the developments in commercial real estate and therefore may provide some guidance and caution and so forth.

Yet, under the Basel II advanced proposal, the commercial real estate basket, or however you want to call it, had a 30 percent drop in capital. Now, how do you square that? Here we are, if we had gone with Basel II this particular category had a 30 percent drop, and yet the regulators right now are about to issue, as I understand it, guidance to the banking industry.

Ms. MARINANGEL. I think I, as Mr. Garnett said, historically, we have had a very healthy industry.

Senator SARBANES. All right. Let us do that. You have a healthy industry. You come along and you do Basel II and the market deteriorates. Now, presumably the deterioration in the industry will occur more quickly than the adjustment in the Basel II standards. What do you do in that situation?

I mean, things are going bad, you have less capital because you did these evaluations, and then, all of a sudden, you are out there on the end of the plank. What do you do about that situation?

Mr. GARNETT. Again, I think the pillar 2 comments that I made just a minute ago address that concern. And that concern, Senator, is a very, very valid concern and should not be overlooked in any way.

If you are using models that are picking up 5 years, 10 years, whatever many, 8 years, you are using, and you go into an economic downturn, it will take a while for those models to catch up and recognize the severity of the current situation. That is a known, I would not call it a weakness, but just an inherent part of the model. That is why the Pillar 2 supervisory oversight is so important.

And as banks are now implementing internationally the Pillar 2 oversight process, the stress testing, the rigorous validation and back testing that have to go along before you are even approved to use the Advanced Approach is a definite part of the accord that needs to be there. And again, I think that we need to be careful that we are not making assumptions too quickly about just Pillar 1 results when it comes to the total picture.

Senator SARBANES. Mr. Isaac, Mr. Tarullo, why don't we hear from the two of you on this point?

Mr. ISAAC. Which point, how far back the models go——

Senator SARBANES. Well, that, and also, if the model gives you a lower capital requirement and then the situation goes badly, it seems to me you are caught in a very difficult situation. How do you rectify that situation? If you put the pressure on the institution and raise its capital standards because things are going bad, of course they are, conceivably, are in a difficult situation as it is. So, they are confronted with an even more difficult problem.

Mr. ISAAC. I have talked to a lot of Basel II banks—not all of them but a lot of them—and I do not know any bank that has data that goes back more than 10 years and most of them do not go back 10 years.

For one thing, the banks do not even look today like they looked 10 years ago because there have been so many mergers and so many systems that have been crammed together. So, I do not believe the data will go back as much as 10 years in most of these banks.

Senator SARBANES. Do you differ with that, Mr. Garnett?

Mr. GARNETT. I think there are probably exceptions to what Mr. Isaac suggests.

Mr. ISAAC. And I allow that there may be exceptions.

Senator SARBANES. But that is the rule, I take it. What he said is basically the rule.

Mr. GARNETT. Unfortunately, I know more about my own institution, and we agreed that we would not share that data publicly here, but I do what every other banking institution does. So, I apologize for not being more precise.

Senator SARBANES. All right.

Mr. ISAAC. I think the four banks have just made a huge contribution to the Basel II process by suggesting the Standardized Approach be made available in the U.S. because it is the way out of the quagmire we are in. My basic problem with the Advanced Approach is that I do not believe any models should be relied on so extensively. You should not place all of your faith in them. We have got to have absolute floors below which nobody can go.

There was a lot of talk until about a year ago that Basel II was going to supplant the leverage ratio. I heard speeches made by regulators saying that.

Senator SARBANES. Oh, yes.

Mr. ISAAC. That would have been a terrible mistake, in my judgment. Look, for example, at long-term capital management. It was run by world famous economists and mathematicians who believed they had the perfect models. I am sure we could all come up with example after example where models just cannot predict everything.

So, my main concern is that we not place too much faith in models. They are not foolproof. We have to make sure that they are not so complex that nobody can understand them. I want boards of directors of banks, managements of banks, analysts, investors, the Congress, and the regulators to be able to understand how the models are working. I think pretty much everyone can get a handle on the Standardized Approach.

Whatever we use, we have got to put floors under it. If the rest of the world wants to have lower floors, or no floors, then so be it. We need to be focused on making sure that our banks are the best banks in the world. They are right now, and I do not want to see us do anything to change that dynamic.

Senator SARBANES. Professor Tarullo.

Mr. TARULLO. Senator, I think your last question raises the issue of what a minimum capital rule is supposed to do. And what I think a capital rule should do is, first, to provide, as Bill just said, a floor, a genuine floor. But second, it has got to be a floor that has meaning, that is stable, and that gives a signal fairly quickly.

If you have got lags before the model takes things into account, the model is not going to be providing the supervisor with the warning signal that some intervention needs to be made in the bank. So I think that the virtue of the leverage ratio in the United States under the prompt corrective action system that the Congress instituted about 15 years ago has been—notwithstanding its simplicity and, frankly, its bluntness—that it does serve as a clear and very difficult to manipulate floor, which, when a bank drops below it, sets off alarm bells here in Washington and tells supervisors that intervention is necessary.

The other point that I think we should reiterate—I think it has been lost a bit—I certainly do not have the view that the leverage ratio is the only tool for supervision that a regulator should use. To the contrary, I think that Mr. Dugan's stated aim last year and this year of making sure that he can get his arms around the risks that a bank is actually assuming is a very important aim. And models, internal credit risk models, are an important tool that the banks use to figure out what is going on in their institution and that regulators can use to figure out what is going on in that institution. That is not the same thing as saying that they should be used to set minimum capital standards.

Mr. ISAAC. I want to particularly endorse the last statement. I agree with everything Professor Tarullo said, but that last statement is very important. The models have a good use; it is just not for setting minimum capital standards.

Mr. TARULLO. And Senator, one other thing—I really do not want our banks to have to spend a lot of money on a duplicative process that they do not find particularly useful for internal risk purposes and that is not a particularly good standard for the regulators to use, either. That is why I think Bill and I both—to some degree—endorse the banks' approach with the standardized option.

Senator SARBANES. I might note that I spared Ms. Bies' today her quote, in which she said that the purpose of this exercise—that eventually they would get rid of the minimum capital leverage ratio. But you know I am greatly influenced by evaluating proposals by, sort of where you say, well, I know where you are coming from. That has been one of the difficulties here, particularly with the Feds——

Mr. Garnett, I just wanted to put a couple—I am just curious. What prompted you and the other three banks to take this public position?

I gather in the end, you ended up meeting, going to OMB—you were the only one who went, as I understand it. Of course that ran the risk of bringing down on you the ire of the regulator. So, it was not, sort of a, it seems to me, sort of a run of the mill decision. So, what was it that prompted you to do that?

Mr. GARNETT. I think it was said very clearly this morning. If we are setting the rules for how risk will be priced globally through the Basel II or other versions of it, whether it is Basel I or Basel IA, I think it is extremely important to get it right.

We need to get it right for safety and soundness reasons. We need to get it right for competitive reasons. We are not dismissive of the differences that exist in the NPR versus the international text. We are very supportive of floors during a transition period. We would just like the floors to be consistent with those floors that are put there for safeguards by the international community.

The importance of getting it right led us to believe that we needed to make sure that the OMB was—we shared our thoughts with that agency as we are permitted to do and probably are expected to do.

With regard to introducing the Standardized Approach, there were two reasons for that. First of all, we realized that we had a domestic issue on our hands. If we were going to permit 12 to 20 banks to use a risk-sensitive, capital aligned with risk approach and have the rest of the community banks, or small banks, or even fairly large banks on a Basel I non-risk-sensitive approach.

Senator SARBANES. Well, it would be everybody else——

Mr. GARNETT. Everybody else——

Senator SARBANES [continuing]. Except the 12 to 20 banks, right?

Mr. GARNETT. Correct.

We realized, and perhaps—we being, probably, predominantly the largest banks, we realized a little bit late that that competitive domestic disadvantage was being created.

So, one of the reasons that we introduced options, and they could go well beyond Standardized, and Basel IA is another example of an option that could be a very viable approach for banks in this country. We have yet to see what it really looks like.

So, that was reason No. 1. Reason No. 2 was that we saw in the NPR revisions that, in our view, were going to cost the industry an enormous amount of money, millions of dollars, to have to adjust to, particularly the internationally active banks, where we are, as we speak, implementing Basel II practically everywhere but here.

So, if we are forced, based on revisions from the international accord, to spend more money on data, different calculations, on systems—that did not seem to be a good use of our money.

Senator SARBANES. Are you implementing it internationally according to the Standardized Approach which is available, as I understand it?

Mr. GARNETT. I am going to make it less personal. There are banks, U.S. banks, international U.S. banks, implementing Standardized and Advanced via the international accord overseas.

Senator SARBANES. OK, thank you Mr. Chairman.

Chairman SHELBY. Thank you.

Professor Tarullo and former Chairman Isaac, Chairman Bernanke stated to this Committee this past summer that he had reservations about the appropriateness of the Standardized Approach to large global banks because it did not, in his opinion, adequately address the types of risk they assume. Do you agree with this view? And, if so, why should large banks be allowed to adopt a capital requirements regime that does not fit their business?

Mr. ISAAC. I am not sure what Chairman Bernanke had in mind and so I cannot really address his remarks. I believe that models are a very important management tool in identifying, pricing, and managing risk in a large, complex institution.

I believe that the regulators, to the extent that large banks are not focused on modeling their risks, and I think they all are, but to the extent that they are not, the regulators ought to be pushing them.

But we are not talking about that here. We are talking about what tool should the regulators use to regulate capital, to put floors on capital in the system. I believe that the Standardized Approach is vastly superior to the advanced modeling approach. All we are doing when we go to the advanced modeling approach is forcing the large banks to run two systems. They are going to have to run their own system and they are going to run the regulatory system, or they are going to run one system that they cannot change unless and until the regulators say they can. And so I think we are just heaping expense on top of expense and I believe the Standardized Approach is superior by a long shot.

Chairman SHELBY. Professor.

Mr. TARULLO. Mr. Chairman, on the first point, is the Standardized Approach sufficient to regulate large, complex banking institutions? Absolutely not, for the reasons that we have stated previously.

But you always have to look at what your viable alternatives are. And with all the questions about the advanced internal ratings-based approach, some of which I detailed earlier, I think it is an enormous heroic leap of faith by anyone to say that it currently constitutes a viable alternative. Policy-making is always a choice among your viable alternatives, not among some idealized view that you hope you can realize.

Chairman SHELBY. We better know where this road leads, had we now, Mr. Isaac?

Mr. ISAAC. I agree.

Chairman SHELBY. And I do not think we know today where this road will take us to in the financial service industry.

Thank you for your testimony. Thank you for your participation in this issue. You can tell that we still have a lot of concerns on this issue. The Committee is adjourned.

[Whereupon, at 12:47 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

For Release Upon Delivery
10:00 a.m., September 26, 2006

TESTIMONY OF

JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

of the

UNITED STATES SENATE

September 26, 2006

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 Shelby, Senator Sarbanes, and members of the Committee, I appreciate this opportunity to discuss the U.S. agencies' proposals to update and enhance our regulatory capital program. The agencies have developed two distinct proposals to better tailor a bank's capital rules to the complexity of its risks. For our largest banks, the fundamental thrust of our efforts is the U.S. implementation of the Basel II Framework – a more risk-sensitive regulatory capital system better suited to the complex operations and activities of these institutions. For banks not adopting Basel II, the primary goal of our so-called Basel IA initiative is to increase the risk sensitivity of our risk-based capital rules without unduly increasing regulatory burden.

These efforts are intended to ensure that bank risk management practices and regulatory capital requirements are commensurate with the current and emerging risks facing the banking industry. I view this goal as one of my highest supervisory priorities and critical to the maintenance of the long-term safety and soundness of our banking system. While the U.S. banking industry continues to operate profitably, supervisors must ensure that bank risk management systems and regulatory capital rules appropriately address current and emerging safety and soundness challenges.

The agencies have and will continue to foster an open process as we move forward with these proposals to consider comments from all interested persons, heed good suggestions, and address legitimate concerns. In this way, we can ensure that we make prudent, well reasoned, and well understood changes to bank capital requirements and to related supervisory policies.

BASEL II

The 1988 Basel Accord, also referred to as Basel I, established a framework for risk-based capital adequacy standards that has now been adopted by most banking authorities around the world. The U.S. agencies have applied rules based on the 1988 Basel Accord to all U.S. insured depository institutions. Although Basel I was instrumental in raising capital levels across the industry in the United States and worldwide, it became increasingly evident through the 1990s that there were growing weaknesses in Basel I. In particular, the relatively simple framework has become increasingly incompatible with the increased scope and complexity of the banking activities of our largest banking institutions. The crude risk-weighting mechanisms of Basel I bear little resemblance to the complex risk profiles and risk management strategies that larger banks are capable of pursuing. The misspecification of risk under Basel I creates inappropriate incentives and arbitrage opportunities that can undermine supervisory objectives. And dealing with outdated and mismatched regulatory requirements is costly to banks.

In response to these issues, the Basel Committee commenced an effort to move toward a more risk-sensitive capital regime, culminating in the publication of the Basel II Framework. As the OCC has noted in earlier hearings, we firmly support the objectives of the Basel Committee and believe that the advanced approaches of the Basel II Framework – the advanced internal ratings-based approach (IRB) for credit risk and the advanced measurement approaches (AMA) for operational risk – constitute a sound conceptual basis for the development of a new regulatory capital regime for large internationally active banks.

Yesterday, the agencies published in the *Federal Register* a notice of proposed rulemaking (NPR) regarding the implementation of Basel II in the United States. While a draft of the Basel II NPR had already been made publicly available, yesterday's publication marks the start of the official 120-day public comment period, which will run through January 23.

This proposal reflects a consensus by all U.S. agencies that implementation of the Basel II Framework should move forward to the next stage in the process. In that context, the agencies agree on two fundamental points: first, supervisors must ensure that regulatory capital rules appropriately address existing and emerging risks, and second, the current, simplistic Basel I framework no longer does that for our more complex banks.

Indeed, the inadequacies of the current framework are especially pronounced with respect to larger U.S. banks, which we know well, because the OCC is the primary federal supervisor for the five largest. These institutions, some of which hold more than $1 trillion in assets, have complex balance sheets, take complex risks, and have complex risk management needs that are fundamentally different than those faced by community and mid-sized banks. For that reason, the agencies developed the Basel II NPR, which is itself complex, but which would be required to apply to only a dozen of our largest and most internationally active U.S. banks.

The purpose of Basel II implementation in the United States is not only to align capital requirements much more closely to the complex risks inherent in these largest institutions, which the proposal attempts to do. At least as important – and this is a total departure from the existing capital framework – the proposal would also require our largest banks to substantially improve their risk management systems, control structures, risk information systems, and related public disclosures. These enhancements would be accomplished using a common framework and a common language across banks that would allow regulators to better quantify aggregate risk exposures, make more informed supervisory decisions, and make peer comparisons in ways that we cannot today. If successful, such improvements would establish a more rigorous relationship among risk, risk management, and capital in our supervisory structure and measurably strengthen our safety and soundness regime for our largest banks. In addition, the enhanced public disclosure required under Basel II would better inform the market about a bank's risk exposures and provide a consistent and understandable disclosure framework that would enhance comparability and facilitate market discipline.

As has been widely reported, we have received several comments on an earlier draft version of this NPR. Certain of those commenters requested that we amend the NPR to permit Basel II banks the option of using simpler approaches in the calculation of capital requirements for credit risk and operational risk. To ensure that all interested parties have the opportunity to comment on this fundamentally important issue, the agencies added a question to the Basel II NPR's preamble addressing this issue. As I mentioned earlier, one of the primary goals of the agencies in developing these proposals is – as much as possible – to tailor a bank's capital rules to the complexity of its risks. Thus, the advanced approaches of the Basel II NPR are targeted to large, complex banks. By the same token, the simpler Basel II approaches, as well as the forthcoming Basel IA proposal, have been developed with an eye towards less complex banks with more traditional risk profiles and activities. In this regard, we are very interested in comments on the appropriateness of permitting simpler alternatives to the advanced approaches for our largest, most complex banks, especially as it relates to safety and soundness and competitive equity concerns. I believe this is a legitimate question, given that the largest banks in other Basel II countries have the option of simpler alternatives to the advanced approaches. On the other hand, as the agencies note in the preamble to the NPR, virtually all non-US banks comparable in size and complexity to our core banks appear to be adopting the advanced approaches, though not with the changes that we propose in the NPR. I hope commenters will take all these factors into account when responding to the question.

The agencies have also received comments from U.S. banks expressing concerns about what they believe is the excessive conservatism of the NPR. Many of the specific provisions of the NPR cited by the banks relate to safeguards put in place by the agencies after an assessment of the results of our last quantitative impact study, discussed below, including the enhancement of the NPR's transition period to strictly limit potential reductions in capital requirements through capital floors and other devices.

In previous Congressional testimony, in Basel Committee deliberations, and in discussions with the industry and other supervisors, the OCC has repeatedly emphasized that reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective manner, consistent with safety and soundness and the continued competitive strength of the U.S. banking system. In furtherance of those standards, the U.S. agencies conducted Quantitative Impact Study 4 (QIS-4) in late 2004 and early 2005.

It is well known that QIS-4 helped us identify significant issues about Basel II implementation that have not been fully resolved. The QIS-4 submissions evidenced both a material reduction in the aggregate minimum required capital for the QIS-4 participant population and a significant dispersion of results across institutions and portfolio types. One measure produced by QIS-4 is the estimated change in "effective minimum required capital," which represents the change in capital components, excluding reserves, required to meet the eight percent minimum total risk-based ratio. This measure is independent of the level of capital actually held by institutions and of their currently measured capital ratios. After application of a scaling factor as proposed in the NPR, the decrease in effective minimum required capital compared to existing standards was 11.7 percent, with a median decrease of 22.6 percent, aggregating over the QIS-4 participants. Additional QIS-4 analyses also confirmed that the dispersion in results – with respect to individual parameter estimates, portfolios, and institutions – was much wider than we anticipated. In particular, the agencies' additional analysis revealed a wide dispersion of results between institutions with respect to individual credit exposures and selected portfolios, even when controlling for differences in risk.

In short, the QIS-4 results and the inevitable questions they raise have been the source of serious concern for the banking agencies. There is consensus among the agencies that, if these were indeed the results that would be produced by a final Basel II rule, that would be unacceptable. Having said that, there were very significant limitations to QIS-4, and as a result, it would be a mistake to assume that the magnitude of the reduction and dispersion in capital requirements that were estimated would hold true with a fully implemented Basel II rule. In particular, because the regulators had not yet specified all the requirements for a complete Basel II regime, QIS-4 could not be designed to take into account such requirements. Even more important, the integrity of the final capital requirements produced by a "live" Basel II system will be affected fundamentally by the scrutiny that examiners will apply to the inputs that banks will provide to produce the final capital requirements. With a final rule, final supervisory guidance, and rigorous examiner scrutiny, we believe the magnitude of capital reductions and dispersion revealed by QIS 4 is likely to be mitigated.

Nevertheless, that outcome is not assured, and as a result, the process for implementing Basel II as established in the NPR is designed to provide the OCC and other agencies a complete understanding of the Framework's implications for the banking system without risking unacceptable capital reductions. Specifically, the Basel II NPR includes several key elements that allow for the progress we believe is necessary, over time, for risk management and supervisory purposes, while strictly limiting reductions in risk-based capital requirements that might otherwise result from systems that have not been proven.

The first element is a one-year delay in initial implementation, relative to the timeline specified by the Basel II Framework. As a result, the "parallel run," which is the pre-qualification period during which a bank operates IRB and AMA systems but does not derive its regulatory capital requirements from them, will be in 2008. The parallel run period, which will last at least four quarters but could be longer for individual institutions, will provide the basis for the OCC's initial qualification determination for national banks to use Basel II for regulatory risk-based capital purposes. Following initial qualification, a minimum three-year transition period would apply during which reductions in each bank's risk-based capital would be limited. These limits would be implemented through floors on risk-based capital that will be simpler in design and more conservative in effect than those set forth in Basel II. For banks that plan to implement the Basel II Framework at the earliest allowable date in the United States, we are proposing the following timetable and transitional arrangements:

Year	Transitional Arrangements
2008	Parallel Run
2009	95% floor
2010	90% floor
2011	85% floor

The OCC will assess national banks' readiness to operate under Basel II-based capital rules consistent with the schedule above and will make decisions on a bank-by-bank basis about termination of the floors after 2011.

We will also retain the Prompt Corrective Action (PCA) and leverage capital requirements in the proposed domestic implementation of Basel II. For more than a decade those provisions have complemented our basic risk-based capital rules, and U.S institutions have thrived while building and maintaining strong capital levels – both risk-based and leverage. This capital cushion has proved effective, not only in absorbing losses, but also in allowing banks to take prudent risks to innovate and grow.

While we intend to be true to the timelines above, we also expect to make further revisions to U.S. Basel II-based rules if necessary during the transition period (*i.e.*, before the system-wide floors terminate in 2011) on the basis of observing and scrutinizing actual systems in operation during that period. That will allow us to evaluate the effectiveness of the Basel II-based rules on the basis of real implementation and to make appropriate changes or corrections while the prudential transition safeguards are still in effect. In other words, we will have strict safeguards in place to prevent unacceptable capital declines during the transition period, and if we believe that the rule would produce such declines in the absence of these safeguards, then we will have to fix the rule. Of course, any future revisions will also be subject to the full notice and comment process, and we expect to look to that process where necessary to help resolve difficult issues.

Much has been said recently about the differences between our implementation of Basel II's advanced approaches in the United States and that of other countries. While optimistic about the bank risk management and risk information systems improvements, enhanced controls, additional public disclosures and other benefits resulting from Basel II implementation, we certainly recognize that we are approaching Basel II with greater caution than some jurisdictions, and I would like to reiterate our reasons for doing so. First, despite their promise, Basel II advanced systems are as yet untested. We are not so much concerned about whether these systems will ultimately succeed – we believe they will – as we are with understanding what additional refinements may be necessary to ensure that success.

Second, the U.S. rulemaking process gives us advantages that are not shared by all supervisors. We are fortunate to be able to assess potential effects and identify potential concerns *before* finalizing a rule for implementation. In contrast, QIS-5 was conducted in Europe *after* the European Parliament finalized its implementation of Basel II into law, leaving European supervisors with very little ability, at least in the near term, to make changes. I cannot predict whether, in the near term, that might result in declines in capital requirements for European banks unavailable to U.S. banks under the Basel II NPR as proposed. If it does, however, I can assure you I would rather be in the position we are in here. And if it occurs, it would be neither unprecedented nor necessarily detrimental to our banks. Almost since its adoption, U.S. Basel I-based rules have been accompanied by additional, complementary safeguards not replicated in other jurisdictions. For example, in addition to our unique PCA framework, we amended our Basel I-based rules to address the risks of certain securitization transactions long before most of the rest of the world (some of which will address securitizations for the first time with Basel II implementation), and yet our banks continue to be world leaders in securitization markets. U.S. banks have long operated with both higher capital *and* higher profitability than most of their peers around the world. Strong capital is by no means antithetical to either innovation or high profitability.

Having said all of this – especially the need for caution during the transition period – there may well be parts of the proposal that are overly conservative. The notice and comment process will undoubtedly result in a complete discussion by commenters of provisions that raise such concerns. I will carefully consider such comments, and to the extent they are valid, I believe we should make changes to the rule before it becomes final.

The OCC has been a frequent critic of many elements of the Basel II Framework, and we have worked hard to make important changes to the proposal that we thought made sense. But it is also true that, at critical points in the process, the OCC has supported moving forward towards implementation. Our reason for doing so is simple – an appropriate Basel II regime assists both banks and supervisors in addressing the increasingly complex risks faced by our largest institutions. While we may not have all the details of the proposals right yet, and we will surely make changes as a result of the public comment process, I fully support the objectives of the Basel II NPR. I want to see these proposals work because I am convinced that, if they do, they will strengthen the safety and soundness of the banking system.

BASEL IA

The complex Basel II NPR is neither necessary nor appropriate for the vast majority of U.S. banks. Many of these institutions need meaningful but simpler improvements in their risk-based capital rules to more closely align capital with risk. The OCC's primary objective in developing the Basel IA proposals is to create a domestic risk-based capital rule with greater risk sensitivity, but without unduly increasing complexity or burden. That is no small challenge, and we recognize that there will be limits in the level of risk sensitivity that we can achieve in a relatively noncomplex rule designed for broad applicability to a vast array of credit exposures.

Nonetheless, we believe there are areas in which our current rules can be significantly improved without requiring massive investments in new systems and controls. In that respect, it is important to note that, unlike Basel II, the Basel IA proposals are not intended, in and of themselves, to dramatically improve risk management. Rather, they represent an effort to design a simple but better measure of minimum regulatory capital requirements. Likewise, the results of Basel IA are not intended to replicate Basel II results – but by moving risk measurements in the right direction, we do expect to narrow some of the potential gaps between Basel IA and Basel II results.

The agencies remain committed to issuing the Basel IA NPR in the near future. We believe that overlapping comment periods for these two rulemakings is a critical element of our on-going effort to assess the potential competitive effects of both sets of proposals on the U.S. banking industry.

Thank you very much.

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

THE INTERAGENCY PROPOSAL REGARDING
THE BASEL CAPITAL ACCORD

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

10:00 A.M.
September 26, 2006
Room 538, Dirksen Senate Office Building

Chairman Shelby, Senator Sarbanes and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning the Basel II international capital accord.

The Importance of Capital

The U.S. banking system is a network of institutions that are highly leveraged and whose financial health bears directly on the health of our broader economy. Significant problems or a lack of financial flexibility at many small banks, or at one or more large systemically important banks, can have contagion effects that impose significant costs on the deposit insurance funds and the overall economy. The special role of banks in our economy creates a federal interest in their sound operation and the adequacy of their capital.

Economic theory describes an important rationale for bank capital regulation. The theory asserts that banks may tend to hold less capital than is optimal for prudential purposes. When calculating economic capital needs, banks do not consider the substantial costs that their potential failure would impose on other parts of the economy. In addition, a bank's depositors and creditors benefit from explicit and perceived safety-net protections. This benefit lowers the premium banks must pay for deposits and other forms of debt. The result is a greater proportion of debt and a lower proportion of capital in banks' overall funding mix than would exist in the absence of federal safety net support.

In the United States, we have a dual system of bank capital regulation. Banks' Tier 1 capital, the high-quality capital that is most critical in absorbing losses, is required to exceed defined percentages of balance sheet assets. This leverage ratio requirement provides a baseline of capital for safety-and-soundness purposes. However, the leverage ratio does not address all risks. For example, it does not address the risks of off-balance sheet positions. Risk-based capital requirements provide a second measurement of capital to capture risks that are not addressed by the leverage ratio.

The purpose of the Basel II process is to improve the current risk-based capital requirements. In designing and implementing these improvements, it is important to recognize both the inherent limitations on the ability to precisely measure bank risk, and the fundamental fact that supervisors' and banks' objectives in the capital regulation process are not always the same. Thus, the more reliance the risk-based capital regulation places on banks' internal risk estimates, the more important is the hard-and-fast capital baseline provided by the leverage ratio. As discussed later in this testimony, the critical importance of the leverage ratio in the context of the Advanced Approaches of Basel II is an issue that is worthy of discussion in the international arena, as well.

Basel II

As you know, Basel II is an international effort by financial institution supervisors with the laudable goal of creating standards for capital requirements that are more risk-sensitive and promote a disciplined approach to risk management at this country's largest banks. Basel II also is intended to address concerns that the regulatory arbitrage opportunities available under Basel I threaten the adequacy of the regulatory capital buffer needed to ensure financial system stability. U.S. bank regulators also are developing a more risk sensitive capital framework known as Basel IA for non-Basel II banks.

Basel II includes several options for banks to calculate their risk-based capital requirements. Basel II's Advanced Approaches allow banks to determine their risk-based capital requirements by using their own estimates of key risk parameters as inputs to formulas developed by the Basel Committee. The Advanced Approaches also contain an operational risk capital requirement that is based on each bank's own estimates and models of its potential operational losses. The key risk parameters used to determine capital requirements for credit risk and operational risk in the Advanced Approaches are subject to supervisory review. The principal issues with respect to the Advanced Approaches revolve around how banks will set their risk inputs and the formulas that translate these inputs into capital requirements. The Advanced Approaches to Basel II include significant expectations for banks to have high quality risk management systems and have stimulated banks' efforts in this area.

Basel II also provides for a Standardized Approach to calculate risk-based capital requirements. The Standardized Approach includes a greater array of risk weights than the current rules, an expanded set of options for recognizing the benefits of collateral and other credit risk mitigants, and new options for computing exposures to derivatives. In addition, the Standardized Approach includes new capital requirements for certain exposures not captured by the current rules, such as short-term loan commitments and the potential for early amortization of revolving credit securitizations. The Standardized Approach also includes a capital charge for operational risk.

The FDIC Board of Directors voted to publish the Basel II Notice of Proposed Rulemaking (NPR) for public comment on September 5, 2006. As the U.S. banking and thrift agencies proceed with the deliberative process for implementing Basel II, it is important that the new capital framework does not produce unintended consequences, such as significant reductions in overall capital levels or the creation of substantial new competitive inequities between certain categories of insured depository institutions. In this regard, there clearly remain several outstanding issues with the proposed rule.

The first of these issues is the impact of the new framework on minimum capital requirements. One of the important premises on the part of financial supervisors for moving forward with Basel II was an expectation that it would not cause a substantial reduction in minimum capital requirements. The agencies concluded, however, that without additional safeguards, implementing the Advanced Approach formulas could produce unacceptably large reductions in risk-based capital requirements.

For example, half of the banks surveyed in the U.S. Quantitative Impact Study (QIS-4) reported that the Basel II formulas would reduce their minimum Tier 1 capital requirements by more than 31 percent, with a dollar weighted average reduction of 22 percent. Almost all of the banks participating in the QIS-4 reported Tier 1 capital requirements that, if implemented, would not be permissible under the current U.S. leverage ratio requirements.

The large reductions in capital requirements reported in the QIS-4 probably do not reflect the full impact of the Basel II proposals. Among other things, the QIS-4 results do not incorporate the effect of important changes in the Basel II methodology for computing exposures to derivatives and other counterparty credit risks. These new methodologies will likely reduce capital requirements for these exposures in a way that was not reflected in the QIS-4. On the other hand, the QIS-4 does not reflect the impact of the 1.06 conversion factor produced by the so-called "Madrid" compromise that would partially offset the reduction in capital requirements that would otherwise be expected under the Advanced Approaches.

Another issue of concern is a lack of an objective process within the Advanced Approaches for producing similar capital requirements for similar risks. The QIS-4 showed that similar risks received very different capital requirements across the participating banks. The framework allows banks substantial flexibility in how they develop risk inputs. It remains unclear how to reconcile the twin goals of individual bank flexibility within the Advanced Approaches and regulatory consistency across banks.

These basic concerns about substantial reductions in capital requirements and lack of consistency under the Advanced Approaches create an additional concern about unintended competitive effects. Implementing the formulas in the Basel II Advanced Approaches without additional limitations could create a substantial difference in risk-based capital requirements between large and small banks. With the exception of credit card lending, banks using the Advanced Approaches likely will have substantially lower risk-based capital requirements than other banks, even with the changes to the current risk-based capital rules for other domestic banks under consideration as part of the Basel IA rulemaking (discussed in more detail later in the testimony). Given the wide variation in capital requirements for the same risks that is possible under the Advanced Approaches, unintended competitive effects also may develop among banks using the Advanced Approaches whose internal methodologies reflect differing degrees of conservatism.

Concerns with the Advanced Approaches, with respect to undue reductions in capital requirements and inconsistent requirements, are not unique to the FDIC. All U.S. bank and thrift supervisors viewed the QIS-4 results as unacceptable and agreed to include substantial safeguards within the Basel II NPR to address those concerns. These include: the retention of the leverage ratio; an additional transition year; a more conservative set of transitional capital floors during those transition years that would apply at the individual bank level; and an aggregate 10 percent downward limit on reductions in risk-based capital requirements that would trigger regulatory changes if exceeded.

The next step in the process is a public comment period following yesterday's publication in the *Federal Register* of the Basel II NPR, along with an NPR on changes to the market risk regulations (Market Risk NPR). In addition, the agencies published two notices in the *Federal Register* that propose certain sets of regulatory reporting templates (referred to as reporting requirements in the NPRs) that insured depository institutions and holding companies will use to report key aspects of their capital calculations under the Basel II and Market Risk NPRs, respectively, on a quarterly basis. The Market Risk NPR will propose to update the agencies' market risk regulations to address strategies banks employ to use their trading books to lower capital requirements in ways that were not originally intended. The regulatory reporting templates will provide for public disclosure of the basic elements of each bank's risk-based capital calculation. A more extensive set of confidential supervisory reports will be shared among the regulators and used for benchmarking, trend analysis and quality assurance purposes. The data also will be used to evaluate the quantitative impact of these rules and their competitive implications on an industry-wide and institution specific basis, and to supplement the on-site examination process. The industry and the public are being asked to provide substantial comment on all aspects of these proposals.

As the members of this Committee are aware, the federal bank and thrift agencies have received a number of letters in recent months requesting that U.S. core banks (large and internationally active institutions that are required to implement the Advanced Approaches of Basel II) and other banks be given the option of using the Standardized Approach to capital regulation that is part of the international Basel II Accord.

The letters question whether any bank should be required by regulation to adopt the Advanced Approaches of Basel II and whether an alternative framework should be available in the U.S. Of the Basel Committee countries, the U.S. is the only country proposing regulatory requirements that would make the Advanced Approaches mandatory for certain banks. Supervisors in some Basel Committee countries have informally made clear their expectations for their largest banks to use the Advanced Approaches. Supervisors in other Basel Committee countries have indicated they have no such expectation and that the choice among the capital frameworks offered in the Basel II Accord is entirely the decision of the banks.

If the Advanced Approaches are not mandatory, an important question is what capital rules will be used in their place? The current risk-based capital rules as supplemented by the future Basel IA framework will contain some of the elements of the Standardized Approach with a few important differences. For example, there will be specific differences in risk weights between the Basel Standardized Approach and the proposed Basel IA framework. In addition, Basel IA will not include an operational risk capital charge. Finally, the Standardized Approach allows qualifying banks to use some of the same new methodologies for computing capital requirements for derivatives and other counterparty credit risks that are available to banks using the Advanced Approaches.

One argument in favor of allowing core banks to use some version of the Standardized Approach instead of the Advanced Approaches is that such an approach would be a simpler and less costly way to improve the risk sensitivity of existing capital regulations. Also, the Standardized Approach does not pose the same potential for a large reduction in capital requirements and consequently would not pose the same potential for significant competitive inequities. On the other hand, some argue that excusing core banks from the requirement to adopt the Advanced Approaches would have a deleterious effect on the evolution of the core banks' risk management practices over the long term.

In short, a fundamental issue is whether the core banks should be permitted alternative approaches provided by the Basel II Accord. The Basel II NPR seeks comment on this important question and public input will be valuable in evaluating this issue.

The federal banking agencies also will issue the Basel IA NPR in the relatively near term covering changes in the capital regulations for non-core domestic banks. Basel IA is expected to be a more risk-sensitive capital framework than the current risk-based capital rules and may appeal to some community banks. However, many, if not most, community banks are content to operate under the current risk-based requirements and do not wish to be subject to Basel IA. This is another area where public and industry comment will be valuable. The Basel IA NPR also will solicit comment on whether these rules should be available to all U.S. banks, and whether additional elements of the Basel II Standardized Approach should be incorporated into the U.S. rules for Basel IA.

Over the long term, there may be a need to think creatively about other ways to move forward. Most of the prescriptive elements of the Advanced Approaches can be attributed to the regulators' realization that, without clear standards, the Advanced Approaches could have problematic safety-and-soundness implications. Banks, on the other hand, chafe at the prescriptive elements and want to be able to use their internal models to set regulatory capital.

As capital requirements continue to evolve, it is critical to preserve the strengths that exist today. As mentioned earlier in my testimony, the U.S. has a dual framework of capital regulation: a leverage ratio, which is a simple ratio of capital to balance sheet assets, and the more complex risk-based requirements. The risk-based and leverage components of capital regulation work well together. The leverage requirement provides a baseline level of capital to protect the safety net, while the risk-based requirement can capture additional risks that are not covered by the leverage framework.

The Basel Committee acknowledged that other measures of capital adequacy might be appropriate, stating in the New Accord "that national authorities may use a supplementary capital measure as a way to address, for example, the potential uncertainties in the accuracy of the measure of risk exposure inherent in any capital rule or to constrain the extent to which an organization can fund itself with debt."

I believe that further consideration of other measures of capital adequacy, such as the leverage ratio, should be initiated by the Basel Committee, which would provide a broader perspective on this important issue. The establishment of an international leverage ratio would go far in strengthening the soundness and stability of the international banking system. Such an agreement also would help to ensure that differences in capital requirements do not lead to competitive inequality among internationally active banks. These objectives are consistent with the Basel Committee's fundamental purposes for revising the 1988 Basel Accord.

In addition to maintaining a simple baseline measure of solvency, the leverage ratio provides U.S. supervisors with a great deal of comfort that banks will maintain a stable base of capital in good times and in bad times. The U.S. banking system will not be subject to the same degree of volatility in capital requirements that other countries will likely experience once they adopt the Advanced Approaches.

Another favorable aspect of a simple capital-to-assets measure is that it limits balance sheet growth to manageable levels and serves as a powerful check against excessive leverage, which has been a longstanding concern of supervisors across the world. A more highly capitalized banking system provides investors with greater comfort and provides banks with greater access to the capital markets for liquidity and funding. The U.S. banking system has flourished under this dual capital framework as banks continue to generate record profits and provide investors with healthy returns on equity.

A recent paper written by economists at the Swiss National Bank (although not necessarily representing the position of the central bank) hits squarely upon issues that confront the international supervisory community in the move toward approaches based on models for determining capital adequacy. In that paper, the authors advance the view that ". . . it is essential that optimal risk-sensitive capital requirements be complemented by a capital floor that does not depend on the riskiness of banks' activities. By setting a floor to banks' absolute (unweighted) capital ratio, a limit can be set to the consequences arising out of the shortcomings of a risk-weighted capital requirement scheme."[1]

The paper even took issue with one of the often mentioned shortcomings of the leverage ratio—that its crude approach to measuring capital adequacy invites regulatory arbitrage. In their paper, the authors note that "the incentive to take advantage of regulatory arbitrage opportunities and to incur excessive risks will be strongest at low levels of capital." The paper also notes that, "the consequences of underestimating the riskiness of banks are particularly damaging when the capital base is low." This is a sobering message, and one that I believe is deserving of further discussion among international banking supervisors as we continue to grapple with the issues associated with adopting models-based capital regulations.

[1] Robert Bichsel and Jurg Blum, "Capital regulation of banks: Where do we stand and where are we going?" *Swiss National Bank Quarterly Bulletin* (April 2005).

Conclusion

In conclusion, it is important that we improve the current risk-based capital rules without significantly reducing capital requirements. I will support implementing the Advanced Approaches only if I can develop a comfort level that this fundamental expectation will be achieved. In addition, the Basel Committee should consider an international leverage ratio as a way of ensuring a baseline of capital for safety-and-soundness. I will review the NPR comments with an open mind, and this includes considering the possibility of allowing a U.S. version of the Standardized Approach as an alternative for implementation of Basel II in the United States. I look forward to working with my fellow regulators to achieve a consensus on an outcome that is in the public interest.

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Statement of

Susan Schmidt Bies

Member

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

September 26, 2006

Chairman Shelby, Senator Sarbanes, and members of the Committee, I thank you for the opportunity to discuss recent developments relating to bank regulatory capital requirements in the United States, including the U.S. implementation of Basel II and updates to regulatory capital rules for market risk.

As Committee members may know, in the past three weeks there have been some very positive developments in the process to revise regulatory capital requirements for large, internationally active U.S. banking institutions. First, the board of the Federal Deposit Insurance Corporation on September 5th approved the Basel II notice of proposed rulemaking (NPR). At the same time, the FDIC board approved an NPR that would update the U.S. regul[illegible] capital rules for market risk exposures. The Office of the Comptroller of the Currency and the Office of Thrift Supervision took similar actions on the same day. Together with the Federal Reserve's approval of the draft Basel II NPR in March and the market risk NPR in August, these steps completed all necessary approvals for the two NPRs. Then just yesterday, the two NPRs were published in the *Federal Register,* initiating the process for formal public comment. Proposed templates for regulatory reporting requirements associated with the two NPRs were also published for comment yesterday in the *Federal Register*.

The market risk NPR is based on a set of revisions developed jointly by the Basel Committee and the International Organization of Securities Commissions (IOSCO) in 2005 to update the Market Risk Amendment (MRA) developed a decade ago by the Basel Committee. The revised market risk rule would apply to any banking organization that has significant trading book activity, whether it stays on Basel I or moves to Basel II in the United States. The market risk NPR is intended to improve the risk sensitivity of the market risk capital framework and to reduce the incidence of arbitrage between the banking book and the trading book. Further, the

NPR will serve to level the playing field between U.S. banking organizations and securities firms that are subject to similar capital requirements.

Moving to the main focus of today's hearing, the Basel II framework represents an important effort by bank supervisors to integrate modern risk-management practices with regulatory capital requirements. We are pleased that the four federal banking agencies have reached consensus to move ahead with the process for Basel II implementation. We recognize the significance of this development to the industry, the Congress, and others who have waited for greater specificity about U.S. efforts to implement Basel II. It has taken quite a bit of work to reach this point. I would like to thank my colleagues here at this table and their staffs, as well as the Fed's own staff, for their tireless efforts.

Overview of Proposed Rulemakings

The Basel II NPR is designed to improve the risk sensitivity of U.S. bank regulatory capital requirements and to enhance the risk-measurement and -management practices of large, internationally active U.S. banking organizations. The NPR is based on the 2004 capital adequacy framework released by the Basel Committee on Banking Supervision. That framework contains the now-familiar "three pillars" of regulatory capital requirements for credit and operational risk (Pillar 1), supervisory review (Pillar 2) and public disclosure (Pillar 3). As you are aware, the agencies propose to adopt all three pillars in the United States. Pillar 1 of Basel II provides banks with three options for computing credit risk capital requirements and three options for computing operational risk capital requirements. In Pillar 1 as proposed by the Basel II NPR, however, only the advanced internal ratings-based approach (A-IRB) for credit risk and the advanced measurement approaches (AMA) for operational risk would be available, and the framework as a whole would be required only for the largest, most complex, internationally active U.S. institutions.

The A-IRB approach for credit risk in the Basel II NPR requires institutions to estimate key risk parameters for each type of credit exposure, subject to supervisory review, and to calculate a capital requirement by using those risk parameters as inputs to supervisory formulas. The AMA approach for operational risk requires institutions to calculate a capital requirement based on their individual operational risk profile--again, subject to supervisory review. The Basel II NPR also specifies, as part of Pillar 2, that each institution must develop a rigorous internal process for assessing its overall capital adequacy in relation to its total risk profile through the economic cycle. These internal assessments will enable each institution to determine the appropriate level of capital for its unique long-term business strategy. These Pillar 2 internal capital assessments are, we believe, critically important, and are also subject to supervisory review. Finally, institutions must publicly disclose key information relating to credit and operational risks, under Pillar 3, to ensure adequate transparency for market participants, customers, and counterparties, so that market discipline can also work effectively to differentiate risk exposures among banking organizations. I would like to stress that the Basel II framework has three Pillars and note that Pillars 2 and 3 are critical components of the overall framework. They should not be overlooked.

As I noted, proposed reporting requirements for institutions planning to adopt Basel II and the updated market risk rules in the United States were also recently published in the *Federal Register*. Each institution that qualifies for and applies the Basel II capital rules and the updated market risk rules would file quarterly regulatory data, some of which would remain confidential, for the agencies' use in assessing and monitoring the levels and components of each reporting entity's risk-based capital requirements and the adequacy of the entity's capital. These data also would support the agencies' efforts to analyze the quantitative impact and competitive implications of the Basel II capital rules and the updated market risk rules on individual reporting entities and on an industrywide basis. In addition, the reporting schedules will help clarify for these entities our expectations surrounding the systems and other infrastructure necessary for implementation and validation of the two proposals. The submitted data would supplement on-site examination processes, and the data released publicly would provide other interested parties with information about banks' risk profiles and capital adequacy.

Importance of the Regulatory Capital Proposals

While our reasons for moving to Basel II have not changed since we began this endeavor, I believe they are worth reiterating. Our core reason is that the current Basel I framework is inadequate for the largest, most complex U.S. banking organizations. The current Basel I capital requirements simply are not able to capture the full array of risks facing these organizations. For example, they do not explicitly recognize the operational risk embedded in many of the services from which the largest institutions generate a good portion of their revenues today.

Further, Basel I does not differentiate the riskiness of assets within the major asset types based on either borrower creditworthiness or the presence of collateral or other risk mitigants. This lack of sophistication can lead to significant distortions and capital arbitrage. The capital required for each exposure should reflect the credit risk of that particular exposure. As banks consciously choose to take higher risk exposures, Basel II requires them to hold additional capital to reflect their business choice. Basel I capital is fixed throughout economic and business credit cycles, and as such, does not require banks to increase capital as their potential for losses rises. Basel II addresses this by including in Pillar 2 the requirement that the bank have a plan in place to ensure that sufficient capital will be available in the downturn of the economic cycle. Thus, for the largest organizations, we need to move beyond Basel I to a more risk-sensitive and more comprehensive framework for assessing capital adequacy. Basel II represents the concerted efforts of the international and U.S. supervisory community, in consultation with banks and other stakeholders, to develop such a framework, drawing upon well-known economic capital concepts that the largest banks already employ as part of their risk management efforts.

In addition to its supervisory authority, the Federal Reserve, as the nation's central bank, has responsibility for maintaining stable financial markets and ensuring a strong financial system. That responsibility mandates that we require banking organizations to operate in a safe and sound manner with adequate capital that appropriately supports the risks they take. This is especially critical in today's environment where we have a growing number of banking institutions with more than $1 trillion in assets, complex balance sheets, opaque off-balance sheet transactions, and far-reaching operations that pose significant risk-management challenges that are fundamentally different from those faced by smaller institutions. Naturally, we must also ensure that our regulations and supervisory oversight are in tune with bank practice, are able to identify the risks being taken by banks today, and have enough flexibility that they will continue to be prudent and relevant in an ever-changing risk environment. As Chairman Bernanke has noted, a regulatory and supervisory system that is not in tune with the financial marketplace may increase the costs of regulation, stifle efficiency and innovation, and ultimately be less effective in mitigating the moral hazard problems associated with the federal safety net.

The advanced approaches of Basel II are much more risk sensitive, cover more areas of potential risk facing banking organizations, and provide better incentives for institutions to improve risk measurement and management. In addition, Basel II provides supervisors with a more conceptually consistent and more transparent framework for evaluating systemic risk in the banking system, particularly through credit cycles. In sum, Basel II will establish a more coherent relationship between regulatory measures of capital adequacy and day-to-day supervision of banks, enabling examiners to better evaluate whether banks are holding prudent levels of capital given their risk profiles.

Continuing the Implementation Process

The agencies' proposed rulemakings, representing our view about how Basel II should be implemented in the United States, have now been published in the *Federal Register* for review by the industry, the Congress, and the general public. The core goal of Basel II, as noted earlier, is to promote the stability of the U.S. financial system by ensuring the safety and soundness of U.S. banks. As Chairman Bernanke has said, the ability of Basel II to promote safety and soundness is the first criterion on which the proposed Basel II framework should be judged. The agencies have presented proposals and will now engage in a continuing dialogue with all interested parties as to whether those proposals meet our stated objectives and how they can be improved.

During the entire process to develop our proposed rulemakings, the agencies have been engaged in a dialogue with the industry, the Congress, and others about both the general direction that U.S. Basel II implementation should take and specific implementation details. Many of the comments received to date have been incorporated into our proposals. In that respect, we have been carefully considering comments received so far and discussing among ourselves how to address them. In addition, we have conducted extensive analysis of other information we have collected, such as the results of quantitative impact studies (QIS), and those results have helped shape the proposals as well. In making adjustments to our proposals based on comments and new information, we have been as transparent as possible. Going forward, we will seriously consider all comments on the proposals. For example, the proposals contain a number of specific questions soliciting comments in key areas. With these questions, the agencies are trying to highlight areas on which we would like additional information. The agencies will continue to carefully consider all comments received and thoroughly analyze all relevant information as we work to develop a final rule for Basel II.

The agencies' Basel II proposals contain certain transitional safeguards beyond what is contained in the 2004 Basel Committee framework. Indeed, these proposed safeguards reflect our intent to ensure that there are no material weaknesses in our proposals prior to full operation. In the coming years, we will continue to monitor institutions' progress toward satisfaction of the Basel II risk-measurement and -management infrastructure standards. In addition, our proposals contain a parallel-run period of at least one year in which we will have the ability to analyze and directly compare capital requirements under existing rules and those produced by Basel II while institutions remain subject to the current rules. Beyond the parallel run, the agencies have proposed a three-year transitional floor period, more stringent than that in the 2004 Basel II framework, to prevent an unwarranted decline in capital levels. In addition, current supervisory safeguards, such as the existing leverage ratio and prompt corrective action, will continue to provide an important backstop against a potential unwarranted decline in bank capital levels. In general, if we at the Federal Reserve see that the U.S. Basel II proposals are not working as intended, we will seek modifications to them.

Providing Alternative Approaches

I also want to acknowledge that the agencies have received comments from several banks and other parties suggesting that banks should have more choices with regard to both credit and operational risk in the U.S. implementation of Basel II. We have taken these suggestions seriously, and the NPR now includes a specific question on whether the U.S. version of Basel II should include a so-called "standardized" approach.

As you may know, in many other countries *all* banking organizations are required to adopt Basel II because Basel I will be dropped when Basel II takes effect. Since Basel II will then apply to a wide variety of banking organizations, the 2004 framework provides for alternative approaches.

The possibility of introducing a standardized option for credit risk, similar to that set forth in the original Basel II 2004 framework raises some difficult public policy issues, which I hope will be addressed by commenters. Foremost is whether such a standardized option is sufficiently risk-sensitive for the largest, most complex, internationally active U.S. banking organizations and whether related disclosures would contribute to better market discipline.

While it is true that large international banks in the other G-10 countries theoretically have a choice among the various Basel II credit risk and operational risk approaches, in practice it appears these banks will be adopting the more risk-sensitive advanced approaches. Indeed, the Basel Committee's report on the results of the fifth Quantitative Impact Study (QIS-5) shows that although the Basel II standardized approaches are available in the G-10 countries other than the United States, no large internationally active bank in those countries has indicated that it plans to adopt the standardized credit risk approach. All fifty-six of the large, non-U.S. banks in the sample said they are most likely to adopt the internal-ratings based approaches for credit risk.[1]

A second public policy issue is how to address the potential for cherry-picking that could accompany a standardized option for credit risk. A number of banks have suggested that their ideal Basel II capital rule would allow them to mix and match elements of both the standardized and advanced approaches--perhaps the standardized approach for wholesale and retail credits, the AMA for operational risk, and the expected positive exposure approach for derivatives and securities financing transactions. Allowing such customization or cherry-picking, where a bank is allowed to select a different approach for each portfolio in order to minimize its aggregate capital requirement, could materially weaken the regulatory capital framework for U.S. banks and, along with it, the effectiveness of prompt corrective action policies. Clearly, there is a natural tension between the private interests of banks in maximizing shareholder profits, on the one hand, and the public interest in protecting the federal safety net and promoting bank safety and soundness, on the other hand.

Lastly, some have suggested that perhaps Basel IA could serve as a standardized approach for our core Basel II banks. Unfortunately, the agencies have been designing Basel IA with the very different risk profiles and economic resources of our smaller banks in mind, and in particular to address competitive concerns between smaller banks and the Basel II banks. We hope that comments on the Basel IA NPR will give us guidance in this area also.

In sum, the Federal Reserve believes strongly that very careful consideration will need to be given to the possible design and implementation of any standardized approach for Basel II in the United States should the agencies decide ultimately to move in that direction. We look

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[1] See Basel Committee on Banking Supervision, "Results of the Fifth Quantitative Impact Study (QIS5)," Table 3, The Bank for International Settlements.

forward to getting more detailed comments on how a standardized approach might fit into the U.S. Basel II framework.

Proposals to Amend Existing Basel I Rules

At this point, I would like to say just a few words about ongoing efforts to revise the existing Basel I regulatory capital rules for non-Basel II institutions. We expect only one or two dozen institutions to move to the U.S. version of Basel II in the near term, meaning that the vast majority of U.S. institutions will continue to operate under Basel I-based rules, which we intend to amend through a separate rulemaking process. The U.S. Basel I framework has already been amended more than twenty-five times since its introduction in response to changes in banking products and the financial services marketplace. The agencies believe that now is another appropriate time to propose modifications to our Basel I rules. The agencies have issued an advance notice of proposed rulemaking (ANPR) discussing possible changes to increase the risk sensitivity of the U.S. Basel I rules and to mitigate competitive distortions that might be created by introducing Basel II. We have reviewed comments on the ANPR and are working on a notice of proposed rulemaking. We are mindful that amendments to the Basel I rules should not be too complex or too burdensome for the large number of small- and mid-sized institutions to which the revised rules might apply. Indeed, a number of those commenting on the ANPR advocated leaving existing rules unchanged.

With regard to both the Basel II proposals and the proposed Basel I amendments, we understand the need for full transparency. For that reason, we expect to have overlapping comment periods for the Basel II NPR and the NPR for the proposed Basel I amendments. In fact, we want all interested parties to compare, contrast, and comment on the two proposals in overlapping timeframes. Accordingly, either of our proposals could change as a result of comments received or new information gathered.

Conclusion

From the Federal Reserve's perspective, the publication of interagency proposals relating to Basel II is a very positive development and demonstrates the ability of the agencies to work cooperatively to modernize our regulatory capital framework. The Federal Reserve's commitment to the Basel II process remains as strong as ever, even as we recognize that the proposals remain subject to further comment and that there is likely much more work to be done. We encourage comments from all interested parties and will give them careful consideration. I would like to emphasize that the Federal Reserve desires to ensure that the final rule for Basel II is a substantial enhancement over existing Basel I rules, appropriately capturing the risks of our largest, most complex banks, and encouraging continual improvement in risk-measurement and -management systems. We look forward to working with the other agencies as we enter into the final rule phase of the Basel II process.

We recognize that many institutions have been diligently preparing for Basel II implementation and we understand our obligation, as supervisors, to support institutions wanting to adopt Basel II at the first available date. We suggest that those institutions continue to move forward with implementation planning, including identification of gaps in their own preparation.

Finally, I would like to assure the Committee members that we at the Federal Reserve are pursuing Basel II because we believe it will help to preserve the safety and soundness of our nation's banking system. In our dual role as the central bank and supervisor of banks, bank holding companies, and financial holding companies, the Federal Reserve is committed to ensuring that the Basel II framework delivers a strong and risk-sensitive base of capital for our largest and most complex banking institutions. That is why we stand behind the additional safeguards contained in the Basel II NPR to ensure strong capital levels during the transition to the new framework. We will remain vigilant, on an ongoing basis, in monitoring and assessing the impact of Basel II on both individual and aggregate regulatory capital requirements and in employing rigorous and thorough analysis to support our evaluation. By so doing, we believe that the proposals being discussed today can be implemented responsibly and in a safe and sound manner.

Thank you very much for your attention. I welcome any comments you may have and will be happy to answer any questions.

EMBARGOED
until September 26, 10:00 am

Statement

of

John Reich, Director
Office of Thrift Supervision

concerning the

New Basel Capital Accord

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

September 26, 2006

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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 the New Basel Capital Accord
by Office of Thrift Supervision Director John M. Reich
before the
Committee on Banking, Housing and Urban Affairs

September 26, 2006

I. Introduction

Good morning, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. Thank you for the opportunity to discuss the views of the Office of Thrift Supervision (OTS) on the recently proposed Basel II capital framework and to update you on risk-based capital modernization in the U.S.

When I testified before this Committee nearly a year ago, I discussed my views on the development of the Basel II framework as of November 2005. I expressed concern about what we had just learned from the quantitative impact study, QIS-4. In particular, I noted that if we applied the emerging U.S. Basel II standard to the portfolios of some of our largest banks, there could be a potentially significant drop in their capital levels and a wide dispersion of capital requirements between banks. I also stated that even beyond these concerns, we had yet to resolve difficult policy issues in the modernization of our risk-based capital standards.

With the publication this week of a Notice of Proposed Rulemaking (NPR), I believe the Federal Banking Agencies (FBAs) have made progress since last year. First, we have to view QIS-4 as a preliminary study in the sense that the participating banks did not have the benefit of viewing the proposed rule. Therefore, I am pleased to say now that the FBAs have made numerous changes to the framework since the last version was published in the form of an Advanced Notice of Proposed Rule back in 2003. These changes should address many of the concerns with QIS-4. I believe the additional prudential safeguards that have been added to the framework should go a long way toward ensuring the safety and soundness of Basel II in the United States.

I am also pleased that, in addition to the models-based approach of Basel II (the Advanced Internal Ratings-Based or A-IRB approach), the NPR includes questions aimed at eliciting comment on non-models-based approaches, commonly known as "standardized" approaches. Challenging policy issues remain, but the FBAs remain committed to resolve these issues and we look forward to receiving fully developed comments to guide us in this process.

II. Basel II – Models-Based Approach

The centerpiece of effective bank regulation is ensuring capital adequacy. Capital protects a banking organization from the risk of unexpected loss. Adequate capital is generally maintained through two different measures, risk-based capital to adjust capital adequacy by asset class based on risk, and a leverage ratio, which provides a baseline that is measured against an institution's balance sheet and that serves as an institution-wide capital floor. When banks took less complicated risks, our risk-based capital system was appropriately less complex. As our banking system evolved and banking risk grew more complex, our risk-based capital system has evolved to capture these risks. Today, at least for our largest banking organizations, the NPR represents a further refinement at capturing those increasingly complex portfolios of risk. This approach, in concept, attempts to be consistent with on-going efforts by the large, sophisticated banking organizations (worldwide) to measure risk quantitatively for their own economic capital purposes.

A few weeks ago, in my capacity as a member of the FDIC Board, I voted in favor of publishing the NPR proposal that, if finalized, would implement the Basel II advanced capital framework in the United States. The Basel II advanced approaches would apply to the largest and internationally active U.S. banking organizations and certain other banking organizations that opt-in to the framework. The publication of the NPR represents the culmination of a multi-year effort by the FBAs. That work, in turn, was based on and was part of a collaborative international effort by banking supervisors from a number of countries.

The Basel II international capital framework holds the promise of an international competitive level playing field for banking organizations that operate in different countries around the world. It also holds promise of a more accurate system of bank capital based on risk. This is appealing to bank supervisors in the United States, as well as to U.S. banking organizations. At the same time, the Basel II advanced framework is extremely complex. It will be costly to implement and it presents a number of significant policy and operational hurdles. For these reasons, I view publication of the Basel II NPR, and the public comment process that follows, as an important opportunity for the FBAs to re-assess the type of capital framework or frameworks that are most appropriate for, at a minimum, the largest U.S. banking organizations.

Basel II is substantially more sophisticated than our existing U.S. risk-based capital rules, based on the earlier international capital accord known as Basel I. Even though our current rules have been amended numerous times since their inception some fifteen years ago, our current risk-based capital rules are part of a relatively rudimentary framework. This framework focuses on measuring risk exposure on an asset-by-asset basis and placing assets into simple, broadly defined risk buckets. For example, our current rules make no distinction between a well-underwritten commercial credit to a strong borrower and a relatively weak commercial credit to a weaker borrower. Both are assigned the same (100 percent) risk weight. Similarly, residential mortgages, which can vary widely in quality, are assigned either a 100 percent risk weight or, if prudently underwritten and meeting certain criteria, a 50 percent risk weight. Most 1-4 family residential mortgages receive 50 percent risk weight. Currently, even some of the lowest risk residential mortgages are subject to a 50 percent risk weight floor; whereas the highest risk residential mortgages are subject to a 100 percent risk weight.

Basel II introduces into the United States a new mathematical models-based system designed to measure regulatory risk-based capital adequacy and improve risk management for our largest banking organizations. Basel II requires institutions to maintain and analyze data and to assess risk among different loan types. It requires assigning estimates of probability of default on individual loans and groups of loans, as well as loss-given-default, exposure-at-default, and, where relevant, maturity. Basel II seeks to promote ongoing improvements in risk assessment capabilities; incorporates advances in risk measurement and management practices; and attempts to assess regulatory risk-based capital charges more precisely in relation to risk, particularly credit and operational risk. Basel II also envisions that institutions will continue to develop their internal economic capital models to measure their own unique enterprise risk. The international agreement articulating these principles was issued in June 2004.

There are several issues raised in the NPR for which public comments are particularly important to assist the FBAs in navigating the best course for this rulemaking. These include whether the NPR achieves its primary objective of capturing the risks embedded in the largest and most internationally active banking organizations in a reasonably clear and transparent manner. It is my hope that the NPR provides sufficient and useful information regarding the application of Basel II in the United States to stimulate comment on the various strengths and weaknesses of the Basel II approach as well as to encourage some creative thinking about non-models based standardized approaches. With the addition of various prudential safeguards, the FBAs have made significant efforts to address the concerns and issues raised by the results of the QIS-4 data collection. These safeguards included:

- The FBAs already revised the proposed timeframes for U.S. implementation of Basel II by delaying the start to 2008 and extending the phase-in period by one year. Starting in 2008, there will be a parallel run of the Basel I and the Basel II frameworks together for participating institutions. Institutions will be able to participate in the parallel run only if they can demonstrate to their primary federal regulator that they have accurate and reliable systems in place for enterprise-wide risk management.
- There will be a minimum three-year transition period during which a potential decline in each Basel II institution's risk-based capital would be limited by a series of graduated floors. During implementation, an institution's primary federal regulator will closely

monitor its systems for gathering and maintaining data, calculating the Basel II capital requirement, and ensuring the overall integrity of the application of the framework. [1]

- Based on information received throughout the implementation process, the FBAs will continually evaluate the effectiveness of the Basel II-based capital rules. In fact, the FBAs anticipate the possibility of further revisions to the Basel II rules prior to the termination of the floors.
- Existing Prompt Corrective Action (PCA) and leverage capital ratio requirements will remain in effect throughout the implementation period.
- If aggregate industry capital falls by more than 10 percent, the FBAs may elect to recalibrate the framework, or revisit the formulas contained in the A-IRB and modify them, as necessary.
- Loss Given Default (LGD), a crucial input into the Basel II formulas, must be calculated based on appropriate stress scenarios (periods where an asset category demonstrates relatively high risk of loss), but only after approval of the primary supervisor. Alternatively, LCD may be calculated according to a conservative formula set forth in the proposal.
- In addition, the proposal includes a credit risk multiplier that limits the reduction in risk-weighted assets, essentially taking model results and multiplying them by a fractional safety factor.

In the near future the FBAs anticipate issuing proposed guidance and standards for implementation of the Basel II advanced framework. The FBAs also anticipate guidance that would implement Pillar II of Basel II, in particular to address the expectations in Basel II for an institution to perform its own internal capital adequacy assessment. Furthermore, the FBAs

[1] The phase-in schedule provides that, in the first year (2009), an institution's capital reduction is subject to a floor of 95 percent of the level calculated for risk-weighted assets under Basel I. That reduction would be limited to a 90 percent floor in the second year (2010) and an 85 percent floor in the third year (2011). Each year, an institution's primary federal regulator will assess an institution's readiness to operate under the graduated floors, as well as on the potential termination of the floors for the institution after 2011.

anticipate issuing proposed reporting templates intended to provide greater transparency and consistency to the Basel II capital calculations of the participating banks.

The FBAs are currently working toward issuance of a final Basel II rule in 2007. Ideally, the timetable will provide U.S. institutions sufficient lead-time to prepare for a 2008 parallel run. However, with a comment period now extending into late January 2007, even that delayed target start date may prove ambitious. The FBAs are committed to getting this right. We expect extensive comment, and we know we still have a great deal of work to do. Further rulemakings may also be necessary to refine the Basel II framework. [2]

III. A Standardized Approach

As we develop a more sophisticated risk-based capital framework, it is important that we also consider what is identified internationally as the "Standardized Approach" – the less complex, non-models-based alternative to the Basel II A-IRB models-based approach. The Basel II NPR requests comment on this alternative. I believe it is important for the FBAs to consider whether the Standardized Approach or some variation of it could achieve many of the same goals as the models-based approach at a lower cost and with greater clarity and transparency. I also think it is important to note that, even within the context of that approach as it is being adopted in other countries, there is a carve-out for different capital treatment for reasons of national discretion.

Given the importance of this proposal and the wide range of views already expressed on different risk-based capital options, I anticipate commenters may go beyond the "Standardized Approach" as written (and developed primarily for banks in other countries without significant

[2] The OTS, like the OCC, is subject to Executive Order 12866, which requires executive agencies to determine whether a proposed rule is a "significant regulatory action." OTS has determined that the Basel II NPR will be a significant regulatory action based on the potential effects of the rule. Thus, OTS is required to prepare a regulatory impact analysis of the NPR, including an analysis of the need for regulatory action, the costs and benefits of the NPR and alternative approaches, and the potential impact on competition among financial services providers. Pursuant to the Executive Order, the NPR and accompanying regulatory impact analysis were submitted to the Office of Management and Budget for review prior to publication of the NPR.

input by the U.S. FBAs). I expect comments that may offer other options, perhaps similar to that standardized approach, but adapted creatively and appropriately to the U.S. banking system.

IV. Basel IA

While Basel II primarily applies to the largest internationally active U.S. banks, its implementation affects all U.S. banking organizations. This is due to the importance of competitive equity among U.S. banking organizations, both large and small. It would be unfair and poor public policy to impose dramatically different capital requirements for the same lending activities posing the same risk, simply because of the size and sophistication of the lending institution. In addition, there is an ongoing need to modernize risk-based capital for all of our banking organizations. To address competitive equity and to modernize capital rules, last year the FBAs issued an Advance Notice of Proposed Rulemaking (ANPR) soliciting comment on modernizing the existing Basel I-based rules. We refer to this effort as "Basel IA".

OTS was an early advocate of comprehensively revising and modernizing our Basel I-based capital requirements. We strongly support amending the existing Basel I standards simultaneously, or in close proximity to Basel II. Modifying the existing rules with more accurate risk-weights allocated to a wider range of asset buckets should improve the risk sensitivity of the current capital framework without unduly burdening affected institutions. Current risk weight categories (or buckets) are 0, 20, 50, 100 and 200 percent, but possible new and additional categories for consideration are 10, 35, 75, and 150 percent.

In addition to more risk buckets, applying commonly used risk criteria for identifying different levels of risk will further enhance our capital rules. For example, loan-to-value ratios, borrower credit assessments, and other broad measures, commonly used by banks of all sizes, could be incorporated into a risk-based capital system that differentiates and assigns risk-weights for some assets, such as 1-4 family residential mortgages. That is the type of increased risk sensitivity without undue burden that could move our risk-based system forward and better allocate capital based on risk. Potentially, such a practical system should mitigate competitive inequity among banks of any size.

In considering revisions to our current capital rules, the following principles guided the FBAs:

- Promoting safe and sound banking practices and maintaining a prudent level of regulatory capital;
- Maintaining a healthy balance between risk sensitivity and operational feasibility;
- Avoiding undue regulatory burden; and
- Mitigating material distortions in the amount of regulatory risk-based capital requirements for large and small institutions.

Basel IA is intended to increase risk sensitivity and minimize potential competitive inequities from Basel II; however, many highly capitalized banking organizations have already indicated they prefer to continue operating under their current Basel I-based framework. I am particularly dedicated to the proposition that we should not burden these institutions and I support this flexibility, consistent with the need to balance safety and soundness with regulatory burden concerns. For that reason, I believe Basel IA should be an optional framework, along with banks having the option to remain in the current Basel I-based system. The FBAs anticipate issuing the Basel 1A NPR within the next month. When we do, I expect and encourage additional comment from banking organizations of all sizes on the risk sensitivity and utility of the Basel 1A proposed changes, and on the flexibility of this system operating parallel with Basel I and Basel II-based standards.

V. Public Policy Concerns with Basel II and Basel IA

Longstanding and successful regulatory risk-based capital adequacy standards combined with a well-established and highly effective supervisory structure have delivered a U.S. banking system that is healthy and robust. As we move forward to modernize our capital rules, it is important that we do not harm or unduly burden this system. The OTS accepts the proposition that complex banking organizations undertake complex risks. I am hopeful that those risks can be captured by the Basel II proposal(s), and in a reasonably clear and transparent manner. Throughout the comment process and thereafter, we will work with the other FBAs towards that public policy outcome.

Implementing more risk-sensitive capital requirements without undue burden is as important for small community banking organizations as it is for large internationally active institutions. Achieving greater risk sensitivity for one part of the banking system and not the whole will inevitably create competitive distortions. While global capital standards are important, we must avoid potential negative effects on U.S.-based institutions not operating internationally. Recognizing that the U.S. banking system is remarkably diverse with a broad spectrum in size and type of banking organization, each set of capital standards we establish requires some reconciliation with the others. It is fundamental to fairness and capital neutrality that we maintain comparable (not necessarily identical) risk-based capital requirements for lending activities that have approximately the same risk characteristics, regardless of the lender.

A final issue that has generated significant discussion is the continued application under Basel II of PCA, including a leverage ratio. PCA provides a graduated capital structure for identifying categories of capital adequacy based on both a leverage ratio and risk-based capital. Along with other prudential safeguards, leverage is an important capital buffer. The OTS remains committed to maintaining an appropriate leverage ratio both throughout the implementation period of Basel II and beyond.

VI. Conclusion

OTS supports the goals of Basel II and we are committed to working with the FBAs to implement an effective risk-sensitive capital framework for all our banking organizations. We look forward to continuing the dialogue on Basel II and the parallel implementation of a Basel IA rulemaking. The Basel II NPR seeks comment on the standardized non-models based capital approaches as well as the advanced models-based approach. We will continue to work with the

Committee, the industry and the other FBAs throughout the Basel process. We encourage all interested parties to comment and participate fully in the development of the important policy objectives of Basel II and IA. Thank you.

TESTIMONY OF

DIANA L. TAYLOR

SUPERINTENDENT, NEW YORK STATE BANKING DEPARTMENT

On Behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

AN UPDATE ON THE NEW BASEL CAPITAL ACCORD

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

September 26, 2006

Room 538, Dirksen Senate Office Building

Introduction

Good morning, Chairman Shelby, Ranking Member Sarbanes, and distinguished members of the Committee. My name is Diana L. Taylor, and I serve as the Superintendent of Banks for the state of New York. I am pleased to testify today on behalf of the Conference of State Bank Supervisors (CSBS). Thank you for inviting CSBS to discuss the New Basel Capital Accord, which is commonly referred to as Basel II.

CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's 6,230 state-chartered commercial and savings banks, and 400 state-licensed foreign banking offices nationwide. For more than a century, CSBS has given state bank supervisors a national forum to coordinate, communicate, advocate and educate on behalf of state bank regulation. I am pleased to be here today with my fellow banking regulators to discuss Basel II, a proposal that when enacted could have a profound effect upon the financial system in the United States.

The financial markets have changed quite drastically in the 10 years since the implementation of Basel I. They are more sophisticated, with many new products and types of financial instruments available, and it was becoming increasingly clear to the regulators that it would be necessary to update the methodologies used, thus Basel II was born. At this point, I think it is worthwhile to reflect upon the Basel Committee's original objectives for the New Basel Capital Accord that would come to be known as Basel II. Those objectives, outlined in June 1999, were as follows:

- The Accord should continue to promote safety and soundness in the financial system;
- The Accord should continue to enhance competitive equity;

- The Accord should constitute a more comprehensive approach for addressing risks; and
- The Accord should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication.

As the U.S. version of Basel II has evolved, through the federal agencies' Advanced Notice of Proposed Rulemaking (ANPR) and now Notice of Proposed Rulemaking (NPR), I have become increasingly about regulations for Basel II banks and the effect they might have on the competitive balance of our domestic banking system and state supervision. Currently, ten states, including my home state of New York, charter banks that are potential core Basel II banks or are likely to opt-in to the Basel II framework. These ten states will be directly impacted by the implementation of Basel II, but all states will be indirectly affected by its implementation. There clearly are potential domestic implications that could affect our banking system and our economy. Specifically, we must understand the impact of these regulations on safety and soundness and competitive equity. I am aware of the criticism of the so-called "conservatism" of the U.S. approach to Basel II and the concern about international competitiveness. Is this what Basel II has become? I do not believe we should be basing competitive equity on reduced capital. While our internationally active banks should be competitive, our first priority must be preserving the safety and soundness of the system and then ensuring a level playing field for our domestic institutions.

A major concern of mine as a state banking supervisor, is that if Basel II goes into effect as currently constructed, the result could be the further erosion of the dual banking system and our nation's broad and diverse financial industry. The dual banking system in the United States is unique to the rest of the industrialized world. We have thousands of institutions chartered by all 50 states. This difference has been our strength. It is widely accepted that community and regional banks play an invaluable role in our nation's economy. They are the foundation of our small business infrastructure and essential to the specialized lending needs of small businesses. The changes that would be implemented by Basel II must be well understood and must not have unintended consequences that may prove harmful to our valuable banking infrastructure.

Support the Need for Basel II

CSBS remains fully supportive of the goal of Basel II: to better align regulatory capital requirements to underlying risks, and to provide incentives to banks to hold lower-risk assets in their portfolios. I believe planning for Basel II has led to several positive results. Risk management has improved at our largest banks and important data collection and modeling efforts have taken place. Supervisors and the industry now have an increased understanding of credit risk and operational risk, and data collection efforts—of characteristics of operational risk events, classification of credit losses, and differentiation of losses during economic downturns—have begun that will be extremely valuable in the years ahead. Supervisors have gained a greater understanding of bank portfolios, and we have had productive interactions with supervisors from other countries. The benchmarking exercises and data collection efforts carried out for Basel II implementation will be essential for validation and model review at Basel II banks.

CONCERNS FROM THE STATE PERSPECTIVE

Potential Drop in Capital

Before we decide to move ahead with implementation of Basel II's Advanced Approaches, however, I believe we need to address a number of important issues. The results of the fourth Quantitative Impact Study (QIS 4) in the U.S. showed drastic drops in required capital. My fellow state supervisors and I have traditionally been conservative with regards to capital requirements because of the pivotal role capital plays in ensuring safety and soundness and in stimulating economic growth. Sufficient capital levels are a prerequisite in maintaining the safety and soundness of an institution. As you know, capital provides a cushion, or safety net, for an institution in the event of an economic downturn. Overall, the U.S. economy has been strong and performing well for over a decade now. And while we are currently enjoying a record-breaking period without a bank failure, it is unlikely that this trend will continue uninterrupted forever.

I am sure each of you is well aware of the benefits that are added to your states by healthy, well-capitalized banks of all sizes and the role that a small bank plays in a local economy cannot be overestimated. As a state supervisor, I am very concerned with the disruption that would be caused by a small bank ceasing to operate in the communities I have sworn to serve. It is in all of our best interests as bank regulators and legislators to ensure that banks, large and small, remain competitive, manage their risks, and maintain adequate levels of capital. Therefore, it is our responsibility to ensure that changes in capital requirements are prudent, do not unduly benefit one type of bank over anther and that any transition to a new calculation of capital is carefully managed.

Impact on Domestic Competition

Research by Federal Reserve staff[1] suggests that adoption of Basel II as described in the NPR could have adverse impacts, particularly for large regional banks. In the Basel II White Paper, "An Analysis of the Potential Competitive Impacts of Basel II Capital Standards on U.S. Mortgage Rates and Mortgage Securitization," by Hancock, Lehnert, Passmore, and Sherlund and released in April 2005, the authors find a potential competitive advantage for banks that adopt the Advanced Approaches of Basel II, but point to securitization practices and uniform pricing within market segments as reducing this advantage.

Hancock et al describe the advantage the Advanced Approach adopters will have as the power to pressure the GSEs on the price of guarantees, since the banks' capital requirements may well be lower than GSE capital requirements. They assert that uniform pricing in all market segments will reduce any impact from the Advanced Approach banks' greatly reduced capital requirements. They also estimate that as of Q3 2003, 36% of loans outstanding in the U.S. were not securitized – these are the loans that end up in bank portfolios, and will be subject to capital requirements. Banks' ability to compete in loan origination is affected by their ability to securitize loans, and the largest banks have an advantage already because they are packagers of loans for securitizations themselves. The potential pressure on GSE pricing identified by the Federal Reserve researchers should be explored further, as a change in GSE pricing would affect all banks and have wide market implications. Also, it is not clear that uniform pricing would hold if the capital requirements for Advanced Approach banks declined significantly.

[1] Source: http://www.federalreserve.gov/generalinfo/basel2/whitepapers.htm.

Banks that adopt the Advanced Approaches for Basel II could have a substantial pricing advantage for loans that banks don't securitize –including nonconforming Alt-A or jumbo loans, prime ARMs, low-doc loans, and subprime loans. Banking regulators have released guidance concerning these and alternative mortgage products, and should now make sure that risk-based capital treatment of these products is consistent with their safety and soundness guidelines. As we move toward implementation of new capital requirements, it is important that we continue research concerning banks' mortgage portfolios.

Under the draft NPR, Advanced Approach banks would treat home equity loans very differently than banks that do not adopt the Advanced Approaches. According to the NPR, "first and subsequent liens, term loans, and revolving home equity lines of credit" are included in the retail portfolio as long as the borrower is an owner-occupier of the building, with an exception for buildings with few rental units. However, under both current capital requirements and Basel IA, home equity loans and junior liens are risk-weighted as residential real estate only if they meet certain stringent conditions and at 100% otherwise. Banks that do not adopt the Advanced Approaches could face competitive pressure for these products, and this should be addressed directly by the federal agencies.

Small business lending may also be adversely effected. In "Potential Competitive Effects of Basel II on Banks in SME Credit Markets in the United States,"[2] Allen N. Berger of the Board of Governors of the Federal Reserve System, found competitive advantages for banks adopting the Advanced Approaches of Basel II. Berger analyzed

[2] Source: http://www.federalreserve.gov/generalinfo/basel2/whitepapers.htm.

small business lending at U.S. banks as of Q2 2002, and discusses the differences in small business lending among commercial banks of four different asset sizes (top twenty banks by asset size, banks between $16 and $56 billion, banks between $1 and $16 billion, and banks between $1 million and $1 billion in asset size). He found that although there were differences in characteristics of small business lending between the top twenty banks and the smallest banks (those with assets between $1 million and $1 billion), there were not significant differences in small business lending between the top twenty banks and those with assets between $1 billion and $56 billion. Berger concludes that the top twenty banks – likely adopters of Basel II Advanced Approaches – could have a competitive advantage in originating the "safer" small business loans (those with lower PDs and LGDs) as far as all non-Advanced Approach banks are concerned, and that banks with assets over $1 billion could face significant competitive pressure from banks that adopt the Advanced Approaches.

The data banks submit on their small business lending for CRA disclosure reports is an important source of information about small business lending by U.S. banks. Additional important sources of small business loan information could be specific questions in the Federal Reserve quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices combined with the quarterly Survey of Terms of Business Lending. These data should be studied to understand the market for small business lending in the U.S. In addition, the PDs and LGDs assigned to small business retail segmentation by Advanced Approach banks during the transition years should be tracked. These parameters estimate the relative riskiness of small business loans, and should be compared to small business lending experience at banks that don't adopt the Basel II Advanced Approaches.

Finally, it is important that we make sure Basel II does not provide incentives to the largest banks to increase their acquisition of smaller banks. We must understand to what extent imbalances in capital requirements for the same assets might make acquisition of smaller banks by Advanced Approach banks desirable. Regional and community banks bring important qualities to small business lending, they have local knowledge, their traditional underwriting may be more flexible than model-driven lending, and there are supervisory tools already in place for monitoring this lending. I would encourage all Basel II stakeholders to consider the JPMorgan report, "And the Big Shall Get Bigger....",[3] which concludes "Basel II should benefit larger, more sophisticated banks much more than smaller banks and may provide an extra catalyst for merger and acquisition given limitations around any sort of direct capital release."

Role of States in Rulemaking

In order to successfully implement regulations such as Basel II in the United States, I believe state supervisors must have a more substantive role in the drafting and implementation process. The state supervisors oversee and regulate the vast majority of financial institutions in this nation. Despite our status as the primary supervisor for most institutions, we have not been included in the drafting process of the Basel II NPR or the Basel 1A NPR. We are very appreciative of Governor Bies' willingness to provide regular briefings to state supervisors on the status of Basel II and Basel 1A. However, we believe it would be appropriate for state regulators, through CSBS, to have a seat at the table along

[3] "Basel II: And the big shall get bigger...." JPMorgan European Corporate Research, J.P. Morgan Securities Ltd., London, September 15, 2005.

with our fellow regulators when rules that affect our institutions to such a great degree are being considered.

Additionally, the Basel II NPR does not provide a defined role for the states during the qualification process. The NPR repeatedly refers to an institution's "primary federal supervisor" as being responsible for qualification and transition to the Basel II framework. As I stated above, there are ten states, including New York, that charter potential Basel II banks. For these banks, the state is their primary regulator. The states must have a role in the implementation of the Basel II framework, but the federal agencies fail to address this issue in the Basel II NPR.

Once Basel II is adopted and implemented, the states will be responsible for ensuring that our affected institutions are Basel II compliant. In order to do so, we must be able to compare the data of our Basel II institutions against data of other Basel II institutions. Therefore, the state supervisors must have access to confidential data for all Basel II banks after implementation. Information sharing with the federal agencies is a necessary tool for states to properly supervise and regulate state-chartered institutions. The draft NPR for reporting public and confidential data limits access to the confidential data to the Federal banking agencies. The NPR states the agencies will use the data to:

• Assess the components of each bank's risk-based capital requirements;

• Assess each bank's capital relative to inherent risks and the agencies' minimum capital requirements;

• Monitor the levels and components of the risk-based capital requirements for banks through peer, outlier, and risk trend analyses;

• Evaluate the quantitative impact and competitive implications of the implementation of the Advanced Capital Adequacy Framework on risk-based capital levels within reporting banks and on an overall industry basis;

• Provide market participants, depositors, the public, supervisors, and other interested parties with information about banks' risk-based capital; and

• Supplement on-site examination processes and decisions pertaining to the allocation of supervisory resources.

The agencies are absolutely correct in their stated need and planned use for this data. State supervisors share this interest in fulfilling their supervisory responsibilities and broader responsibility for the state banking system.

To further this point, in a 1997 speech before CSBS, former Federal Reserve Chairman Alan Greenspan credited the large number of community banking institutions in the U.S. as being the key "to the stability of the banking system and the well-being of the macro-economy." He went on to add, "...Just as large numbers of smaller banks are a key to the robustness of our economy, the state charter is a key to the robustness of our banking structure...." Moreover, Chairman Greenspan concluded that the decentralized nature of banking and bank supervision were "arguably the key to weathering the financial crisis of the late 1980's."

As we experienced in the 1980's, capital requirements are an essential cornerstone of bank regulation and if the states are excluded from decisions affecting this critical regulatory tool, a major strength of our diversified system identified by Chairman Greenspan is lost. Centralized power and decision making may be easier, but in the U.S. banking system, it has not proven to be better.

Addressing Basel II Concerns

CSBS is pleased with the inclusion of several safeguards that have been incorporated into the Basel II NPR. Primarily, the maintenance of the current leverage ratio is crucial in preserving safety and soundness in the system. My fellow state supervisors and I believe strongly that the preservation of the leverage ratio is an absolutely necessary component of the Basel II framework. As the NPR itself states, "the leverage ratio is a straightforward and tangible measure of solvency and serves as a needed complement to the risk-sensitive Basel II framework based on internal bank inputs." We commend FDIC Chairman Bair for initiating a dialogue on the need for an international leverage ratio. This would be a significant step to strengthening the international banking system.

A second useful safeguard is the trigger of regulatory changes if there is a material reduction in minimum regulatory capital. If a 10 percent or greater drop in aggregate capital occurs among the group of institutions that adopt the Basel II framework, regulatory changes will be required of the supervisory risk functions of the framework. CSBS is wary of any proposal that could possibly lower the overall level of capital in the banking system, so we are pleased with the inclusion of this safeguard.

And finally, the proposed transition period is a wise approach to ensure that institutions are fully prepared for the implementation of the Basel II framework. The required one-year parallel run and the three-year implementation period will make certain that institutions are able to adopt the advanced Basel II approach while maintaining adequate capital to ensure safety and soundness. This transition will also give us the opportunity to evaluate the competitive implications and relative strength of the system.

We propose that the federal agencies—working with state banking supervisors—release reports during this period describing the progress of Advanced Approach banks (based perhaps on the proposed federal regulatory reporting forms) and the results of Advanced Approach benchmarking and model validation exercises. These reports will allow us all to gauge the effectiveness and possible consequences of the Basel II revisions.

U.S. banking regulators should also publish detailed plans describing how they will assess levels of required capital across the system once revised capital regulations are released. Moving forward with revised capital regulations will be much easier if bankers and supervisors understand the methods for assessing changes in the level of capital. This assessment should cover the entire banking system and should include a study of the areas where required capital either increases or decreases, by portfolio, institution type, region, and local community.

We now have the opportunity and the responsibility to make sure that when Basel II is implemented in the United States it will meet the objectives first put forth in 1999. I propose that we consider simpler Basel II options until we better understand the consequences of adopting Basel II's Advanced Approaches. We still do not know if Basel II will be successful in significantly reducing capital arbitrage. Basel II is an elaborate and complex set of regulations, and we are simply not far enough along to truly understand the exact nature of its incentives and motivations. It is my belief, however, that capital arbitrage will not only continue, but will itself increase in complexity and become more difficult to monitor and supervise.

The Standardized Approach

Recently, CSBS requested that the federal agencies seek public comment on offering the Standardized Approach in the United States. The agencies have included such a question in the Basel II NPR, and we commend them for doing so.

Several of the core Basel II banks have complained about details of the U.S. implementation of Basel II, and requested that they be allowed to follow the Standardized Approach. The arguments against allowing these banks to follow this approach seem to be (a) this approach is not appropriate for U.S. mandatory banks and comparable banks in other countries are not utilizing the Standardized Approach; and (b) U.S. regulators have not performed the work necessary to implement the Standardized Approach.

We are aware, however, of several comparable foreign banks that are considering following the Standardized Approach for credit risk. It is our belief that the Advanced Approaches are not being adopted uniquely in any other country. The United States appears to be the only nation that refuses to allow institutions to adopt the Standardized Approach.

Also, I believe it would be feasible for U.S. banking agencies, working in conjunction with the states, to produce estimates of the effect of the Standardized Approach across the country. The Basel Committee and other countries, such as Germany, have performed studies of the Standardized Approach and made their results available. In addition, much of the work the federal banking agencies have carried out to develop Basel IA could be used in drafting a U.S. implementation of the Standardized Approach.

In my opinion, it is possible that adopting the Standardized Approach could allow us to increase the risk sensitivity and comprehensiveness of current risk-based capital requirements and establish uniform capital requirements across all institutions, which were original objectives of the Basel II framework put forth in 1999. The Standardized Approach could capture more off-balance sheet risk than current capital requirements, thereby offering a superior complement to the leverage ratio. Also, the Standardized Approach does not call for enormous expenditures by banks, and can be supervised by examiners without relying unduly on bank staff.

It is important to remember that the Standardized Approach is part of the original Basel framework. This is not a novel or surprising aspect of Basel II. In my opinion, if a regulation can be simplified, it should be. Our domestic financial system could benefit from a less complex, more risk sensitive approach to monitor risk-based capital requirements.

The End Game of Basel II

Despite its current complexities, the original purpose of Basel II was really quite simple. Ultimately, the intention of Basel II is to produce a stronger international system that does not weaken our domestic dual banking system. In our rush to improve safety and soundness and competitive equity in the international system, we absolutely can not afford to weaken safety and soundness and competitive equity in our own domestic institutions. As U.S. regulators, our first priority must be to our domestic institutions.

The objectives of Basel II outlined in June 1999 must be met as we implement Basel II in the coming years. As regulators and legislators, it is our duty to ensure that the Basel II framework, including both the Advanced and Standardized Approaches, promotes safety and soundness, enhances competitive equity, provides a comprehensive approach for addressing risks, and embodies principles that are applicable to banks of varying sizes and levels of complexity. Most importantly, we must not diminish the dual banking system which has served our citizens and economy so well.

I commend you Chairman Shelby, Ranking Member Sarbanes, and the distinguished members of the Committee for addressing this matter. On behalf of CSBS, I thank you for this opportunity to testify, and I look forward to any questions that you may have.

Testimony of

Jim Garnett

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Banking, Housing and Urban Affairs

Of the

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United States House Senate

September 26, 2006

Mr. Chairman and members of the Committee, my name is Jim Garnett. I am the Head of Risk Architecture for Citigroup and in this capacity I am responsible for implementation of the Basel II Capital Accord for Citigroup within the United States and other countries in which Citigroup operates. Citigroup is a member of the American Bankers Association ("ABA"), and I am here today to testify on behalf of the ABA.

ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

Thank you for the opportunity to present the ABA's views regarding the ongoing efforts to implement the Basel II risk-based capital requirements in the United States. The ABA appreciates Congressional oversight of the regulators' actions in this important area. Recent proposals by the regulators, while well-intended, have the potential to reduce the availability of affordable credit, adversely affect competition among banks, discourage progressive risk management practices, and add to the already heavy costs of compliance.

The ABA has long supported a comprehensive approach to the regulation of risk-based capital that encompasses minimum capital requirements, supervisory review, and market discipline. The stated goal of the Basel II accord is to arrive at capital requirements that better reflect risk in a bank. However, the Basel II capital requirements as embodied in the banking agencies' ("Agencies") recently promulgated Notice of Proposed Rulemaking ("Proposal") fall short of that mark. In my testimony concerning the capital rules I would like to make the following points:

- First, the capital adequacy framework recently proposed by the Agencies is inconsistent with the international Basel II accord, would place U.S. banks at a competitive disadvantage with banks in other countries, and would impose significant compliance costs on U.S. banks.

- Second, the Agencies should expedite contemporaneous review and revision of the capital rules for the entire banking industry in order to avoid competitive imbalances domestically.

- Third, the variety and complexity of the American banking industry call for a menu of capital options in order to achieve the best match of capital with banking operations; a one-size-fits-all approach means a bad fit for most banks.

The above points are discussed in further detail below.

I. The Agencies are Diverging from the Basel II Standards to the Detriment of U.S. Banks.

The Basel II accord is intended to promote consistency in international regulatory capital standards. Consistency promotes free competition for banks operating across national boundaries, and it avoids the significant compliance costs that would be associated with different capital regimes in different countries. However, the Agencies have chosen a more restrictive and prescriptive approach than that being implemented in other countries. The provisions to be applied to large and complex U.S. banks, along with additional limitations that slow implementation, mark a divergence from the standards embodied in the internationally agreed upon Basel II accord.

Under the international accord, three options for approaching credit risk are permitted. These include the Standardized Approach, the Foundation Internal Ratings-Based Approach, and the Advanced Internal Ratings-Based Approach. With respect to operational risk, Basel II provides for the Basic Indicator Approach, the Standardized Approach, and the Advanced Measurement Approach. In the U.S., the Agencies have proposed rules that implement ***only the Advanced Internal Ratings Based Approach and the Advanced Measurement Approach*** (collectively, the "Advanced Approaches") for credit risk and operational risk, requiring the largest banks – the so-called "mandatory banks" – to abide by them.

The Agencies propose to implement the Advanced Approaches in ways that are more restrictive than those embodied in the international Basel II accord. For example, the Proposal requires a bank that sells loans from a single borrower at a discount of five percent or more to treat ***all*** other loans from the same borrower as being in default, regardless of the situation. Other banks lending to the same borrower would ***not*** be subject to the same requirement. Such a provision creates artificial differences among competing institutions, and contradicts the intent of Basel II.

Furthermore, the Advanced Approaches as proposed contain several limits that would prevent banks from realizing the potential benefits of capital reform. For example, the Proposal involves phasing in Basel II over a three-year period following implementation of the new standards. U.S. banks will be limited during this phase-in period by "transition floors." These floors last longer than those adopted by other nations, and only U.S. banks must seek permission from regulators to move to the next floor. As a result, banks around the world will have moved on to Basel II long before U.S. banks even begin.

A second limitation involves retention of the leverage ratio. Over the past decade, banks and regulators have made significant advances in risk management techniques. These advances are reflected in the Basel II accord and it is important to review objectively whether the leverage ratio is still necessary in light of the new framework. The leverage ratio will require banks to hold more capital than is justified by a risk analysis, creating incentives for banks to acquire riskier assets in order to earn an acceptable return on the excess capital.

Third, the Agencies have promised to make further adjustments to the capital rules if the aggregate capital of banks employing Basel II decreases more than ten percent. This is an arbitrary limit that has no relationship to economic conditions. In strong economic cycles, a drop in required regulatory capital of ten-percent or more may well be appropriate and would not pose any safety and soundness concerns. Conversely, in economic downturns, the amount of required regulatory capital could easily be in excess of the amount required under Basel I. Furthermore, it is entirely possible that a significant decline of risk-based capital for just a few Basel II banks could bring the aggregate decline of all Basel II banks above 10 percent. Under such circumstances, it would not be appropriate to penalize all Basel II banks.

The objective of the rulemaking should be to tie capital to risk. Banks do this every day, separate and apart from regulatory capital requirements. Mandatory banks have been using internal models for years and have demonstrated their reliability throughout all phases of the credit cycles. Further, the largest U.S. banks have full-time, resident regulatory examination teams with detailed knowledge of and access to the bank's intricate capital management processes. However, if regulatory constraints are not appropriately risk sensitive, most banks will be forced to run parallel capital systems. One system will be used to report to regulators, while the other system – which will be a better gauge of actual risk – will be used to run the bank. It will be extremely costly for banks to operate in an environment that requires two, disparate capital systems.

As a result of the disparities between the Proposal and the international accord, the U.S. banking industry is likely to realize few, if any, of the benefits that were anticipated at the inauguration of the Basel II exercise. Capital requirements will not be appropriately linked to risk, U.S. banks will be placed at a competitive disadvantage to foreign banks, and U.S. banks will be subject to a costly compliance burden. By being too restrictive, the Agencies would effectively impose a regulatory tax that either would make U.S. banks less able to serve as an economic catalyst in this country or prompt them to engage in risk-taking solely to use the excess capital required by the regulation.

It is also important to note that competition and capital flows do no stop at national borders. Therefore, even those U.S. banks that have mostly domestic operations will be put at a disadvantage in competing for major business customers who can easily turn to foreign banks operating under more appropriate Basel II rules.

The adverse consequences of the Advanced Approaches as embodied in the Proposal are not confined to the mandatory banks. A bank considering whether to "opt in" to adoption of the new standards likely would find the compliance burdens far outweigh any benefits. Hence, the Basel II goal of encouraging superior risk management will be significantly undermined

These detrimental effects of the Proposal can be avoided if the Agencies adopt instead rules that more closely follow the international Basel II accord. By making the capital rules that apply to U.S. banks comparable to those adopted in other countries, the competitive disadvantages that flow from the Proposal would fade, and U.S. banks would have regulatory capital that is a much better match for their risks.

II. The Agencies should expedite contemporaneous review and revision of the capital rules for the entire banking industry in order to avoid competitive imbalances domestically.

If the Agencies were to adopt advanced capital rules comparable to those of the international Basel II accord, this could result in lower capital charges in many instances for the mandatory banks and opt-in banks (collectively, "Basel II banks"). Taken by itself, however, that could leave much of the rest of the banking industry subject to admittedly out-of-date capital standards and subject to higher capital retention requirements. As a result, the vast majority of U.S. banks could find themselves at a disadvantage when competing with Basel II banks. Basel II banks could make the same loans as community and regional banks, but at a fraction of the risk-based capital assessment. This in turn could tempt Basel II banks to acquire community banks in order to unlock the excess capital they hold.

It is imperative that the Agencies not create winners and losers based on how much capital a given bank must set aside for a particular asset. To maintain competitive balance within the American banking industry, an appropriate update of capital rules is needed for all the community and regional banks for which the more advanced elements of Basel II are excessively expensive and complex. It is essential that each of these rules should require roughly the same amount of capital for the same asset, regardless of the size or complexity of the banks involved.

The original Basel Accord was developed more than fifteen years ago to provide a uniform international regulatory standard specifically for large, internationally active banks. However, the Agencies elected to apply it to every bank in the country regardless of their size, and the original accord has never been a good fit for the wide variety of individual circumstances of American banks, particularly the smaller institutions. Now, with multinational adoption of Basel II, the existing risk-based capital regime has become an archaic, idiosyncratic U.S. standard. In profound irony, the original accord will be applied chiefly to the banks for which it was not intended, those that are not in the ranks of the largest or internationally active institutions. This misappropriation of capital standards needs to be addressed.

We congratulate the Agencies on their announced commitment to develop a revised version of the existing capital standards, sometimes called a Basel I-A standard. We compliment the Agencies on their plan to expedite the schedule for proposing alternatives to the Basel II capital rules so that they can be reviewed contemporaneously with the review of the current Proposal. The mandatory banks have been working on their Basel II conforming systems for years. If the revised risk-based capital rules for all other banks are applied sequentially to the Basel II Advanced Approaches, then the institutions adopting these standards will be ready to take advantage of their new paradigm while all others will be just beginning to adjust to theirs. These second-stage banks would, as an unintended result of regulatory action, surely lose customers and business to their larger rivals. Therefore, the Agencies need to move forward expeditiously to revise the general risk-based capital standards that will apply to banks not adopting the Basel II approach. This way the entire industry can be prepared to follow standards that are competitively comparable.

Moving up the existing risk-based capital standard revision schedule will also help with acceptance and implementation of Basel II. Accelerating the revision of the rule for the entire industry together would help allay competitive balance concerns voiced in the industry and by governmental leaders and reduce resistance to finalizing Basel II.

III. The variety and complexity of the American banking industry call for a select menu of capital options in order to achieve the best match of effective capital standard with banking institution; a one-size-fits-all approach means a bad fit for most banks.

Prudent changes to the Proposal could make the Advanced Approaches a workable, effective means for determining how much capital is appropriate for the adopting banks. The ABA intends to submit detailed comments to the Agencies that will focus on changes we believe should be made to the "transitional floors," to the continued application of the leverage ratio, to the definition of "default," and to other areas where the regulators have inappropriately deviated from the international accord. These changes would conform the Advanced Approaches for U.S. banks more closely to those set forth in the international Basel II accord. If the problems highlighted during the comment period can be resolved, we would support adoption of the Advanced Approaches as one option for banks to consider.

In addition to addressing the problems with the Advanced Approaches, the Agencies should provide banks other appropriate risk-based capital options. Giving banks a choice of methodologies for risk-based capital compliance has several benefits:

- It allows banks to choose among methodologies that are simple and transparent;
- It promotes a competitive marketplace both domestically and internationally;
- It ensures appropriate minimum regulatory capital requirements; and
- It allows banks of all sizes to make their own cost/benefit assessments of the risk sensitivity of each option.

One option that should be considered is the Standardized Approach under Basel II. The Standardized Approach for credit risk has been part of the basic Basel II framework. Its terms and conditions are set forth in great detail in the international accord that the Agencies approved in June 2004, and those terms and conditions are fully known and understood by the Agencies. With so much work already done on this approach, its inclusion in a menu of capital options for American banks should not require extensive additional work.

The Standardized Approach ties capital charges to factors such as the credit rating of the borrower and the strength of collateral. It also recognizes that prudently underwritten residential real estate loans deserve a lower risk-weighting than is assigned under current rules.

While the Standardized Approach to credit risk is not as complex as the Advanced Internal Ratings Based Approach, it is nevertheless an improvement in many ways over existing rules and could be an optimal capital standard for many banks. For the mandatory banks, it may offer an appropriate balancing of the benefits of greater risk sensitivity and the burdens of regulatory compliance, while allowing flexibility to accommodate a bank's latest internal risk management program. For banks considering whether to opt in to the Basel II framework, the Standardized Approach may present a better fit. We appreciate the question in the Proposal about whether the Standardized Approach should be a part of the U.S. Basel II rules, and support work to provide this option.

The Agencies also should continue their efforts to develop a "Basel I-A" approach that provides a meaningful option to the Standardized Approach. The current Basel I-A initiative was prompted by a recognition that existing capital rules are not sufficiently risk-sensitive for most banks but that the Basel II rules are likely to be too complicated. These concerns remain valid. An appropriate Basel I-A standard should provide smaller banks with a more risk-sensitive capital structure and may be an appropriate choice for many banks. The development of Basel I-A is a constructive, necessary step in the implementation of the Basel II accord in the United States.

Many of the ideas discussed in the Agencies' Advance Notice of Proposed Rulemaking ("ANPR") concerning Basel I-A are potentially very helpful. These include such things as using more "risk buckets" when classifying assets and considering loan-to-value ratios when determining the capital charge for 1-4 family residential mortgage loans. However, given that no proposed rule has been published, it is impossible to offer views on particular changes to an existing regulation. If a Basel I-A proposal turns out to be largely the same as the Standardized Approach, we would encourage the Agencies to consider other options that would provide more flexibility when determining the appropriate amount of capital based on the quality of a bank's systems.

A fourth option should be to retain Basel I standards for banks with uncomplicated balance sheets. For many banks of this nature, the supervisory and paperwork burden of adopting a new system, even if it could lower the capital requirement, would not be an efficient use of resources. Hence, the existing Basel I rule is a prudent standard for many banks and should be retained as an option.

It is important that risk and capital be appropriately linked for all banks regardless of their size, and in such a way as to avoid creating competitive disparities. However, the efforts to improve the risk sensitivity of regulatory capital requirements should not result in disproportionate compliance burdens. Applying a select menu of reasonable capital standards for banks of all sizes is the best course of action. Just as applying the Advanced Approaches to small banks with uncomplicated balance sheets would result in a bad fit, so too would continuing to apply the existing Basel I program for large, internationally active banks. That principle holds true, as well, for banks in the middle. One-size-fits-all is likely to be a bad fit for most banks.

CONCLUSION

The initiative to improve existing capital rules could impose burdens that far outweigh its benefits. Alternatives exist that would strike a better balance between costs and benefits than does the Proposal. We appreciate the Agencies' willingness to consider alternatives, and we remain committed to working with the Agencies toward the goal of keeping the banking industry a safe, sound, and vibrant provider of financial services.

Testimony of

America's Community Bankers

on

"An Update of the New Basel Capital Accord"

before the

Committee on
Banking, Housing and Urban Affairs

of the

United States Senate

on

September 26, 2006

Kathleen E. Marinangel
Chairman, President and CEO
McHenry Savings Bank
McHenry, Illinois

and

Member
Board of Directors
America's Community Bankers
Washington, DC

Chairman Shelby, Ranking Member Sarbanes, and members of the Committee, I am Kathleen Marinangel, Chairman, President & CEO of McHenry Savings Bank, a $275 million community bank located in McHenry, Illinois. McHenry Savings Bank is a state-chartered, community financial institution serving customers in McHenry County in Northeastern Illinois. The bank currently operates five full-service banking offices. The primary business lines of the bank are focused on retail customers and small business owners, resulting in a diversified portfolio of single-family mortgages and commercial and consumer loans. We compete head-to-head throughout our market area with many large national financial institutions, including Washington Mutual, Citibank, JP Morgan Chase, Fifth Third, and TCF National Bank. We also compete with large foreign-owned banks such as Harris Bank, LaSalle Bank and Charter One.

I am submitting this statement on behalf of America's Community Bankers (ACB) of which I serve on the Board of Directors. I thank Chairman Shelby for calling this hearing on the Basel II and Basel IA proposals. The rulemaking process and the eventual implement of final rules are critically important to ACB member institutions.

Overview of Basel II and Basel IA

ACB and its members took the early lead on the proposed regulatory capital changes affecting banks and savings associations. We believe that the development and implementation of Basel II and Basel IA are critically important regulatory initiatives for financial institutions today. We support the adoption by U.S. and international bank supervisors of a risk-based capital system that more accurately links the amount of capital an institution holds to the risk taken by that institution. However, ACB remains concerned about the possible competitive impact Basel II will have on community banks when it is implemented in the United States. Furthermore, ACB is concerned that the complexity of implementing Basel II will place the large, internationally active U.S. banks at a competitive disadvantage vis-à-vis foreign banks that have been given a choice between the internal models version of Basel II and a more standardized approach.

Since the Basel Accord was first adopted in 1988, financial institutions have developed sophisticated tools to more accurately measure credit, interest rate, operations, market, and other risks. We believe that now is an appropriate time to review the current capital requirements that apply to all financial institutions and revise them to reflect changes in risk management that have occurred over the last decade.

In the United States, the federal banking agencies (Agencies) are working to update the Basel framework and create for the first time a bifurcated regulatory capital system. As currently contemplated, only about 10 financial institutions in the United States would be required to comply with Basel II. An additional 10 to 15 believe that they have the resources to voluntarily comply or opt-in. All other banks and savings associations would remain subject to Basel I or, as amended, Basel IA.

We commend the efforts of the Agencies to develop a Basel II proposal that is workable for the largest, internationally active U.S. banks. However, we strongly believe that Basel II should not be implemented unless changes are made to Basel I to more closely align capital with risk for other depository institutions. Otherwise, we believe that Basel I banks would be left at a serious competitive disadvantage and would become possible acquisition targets for Basel II banks. Finally, ACB strongly recommends that small community banks continue to have the option to comply with Basel I in its current form.

We understand that the banking regulators expect to issue a Basel IA proposal in the near future. We also understand that the Agencies plan to substantially overlap the public comment periods for the Basel II and Basel IA proposals and that the proposals are expected to be implemented at the same time, allowing for the consideration of the overall capital framework for all banks. It is clear that the Agencies are listening to the industry's perspectives on Basel issues that affect an institution's capital requirements and business strategy. It is our hope that Basel II and Basel IA will establish a coordinated, more risk-sensitive capital regime without adding significantly to regulatory burden.

Basel II Accord

Early in the process of developing a Basel II proposal, the Agencies determined that U.S. Basel II banks would use the "Advanced Approach," which would require each bank subject to Basel II to develop its own credit risk and operational risk models to determine capital levels. In contrast, banks in other industrialized countries are allowed by their regulators to choose between the methods described in the international Basel II Accord in order to determine capital requirements, including the "Standardized Approach." The Standardized Approach is simpler than the Advanced Approach.

In 2003, the Agencies requested public comment only on the Advanced Approach for determining capital levels. We are uncertain as to why the Agencies did not consider use of the Standardized Approach for U.S. Basel II banks.

We strongly believe that banks must have the opportunity to choose the capital calculation that best suits their business needs and risk profile and that Basel II banks be able to choose between the Standardized Approach or the Advanced Approach. The flexibility to adopt the Standardized Approach will help U.S. banks to compete both domestically and internationally with foreign banks that will be implementing Basel II in 2007.

ACB has significant concerns about the complexity of the Basel II proposal and the ability of financial institutions to bear the significant costs of accurate implementation of the proposal. We are also concerned with the capacity of the Agencies to adequately administer and enforce the new capital requirements without significant new reporting requirements. Furthermore, we are under the impression that there will be a substantial recordkeeping and reporting burden for institutions that would be subject to Basel II. We believe this is another reason that banks should be able to adopt the Standardized Approach for calculating capital. In addition to simplifying capital calculations, the Standardized Approach would allow banks to manage their reporting burden as well.

We are pleased that the FDIC board recently voted to seek public comment on whether Basel II banks should be permitted to choose between alternative methods for calculating capital requirements.

In summary, ACB believes that prior to the final adoption of Basel II, the regulators and the industry need to evaluate the complexity of the proposal and the ability to monitor compliance. This would include greater consideration of the real-world consequences of adopting an extremely complicated capital regime, the resources needed for implementation, the problems inherent in ongoing maintenance, the likelihood of effective regulation and market oversight, and the competitive pressures that could potentially encourage banks to "game" the system.

Competitive Concerns for Community Banks

Unfortunately, the complexity and costs associated with developing and implementing the models needed to measure and evaluate risk likely will preclude all but a small number of banks in the United States from opting into the more risk-sensitive capital regime proposed in Basel II.

The best available evidence suggests that Basel II will open the door to competitive inequities between large banks and community banks. The quantitative impact study, QIS-4, conducted by the Agencies showed that the Basel II Accord would result in significant capital savings for some of the largest banks in the United States and other countries. These large institutions compete head-to-head domestically with community banks in the retail area. Retail lending, particularly residential mortgage lending, is a fundamental business of community banks.

Under this bifurcated system, two different banks, a larger Basel II bank and a small Basel I community bank, could review the same loan application that presents the same level of credit risk. However, the larger bank would have to hold significantly less capital than the small bank if it makes that loan, even though the loan would be no more or less risky than if the community bank made the loan. Because capital requirements play a part in the pricing of loan products, the community bank may not be able to offer the same competitive rate offered by the larger institution. This result is not acceptable. Capital requirements should be a function of risk taken, and if two banks have very similar loans, they should have a similar required capital charge.

In addition, we are concerned that unless Basel I is appropriately revised, smaller institutions under a bifurcated capital regime will become takeover targets for institutions that can utilize capital more efficiently under Basel II. For instance, if a large bank could acquire a community bank's assets at a fraction of the required capital ratio imposed on the large bank, they would surely do so. The required capital at the acquired bank now would be excess capital under a Basel II structure. The bifurcated capital structure could drive acquisitions that otherwise would have no economic purpose.

Community banks must be permitted to utilize their capital effectively and judiciously while improving their ability to manage risk. Therefore, community banks must be given the choice to opt-in to the Basel II Standardized Approach, comply with a revised and more risk-sensitive Basel IA, or continue to comply with the current Basel I framework if it better suits the institution's business needs and risk profile.

In short, the same capital options available to larger institutions must be available to smaller institutions and vice versa.

Creation of Basel IA

In October of last year, the Agencies issued an Advance Notice of Proposed Rulemaking (ANPR) regarding possible changes to the capital framework to create Basel IA. ACB made many suggestions and observations in the comment letter we filed with the Agencies (See Appendix A). We look forward to studying and commenting on the Basel IA Notice of Proposed Rulemaking (NPR) that is expected to be published for public comment in the near future.

ACB has advocated in its letters to the Agencies and in previous testimony before Congress that the current Basel I capital regime be amended to take advantage of the ability of institutions and supervisors to measure risk more accurately.

Basel I fails to consider such risk factors as the loan-to-value ratio of collateralization and banks' significant nonfinancial assets. For example, a mortgage loan with a 20 percent loan-to-value ratio is risk-weighted the same as a mortgage loan with a 90 percent loan-to-value ratio. However, the risks associated with these loans are not the same. These are examples of elements of risk measurement that will be available to the banks that comply with Basel II, while the vast majority of U.S. banks will have to comply with the outdated risk measurement, unless Basel I is amended.

As proposed in the ANPR, a revised Basel IA would include more risk buckets and a breakdown of particular assets into multiple baskets to take into consideration collateral values, loan-to-value ratios, and credit scores. Credit risk mitigation measures, such as mortgage insurance and guarantees, would be incorporated into the framework. Other revisions would be made to further refine current capital requirements. Such an approach would be relatively simple for banks to implement and for regulators to supervise.

We also believe that small community banks should have the option of continuing to comply with Basel I in its current form. We encourage the Agencies to allow institutions the flexibility to choose a model that best works for that institution. There are many smaller institutions that hold capital well in excess of minimum requirements and will continue to do so after Basel IA or Basel II is implemented. These institutions often operate in small communities, may be mutually owned, family-owned, or privately held. These institutions believe that higher capital is appropriate to their ownership structure. Institutions should not have to comply with the increased regulatory burden of changed capital requirements if they would prefer to remain compliant with a more straightforward, but a less risk-sensitive Basel I.

Leverage Ratio

We understand that the Agencies intend to leave a leverage requirement in place. We support the maintenance of a leverage ratio for all financial institutions and believe that a regulatory capital floor is necessary to mitigate the imprecision inherent in internal ratings-based systems. The results of QIS-4 raised significant concerns over the implementation of Basel II and the potential for a significant reduction of risk-based capital. That study was conducted with a group of U.S. institutions that are expected to adopt Basel II and showed evidence of large reductions in the aggregate minimum required capital. Because of this study, the Agencies agreed to a minimum aggregate decline of 10 percent per year and a leverage ratio floor of 5 percent in the Basel II proposal.

In 1991, Congress enacted FDICIA, which set out a requirement for a leverage ratio component in capital for U.S. financial institutions. Congress specifically set the "critically undercapitalized" level at 2 percent. While Congress left the other ratios to agency discretion, it is appropriate for Congress to oversee the implementation of a requirement it created. ACB suggests that the precise level of the leverage requirement should be open for discussion. Institutions that comply with Basel II, and institutions that comply with a more risk-sensitive Basel IA, may not achieve the full benefits of more risk-sensitive capital requirements if the current minimum leverage ratio remains unchanged. Absent changes to the current leverage ratio, institutions may make balance sheet adjustments based solely on capital requirements rather than on the best interests of the business.

In addition, ACB suggests that foreign bank supervisors should also consider adopting a leverage ratio as a means of protecting their financial systems. This would be an important improvement to the original Basel Accord.

Capital Considerations Specifically Related to Business Lending

ACB's comment letter to the Agencies' on the Basel IA proposal specifically stated the following as it relates to business and commercial real estate lending:

- We believe that risk criteria should be taken into account to differentiate loan types, include collateral characteristics and value, credit enhancements, LTV ratios, leasing commitments and structure, and other factors.

- We support the approach in the proposal that would provide lower risk weights for commercial real estate loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity.

- We propose that in order to ensure that Basel I banks are not put at a competitive disadvantage with regard to Basel II banks for the treatment of commercial real estate, institutions should be provided an option to risk-weight these loans in additional buckets using LTV ratios and loan terms as risk measures.

- While we support the use of credit ratings as a factor in determining the risk of commercial loans, we also urge the Agencies to allow banks to use additional types of collateral and LTV ratios when no credit rating exists. Many community banks make both large and small commercial loans to borrowers that do not have a credit rating. We believe the permitted use of additional non-rated collateral LTVs will help keep capital requirements fairly simple, encourage lending to creditworthy and unrated businesses, and avoid any potential competitive disadvantages.

- We believe that any expansion of the types of eligible collateral or guarantees that can be used to mitigate risk should be optional for the institution. Institutions that want to keep capital requirements simple and do not want the added burden of continually tracking collateral should have that option.

Conclusion

We wish to thank Chairman Shelby, Ranking Member Sarbanes and the rest of the Committee members in giving ACB this opportunity to present our views. As we mentioned at the outset, capital requirements for U.S. financial institutions are a critical component in the safe and sound functioning of the banking system, as well as the ability of U.S. banks to compete against each other and foreign banks. ACB stands ready to support Congress and the Agencies in implementing capital standards that more closely align capital to risk for all institutions.

APPENDIX

America's Community Bankers Shaping Our Future

January 17, 2006

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail stop 1-5
Washington, DC 20219

Attention Docket No. 05-16
regs.comments@occ.treas.gov

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Attention: Docket No. R-1238
regs.comments@federalreserve.gov

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

comments@FDIC.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

Attention: No. 2005-40
regs.comments@ots.treas.gov

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications
70 FR 61068 (October 20, 2005)

Dear Mesdames and Sirs:

America's Community Bankers ("ACB")[1] is pleased to comment on the joint advance notice of proposed rulemaking ("ANPR") issued to solicit comments on changes to the risk-based capital framework for depository institutions in the United States.[2] The revised framework would apply to those banks and savings associations that are not required to comply with, nor are able to opt-in to, the revised Basel Capital Accord developed by the Basel Committee on Banking Supervision at the Bank for International

[1] America's Community Bankers is the member-driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit *www.AmericasCommunityBankers.com.*

[2] 70 Fed. Reg. 61068 (October 20, 2005).

Settlements ("Basel II"). This ANPR would lead to the issuance of a notice of proposed rulemaking at or near the time that the agencies also issue a notice of proposed rulemaking for Basel II.

ACB Position

We are pleased that the agencies have taken this step to revise risk-based capital requirements for all depository institutions. We believe that now is an appropriate time to review the current capital requirements that apply to everyone and revise them to reflect the changes in risk management and operations that have occurred over the last decade. Also, as we have made clear in our comment letters on the Basel II proposal and at Congressional hearings, we strongly believe that Basel II should not be implemented unless changes are made to Basel I for other depository institutions. Otherwise, we believe that Basel I banks would be left at a serious competitive disadvantage and also would become possible acquisition targets for Basel II banks.

You will note that our comments discussing different asset categories generally argue for more risk buckets and the ability of an institution to choose how much burden they wish to incur in exchange for more risk-sensitive capital requirements. We believe that more buckets provide greater ability to differentiate risk among loans in a certain asset category. However, we would encourage the agencies to allow institutions some flexibility in choosing a model that best fits their needs and matches their resources. For some institutions, the process of collecting, updating and reporting borrower and loan characteristics that are relevant barometers of risk will not be too burdensome. Other institutions may prefer simpler, more straightforward capital requirements, as are prescribed under existing Basel I standards.

The following is a summary of our position on the many questions contained in the ANPR, with more detail on each of these topics provided in the remainder of this comment letter.

- ACB strongly supports risk buckets based on loan-to-value ("LTV") ratios for one-to-four family residential mortgage loans. If other risk criteria, such as credit scores and debt-to-income ratios are to be included in a revised Basel I, they should be optional for those institutions that wish to incur additional burden in order to have capital requirements even more closely aligned with risk. We support the use of private mortgage insurance ("PMI") to reduce the numerator in the LTV ratio. There should not be different treatment for what the ANPR refers to as "non-traditional" mortgage products. We also provide an alternative approach to the proposed treatment of second lien mortgages.

- The risk criteria that should be taken into account to differentiate multifamily residential mortgages should be LTV ratios and number of units. A similar approach to the buckets for single-family residential mortgage loans should be used to stratify these mortgages based on risk.

- The collateral value for automobile and other secured consumer loans should be taken into account to differentiate these loans by LTV ratios. The agencies should consider allowing an option for banks to also use the loan term, credit scores and debt-to-income ratios for other types of unsecured retail loans to attain an even more accurately aligned risk weighting.

- We support the approach in the proposal that would provide lower risk weights for commercial real estate loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity. In order to ensure that Basel I banks are not put at a competitive disadvantage with regard to Basel II banks for the treatment of commercial real estate, we believe institutions should be provided an option to risk-weight these loans in additional buckets using LTV ratios and loan terms as risk drivers.

- We believe that it is appropriate to provide a lower risk-weight for small business loans that have lower LTV ratios based on the value of eligible collateral, no defaults and full amortization over a seven-year period. Two or three buckets should be available to institutions that are willing to incur more burden, with loans slotted based on LTV ratios and loan term. An alternative could also be offered that would allow an institution to adjust the risk weighting based on the credit assessment of a shareholder guarantor. Small business loans should be defined as those loans under $2 million on a consolidated basis to a single borrower.

- While we support the use of credit ratings as a factor in determining the risk of commercial loans, we also urge the agencies to allow banks to use additional types of collateral and LTV ratios when no credit rating exists. Many community banks make both large and small commercial loans to borrowers that do not have a credit rating. We believe the permitted use of additional non-rated collateral LTVs will help keep capital requirements fairly simple, encourage lending to creditworthy and unrated businesses, and avoid any potential competitive disadvantages.

- We believe the substantial cliff effect that occurs for short-term commitments should be removed by applying a credit conversion factor of 20 percent to all commitments regardless of term. This should not apply, however, to commitments that are unconditionally cancelable at any time or that effectively provide for automatic cancellation. These commitments should have a zero credit conversion factor.

- We do not support an increase in risk weighting for past due loans. Current regulatory requirements provide that depository institutions set aside reserves and take other steps to mitigate the risk of these loans and their impact on the institution. Also, an automatic upward adjustment without consideration of LTV ratios would not be appropriate.

- We believe that any expansion of the types of eligible collateral or guarantees that can be used to mitigate risk should be optional for the institution. Institutions that want to keep capital requirements simple and do not want the added burden of continually tracking collateral should have that option.

- We strongly believe that a leverage ratio should remain in effect.

- The agencies should consider developing, or encouraging third parties to develop, a simplified risk-modeling system that could be used by less complex banks to establish minimum capital requirements.

- Depository institutions of any size that would prefer to remain subject to Basel I as it currently exits should have the option to do so. Also, institutions should be provided flexibility to utilize some of the fundamental principles in a revised Basel Ia approach to gain a more risk-sensitive capital approach without undue burdens.

One-to-Four Family Residential Mortgage Lending

Risk-Weight Categories. The agencies are contemplating revising the 50 percent risk weighting for all mortgage loans that would adjust the risk weight based on LTV ratios. ACB strongly supports this approach. LTV ratios historically have been a strong indicator of risk, are readily available to community banks, and can be updated fairly easily even if on a quarterly basis. We believe that the numerator of the LTV ratio should be based on the net balance carried on the books of the institution to take into account any discount on purchased loans. Net balance reflects the true exposure of the institution.

With regard to updates of LTV ratios, we believe that the denominator should be based on the appraisal of the property obtained at the time of the loan closing. However, institutions should be given the option of updating the appraisals if they would like to undertake that burden to get capital requirements even more closely aligned with changing risk.

With regard to other loan characteristics that might reflect risk, our members have various opinions with regard to whether credit scores or debt-to-income levels would be more appropriate to put into a matrix with LTV ratios to determine risk. Most of our members believe that the LTV ratio is the best indicator of the risk of a mortgage loan and that credit scores or other ratios could be used in combination with LTV ratios, but should not be used in isolation. Credit scores and debt-to-income ratios provide valuable information and are appropriate indicators of a borrower's ability to repay a loan and, therefore, the risk level of the loan. We know of no study that shows which alternative, credit scores or debt-to-income ratio, is a better indicator of risk, so a proposal could offer the opportunity to use one or the other or both in the matrix.

There is some concern that any requirement to update the information with regard to credit scores or debt-to-income levels would be too burdensome for many community banks. Therefore, we support an approach that would permit those institutions that wish to include these characteristics in their risk assessment be permitted to do so in accordance with any parameters established by the agencies. This gives institutions the greatest flexibility to choose the level of risk sensitivity that is appropriate to the amount of burden they wish to incur.

The ANPR references "non-traditional" mortgages and questions whether these loans should be treated in the same matrix as traditional mortgage products or whether they pose unique and greater risks that warrant higher capital charges. Our members strongly believe that all single-family residential mortgages should be treated the same under the capital framework. As an initial matter, it is unclear what products would be considered non-traditional mortgages in the current environment where the types of mortgage loans made in the past may not be the only ones appropriate in a more mobile society that manages finances and debt differently. Many of our members have several decades of experience with a whole range of mortgages, including adjustable rate and other alternative products, and this experience has occurred through times of significant economic stress. Any capital proposal should draw upon this actual experience when developing relevant risk weightings.

Our members feel that LTV ratios are the best indicator of risk for any single-family mortgage loan, notwithstanding the characteristics of the loan. Similarly, credit scores and debt-to-income ratios are calculated in the same way for all types of mortgage loans and are applied differently only in the sense that a higher or lower credit score or debt ratio may be required for different types of products.

PMI. The agencies have questioned whether there should be certain limits on the use of PMI to decrease the numerator in LTV ratios. We understand there could be some concern with the ability of PMI companies to honor commitments during a time of economic stress. Therefore, we support the approach that would recognize PMI only if it is written by a highly rated company. ACB believes that pool insurance and other types of guaranty programs do help reduce risk and should be considered in risk weighting mortgage loans. We suggest that the agencies recognize these risk mitigation methods consistent with the recourse provisions in the agencies' capital guidelines on asset securitization. Also, mortgage insurance protection provided under special policies for loans sold to a Federal Home Loan Bank under its mortgage purchase program should be fully recognized when determining capital requirements for recourse obligations associated with those sold loans.

For the reasons discussed above, we believe that PMI should be recognized for all types of mortgage products, without regard to the characteristics and terms of the mortgage. We see no reason to treat certain mortgage loans differently if they are covered by PMI.

Nor do we see a need for risk-weight floors if PMI will be recognized only if written by highly rated companies.

Second Liens. The proposal discusses the treatment of second liens, which would differ depending on whether the institution also holds the first lien on a property. If an institution holds a first and second lien, including a home equity line of credit ("HELOC"), the loans can be combined to determine the LTV ratio and the lender can apply the appropriate risk weight as if it were one first lien mortgage. We believe that institutions should have the choice to treat first and second liens as separate risks. The first lien carries less risk and is more likely to be repaid in full, so it should carry a lower risk weighting than the second lien. For example, a first mortgage with an 80 percent LTV should not have its risk-weight adjusted from 35 percent to 100 percent if the borrower also carries a second bringing the LTV to 95 percent. Such an effect will likely cause the lender to be less willing to extend the second lien, forcing the borrower to utilize alternative lending sources and incurring much higher borrowing costs/fees in obtaining the second mortgage.

For stand-alone seconds or HELOCs, if the LTV at origination for the combined loans does not exceed 90 percent, the agencies propose a 100 percent risk weighting. If the LTV is over 90 percent, the agencies believe a risk weight higher than 100 percent would be appropriate. We do not support this approach. Again, the weighting should be more closely aligned with the actual risk. It should not be set in a way that forces lenders to forego second liens because the capital requirements are not proportional to the risk. The result of the proposal is that if the lender holds a first mortgage with an 85 percent LTV, that loan would have a risk weight of 50 percent. If the lender holds only a second mortgage where the combined LTV is 85 percent, the risk weight for the second mortgage is doubled to 100 percent even though the risk is the same based on an LTV ratio. We do not believe this is the proper result.

Capital treatment of first and second liens, regardless of whether the same institution holds both, should be consistent to avoid gaming of the system or unnecessary burdens on borrowers who might have to spend more time and money securing second mortgages. We also believe that PMI should be factored in when determining the risk weight of a second lien just as it would be for a first lien.

Multifamily Residential Mortgages

Multifamily residential mortgages currently receive a risk weighting of 100 percent, except for certain seasoned loans that may qualify for a 50 percent risk weighting. The agencies are seeking comments and supporting data as to whether there are ways to differentiate among these loans with regard to risk.

We believe that a stratification of these loans into three or four risk buckets, similar to single-family residential loans, would be appropriate. We recognize that the risk weighting for these loans would have to take into account the higher risk of this type of lending. Since LTV ratios are the most accurate predictor of a mortgage loan's risk, we believe that the buckets should primarily be based on these ratios. However, we also believe that the number of units financed also should be considered. For example, loans could be classified as fewer than 20 units, 20 to 36 units, and more than 36 units. The number of units is correlated with the size of the loan and the size of the loan is associated with risk. Appropriate risk weight buckets could be determined by consulting with banks and savings associations experienced with multifamily residential mortgage lending through periods of economic stress.

Other Retail Loans

The agencies have requested information on alternatives for structuring a risk-sensitive approach for consumer loans, credit cards and automobile loans.

We believe that LTV ratios for automobile lending and other secured consumer lending should be used to differentiate risk at the option of the institution. There are objective, standard resources for determining the value of an automobile. Other types of collateral that have objective means for determining value also should be considered. Those institutions that are willing to collect, update, and report this information should have the option of using LTV ratios to better align capital requirements with credit risk.

For automobile loans, credit card lending, and certain types of unsecured consumer loans, loan term can be used to differentiate risk, with less risk assigned to shorter terms. Credit scores or debt-to-income ratios also could be used to differentiate risk at the discretion of the institution. As with mortgage loans, there is no evidence indicating which measure is more accurate as a barometer of risk. Those institutions that are willing to collect, update, and report this information should have that option. Other institutions that would prefer less burden should be able to comply with simpler, more straightforward requirements such as risk weights based only on LTV ratios and loan term.

Commercial Real Estate Exposures

The agencies have long had supervisory concerns with loans made for the acquisition, development and construction ("ADC") of commercial property. Currently, these loans are subject to 100 percent risk weighting. The agencies are considering increasing the risk weight above 100 percent unless the loan meets certain conditions, including complying with interagency real estate lending standards and having long-term borrower equity of at least 15 percent. The agencies request comment on this approach and also on whether there are other types of risk drivers, such as LTV ratios or credit assessments that could be used to differentiate the risk of these loans.

We understand the concerns that the agencies have had with commercial real estate loans. However, capital requirements should be proportionate to the risk to ensure that prudent ADC lending is not discouraged. Our main objective in this area would be that Basel I banks be treated as similarly as possible to Basel II banks. This is a primary area of lending where our member community banks compete with the larger banks and they should not be left at a competitive disadvantage.

We support the approach in the proposal that would provide lower risk weights for loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity. LTV ratios and other drivers of credit risk, such as loan term and borrower equity, should be considered, at the discretion of the institution. This could be done by slotting these loans into two or three buckets with different risk weights based on the characteristics of the loan and the additional risk drivers.

There have been concerns among our members that the general reference to ADC loans in the ANPR could be interpreted to include loans to residential real estate developers. ACB would strongly oppose the application to residential ADC loans, as these types of loans do not involve the same type of risk as more speculative loans to commercial builders. We would appreciate having clarification that these ADC provisions would not apply to single-family homebuilders and developers.

Small Business Loans

Small business loans currently are assigned to a 100 percent risk-weight category unless covered by acceptable guarantees or collateral. The agencies are considering reducing the risk weight for small business loans to 75 percent if certain conditions are met, such as full amortization of the loan within seven years, no default in contract provisions, full collateral coverage, and application of appropriate underwriting guidelines. Small business loans would be those loans under $1 million on a consolidated basis to a single borrower.

An alternative approach would be to use a risk weight based on the credit assessment of the principal shareholders and their ability to service the debt when the shareholders provide a personal guarantee.

We support the proposed approach that would provide lower risk weights for small business loans that meet certain conditions, such as compliance with appropriate underwriting guidelines, no defaults, and full amortization over a seven-year period. We question, however, whether full collateral coverage should be required. We would prefer an approach that provides two or three different buckets based on LTV ratios, with lower ratios receiving lower risk weights. To provide even more alignment with risk, loans could be slotted into buckets based on the loan term, with shorter terms receiving a lower risk weight.

An alternative option could be offered that would allow an institution to base the risk weight on the credit score or debt-to-income ratio of a principal shareholder that guarantees the loan. Again, multiple buckets should be offered based on the results of the credit assessment.

We believe that the definition of small business loan should be changed to include those loans under $2 million on a consolidated basis to a single borrower. This would be consistent with the clear definition of "small business loan" provided in the OTS lending and investment regulations.

Any approach that would revise the risk weights for small business loans should be optional to the institution. Only those institutions wishing to incur the burden of collecting, updating and reporting relevant information in exchange for more risk-sensitive capital requirements should have to incur any increase in burden. Some institutions may find that maintaining and reporting data on loan terms for small business loans may not warrant the requirement to maintain, update and report on collateral value and LTV ratios. Other institutions may find it less burdensome to rely on a guaranteeing shareholder's credit assessment. It is better to provide as much flexibility as possible without over-taxing the resources of the institutions or the agencies.

Use of External Credit Ratings

The agencies propose allowing institutions to assign risk weights for certain assets by relying on external credit ratings publicly issued by a recognized rating agency. For example, a commercial loan to a company with the highest investment grade rating would have a 20 percent risk weight, while the lowest investment grade rating would receive a risk weight of 75 percent. Exposures with ratings below investment grade could receive a capital charge up to 350 percent. The agencies would retain the ability to override the use of certain ratings, either on a case-by-case basis or through broader supervisory policy.

We do not support the use of external credit ratings in determining the risk of commercial loans without some comparable method for determining the risk of unrated companies. Ratings are designed to measure the likelihood of default, but not the likelihood of a loss. The rating also does not reflect the fact that an institution may have purchased the loan at a discount. Many community bank commercial loans are made to businesses that are not assigned credit ratings, but are good credit risks with low probability of default. It would be unfortunate if capital requirements discouraged lending to very strong companies who help create jobs in the community simply because the company is not rated by a recognized rating agency. We support capital requirements for commercial loans that are simple, encourage approval of loans to creditworthy, unrated businesses, and avoid any competitive disadvantage to the community banks that make most of their commercial loans to unrated companies.

We would support recognizing additional types of collateral and slotting these loans into risk buckets based on LTV ratios to differentiate the risk of commercial loans. There are objective sources available to calculate value for collateral such as real estate and equipment. Financial collateral, such as certificates of deposit held at other institutions, also could be considered.

Short Term Commitments

There currently are no risk-based capital requirements for commitments lasting less than one year. For commitments greater than one year, the commitment is converted to an on-balance sheet credit equivalent using a 50 percent credit conversion factor ("CCF").

The agencies are considering applying a 10 percent CCF for short-term (less than one year) commitments, with the amount then risk-weighted according to the underlying asset. This would not apply to commitments that are unconditionally cancelable at any time or that effectively provide for automatic cancellation based on credit deterioration. An alternative suggestion is to apply a CCF of 20 percent to all commitments, whether short or long term.

We believe the substantial cliff effect that occurs with short-term commitments should be removed by applying a CCF of 20 percent to all commitments regardless of term. Commitments that are unconditionally cancelable at any time or that effectively provide for automatic cancellation should have a CCF of zero.

Past-Due Loans

The agencies are considering assigning higher risk weights to exposures that are 90 days or more past due and those on nonaccrual. The amount at risk, however, would be reduced by any reserves directly allocated to cover potential losses on the past-due exposure.

We do not support this approach. Current regulatory requirements provide that depository institutions set aside reserves and take other steps to mitigate the risk of these loans and their impact on the institution. The proposal does not take into account the improvements to risk management systems developed by lenders that call for quick intervention to resolve payment issues. Finally, automatic upward adjustments for past due loans do not take into account LTV ratios or other relevant risk drivers that could reduce the amount of loss upon default.

Use of Collateral and Guarantees to Mitigate Risk

The agencies propose to allow greater use of collateral and guarantees to reduce the capital requirements for exposures. Currently, the only collateral recognized in the capital rules is cash and certain government, government agency and government-sponsored enterprise securities. The list of recognized collateral would be expanded to include short- or long-term debt securities that are externally rated by a recognized rating agency. Portions of exposures collateralized by these instruments would be assigned to risk-weight categories according to the risk weight of the instrument. To recognize more types of collateral, an institution would need a collateral management system in place that tracks collateral and can readily determine its value.

The agencies also are considering increasing the types of recognized guarantors. The list would be expanded to include entities whose long-term senior debt has been assigned an external credit rating of at least investment grade. We believe that any expansion of the types of eligible collateral and the use of guarantees could be useful, but this should be optional, as some institutions may find tracking of collateral and the management of guarantees to be overly burdensome and unjustifiable. Also, the institutions that would benefit from such a change are those that take externally rated collateral or get guarantees from rated organizations. Many community banks do not take collateral in the form of rated securities. Also, although many of our members get personal guarantees for small business loans and commercial loans, these guarantees are from individual shareholders and not guarantors with externally rated long-term senior debt. We do not believe that allowing the use of externally rated debt securities and guarantors in order to get more risk-sensitive capital requirements will change the behavior of community banks with regard to how they underwrite and collateralize small business and commercial loans.

As discussed above, we think the types of recognized collateral should be expanded to include other items types of collateral that are used to secure commercial loans and that have objective sources of valuation. This would include real estate and industrial equipment as well as financial collateral such as certificates of deposit held at other institutions.

Leverage Ratio

The regulators propose to keep the leverage ratio requirement in place for both Basel I and Basel II institutions. We believe that a regulatory capital floor must remain in place to mitigate the imprecision inherent in the internal ratings-based system to be used by Basel II banks and to provide a safeguard for Basel I banks. However, the precise level of the leverage requirement should be open for discussion, so that consideration might be given to allow institutions that comply with Basel II and Basel I-A to more fully achieve the benefits of more risk-sensitive capital requirements.

Risk Modeling Approach

We would like the agencies to consider establishing a simple risk modeling system for use by community banks, much like the OTS developed for interest rate risk modeling used by savings associations. The modeling approach could establish capital levels that more clearly reflect each institution's actual risk levels without adding the significant costs of implementing the more sophisticated approaches in Basel II. An alternative might be a private industry approach whereby third party vendors could develop simplified internal ratings-based systems subject to regulatory review. This would give smaller institutions the proper incentive to improve their risk management and measurement systems, notwithstanding the fact that they do not possess the expertise to develop such systems internally. If such an approach is not deemed to be practical for all asset categories, it could at least be considered for commercial loans. Such a modeling approach could be based on similar ratings systems established by private, third-party firms that are readily available for business loans.

Other Issues

We support the use of more risk weight categories and the ability to more accurately differentiate among all balance sheet assets, not just those mentioned in the ANPR. For example, certificates of deposit of less than $100,000 held in insured depository institutions and similar correspondent bank deposits should receive a zero risk weighting, rather than the current 20 percent. Land and buildings could get lower risk weights based on appraised and net book value. Accrued interest on loans could be slotted in the same bucket as the loan itself.

We believe that institutions that prefer to remain on Basel I, without additional changes, should be permitted to do so regardless of size. There are some institutions that do not see the need, either from a management and operational perspective or a competitive perspective, to have more risk-sensitive capital requirements. For these institutions, the choice to avoid any regulatory burden associated with changes to the capital requirements should be respected. We see no reason why this choice should be limited to institutions of a particular size. Regulators are accustomed to supervising compliance with current Basel I. To the extent a significant number of institutions choose to remain subject to Basel I without change, this could also reduce the burden on the regulatory agencies.

We also believe that institutions should be afforded some flexibility in the approach used to obtain more risk-sensitive capital requirements. For many of our members, the ability to have more risk-sensitive capital requirements only for residential loans would be sufficient to mitigate any competitive disadvantage they would face with regard to Basel II banks. Some institutions may be interested in more risk-sensitive capital requirements only if is comes without significant burdens to compliance. Other institutions are willing to spend significantly more initial resources in order to attain capital requirements that can be even more closely associated with risk. For instance, some of our members may be satisfied with weighting the risk of their mortgages solely by LTV ratios, while others may be willing to incur greater burden by also taking into account credit scores or debt-to-income ratios. We believe that the more flexibility that can be provided, without unduly burdening the regulatory agencies, the better it is for the industry.

The agencies also should consider whether the creation of a risk-sensitive Basel 1-A could be applied to the entire industry, rather than single out some of the largest banks for compliance with Basel II. In light of the implementation issues that have arisen with Basel II, and ongoing concern about the use of sophisticated internal ratings-based models in the advanced approach to determine capital requirements, one overall framework may be a more useful and appropriate approach. At a minimum, we believe that Basel II banks should be allowed to utilize the Basel I-A model as a floor during the three-year implementation phase of Basel II.

Our members understand that in order to get the benefit of more risk-sensitive capital requirements, they will have to provide more information to the agencies on Call and Thrift Financial Reports. However, we believe that the changes made to the reports should be limited to those necessary for the agencies to adequately supervise compliance with the capital requirements. We also believe that it is important to give institutions choices, so that they can decide to adopt only certain changes to capital requirements in order to keep their reporting burden in check.

ACB appreciates the opportunity to provide this comment letter and intends to remain engaged on this important matter. If you have any questions, please contact the undersigned at (202) 857-5088 or via e-mail at rdavis@acbankers.org, or Sharon Lachman at (202) 857-3186 or via e-mail at slachman@acbankers.org.

Sincerely,

Robert R. Davis

Robert R. Davis
Executive Vice President and
Managing Director, Government Relations

TESTIMONY OF

WILLIAM M. ISAAC
CHAIRMAN
THE SECURA GROUP
AND
FORMER CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

BEFORE THE
COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

SEPTEMBER 26, 2006
WASHINGTON, DC

Mr. Chairman, Senator Sarbanes, members of the Committee, it is a distinct privilege to appear before you today to discuss the future direction and implications of the proposed Basel II capital accord currently under consideration by U.S. regulators and those in other major countries.

Nearly a decade in the making, at a cost measured in billions of dollars, the Basel II capital regime proposed by regulators for the largest banks in the world has been mired in policy and political debates. Fortunately, an end is in sight – we have a clear opportunity to remove Basel II from the quagmire.

The original premise behind Basel II was that risk management at the largest, most complex banks could be improved by developing mathematical capital models, while broadly maintaining the overall level of capital. The models – incomprehensible to mere mortals, such as boards of directors and senior managements of the banks – would measure the risks in these institutions and assign capital to cover those risks.

This original premise was somehow transformed into an expectation that large banks would be offered the carrot of reduced capital in exchange for developing the models. ***Let's pause right here . . . and think about the proposition that the largest banks have excess capital and should be allowed to reduce their capital materially.***

Does anyone really believe in that notion – particularly anyone who lived through the two decades in banking from 1973 to 1993? Thousands of banks and thrifts failed during that period – many more, including most of the largest banks, would have failed but for very strong and costly actions taken by the Federal Deposit Insurance Corporation and the Federal Reserve to maintain order. It was a very scary period that nearly careened out of control.

For any regulator to accept the premise that the world's largest banks, as a group, have significant excess capital is unfathomable to me. **Yet, that is the glue holding Basel II together.**

Fortunately, a degree of sanity is now being restored to the Basel II process. U.S. regulators, unlike their foreign counterparts, wisely imposed on Basel I a floor on capital (known as the "leverage ratio"). They decided a year or so ago to apply that same ratio to Basel II. This limits the ability to rationalize large reductions in capital through modeling.

More recently, U.S. regulators amended the Basel II proposal to limit the percentage capital reduction that could occur in the Basel II banks, individually and as a group.

In July, four Basel II banks (JP Morgan/Chase, CitiGroup, Wachovia, and Washington Mutual) sent a letter to regulators requesting that U.S.

banks, like their foreign counterparts, be allowed to use the "standardized" approach to Basel II instead of being required to adopt the "advanced modeling" approach.

The standardized approach to Basel II is similar to Basel I in that it places various types of risks in buckets and assigns risk weightings to each bucket (Basel II has more buckets than Basel I). The standardized approach is vastly superior to the advanced modeling approach:

- **The standardized approach is much less expensive to implement and maintain. I have met with a number of the Basel II banks and understand that they have each spent between $100 million and $300 million in an attempt to build advanced models under Basel II. The banks I have spoken with believe their current systems for identifying, managing, and pricing risks are superior to the advanced approach.**
- **The standardized approach does not purport to deliver more reliability than can be delivered, while the advanced approach conveys a false sense of security and reliability. Among other things, large banks do not have detailed loss data going back as much as ten years, which means they do not have data for any**

period in which we have experienced serious economic and banking problems.

- **The standardized approach is less intrusive than the advanced approach and will allow the banks more flexibility to manage themselves. Models are important to large banks in managing and pricing risks. They are a management tool and are very poorly suited for use in setting regulatory capital standards. Banks need the ability to make continuous adjustments in their models and can't wait for a regulatory committee to decide what changes are appropriate.**
- **The standardized approach is more transparent and much easier for all of the important users of the information to understand, including boards of directors, senior managements, customers, investors, analysts, regulators, and the media.**
- **The standardized approach will produce a smaller disparity in capital requirements between large and small banks. Moreover, it will allow Basel II banks in the U.S. to be treated in the same fashion as Basel II banks in other countries, which are not required to use the advanced modeling approach.**

We have already experienced a great deal of consolidation in the U.S. banking industry, with the 25 largest banking companies now controlling some 70% of the nation's banking assets. I am convinced that creating a large disparity in capital standards between the large and small banks will lead to increased consolidation, leaving fewer banking choices for smaller businesses. Further consolidation in banking is inevitable, but it ought to be driven by market forces not by capital rules that favor larger banks.

It is argued that large banks from other countries will have a competitive advantage unless U.S. banks are allowed to use the advanced modeling approach free of limitations on reductions in their capital. I don't buy that argument.

The fact is that U.S. banks are by far the best capitalized and most profitable banks in the world. They do a great job of meeting the credit needs of businesses and individuals and are a major reason the U.S. has the strongest economy in the world.

Other countries should emulate the U.S. system, not the other way around. The U.S. should urge other countries to impose minimum capital standards on their banks rather than enabling U.S. banks to lower their capital to unsafe levels.

Nearly every professional bank supervisor with whom I have spoken believes the advanced approach under Basel II is fundamentally flawed. Every major industry trade group has requested that the standardized approach be made available as an option. Congressional leaders on both sides of the aisle in the Senate and House clearly have grave reservations about the advanced approach under Basel II.

As noted, four of the Basel II banks have asked publicly that they be given the option of selecting the standardized approach. I believe many of the remaining Basel II banks feel the same way, although most are reluctant to speak out due to their concerns about regulatory reactions.

I said at the outset that an end to the Basel II ordeal is in sight. U.S. regulators should follow the path established by the Basel Committee and authorize U.S. banks to use the standardized approach.

The standardized approach will reduce the unnecessary complexity of Basel II and make it more understandable and transparent to all concerned. It will reduce greatly the cost of implementing and maintaining the system. Bank managements will retain the flexibility they need to change their internal systems for managing and pricing risks without first having to deal with a committee of regulators. Finally, it will reduce the disparity in capital requirements between large and small banks.

Now that the regulators have placed a number of safeguards around the advanced approach under Basel II, I am less concerned than I was about a precipitous decline in large bank capital in the U.S. Nonetheless, the advanced approach remains fundamentally flawed. Moreover, I worry greatly that a few years from now when different regulators are at the helm who will not have experienced the banking crisis of the 1980s, they will succumb to the pressure to eliminate or ease off on the safeguards.

I can't tell you how grateful I am that this committee has taken the time to focus on Basel II. This is by far the most important bank regulatory issue in front of us today. If we get this one wrong, our nation and taxpayers will almost certainly pay a very big price down the line – a price that will make the S&L debacle seem like child's play.

Let me close by emphasizing once again that no matter what anyone tells you to the contrary, it would be a serious mistake to allow our large banks, as a group, to reduce their capital materially. The largest banks in the world are a lot of things, but overcapitalized is not one of them.

Thank you. I will be pleased to respond to any questions you might have.

UNITED STATES SENATE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS

Hearing on an Update of the New Basel Capital Accord
September 26, 2006

Prepared Statement of
Daniel K. Tarullo

Mr. Chairman, Senator Sarbanes, I appreciate your invitation to testify today. I am currently Professor of Law at Georgetown University Law Center and a non-resident Senior Fellow at the Center for American Progress. I teach, among other things, Banking Regulation and International Economic Law. At present I am completing work on a book about Basel II. As you know, I held several economic policy positions in the Clinton Administration, ultimately as Assistant to the President for International Economic Policy. I testify today purely in my individual capacity as an academic, with no client interests or representation.

Last November many of us sat in this same room considering essentially the same issues we are discussing today. We questioned the reliability of the Advanced Internal Ratings (A-IRB) approach as a method for setting regulatory capital levels. We stated concern at the prospect of significantly reduced capital levels under that approach. We expressed skepticism that banks adopting the approach could be adequately monitored by supervisors, and that adequate oversight of the supervisors of A-IRB banks was feasible given how opaque the whole process would be.

Today it is appropriate to assess where progress has been made in the last ten months and, just as importantly, where it has not been made. As has been true throughout the Basel II process, the details of this saga can be arcane. But we should make no mistake about what is at stake here – the basic soundness of our banking system in an era of massive capital flows, highly complex banking institutions, and constant financial innovation.

The bottom line is that the big questions about the advisability of the A-IRB approach in Basel II have not been answered satisfactorily:

- The banking agencies have yet to demonstrate they can predict what the impact of the A-IRB approach will be on bank capital and on competition among U.S. banks adhering to different capital methodologies.
- Distinguished academic economists – of all political persuasions, I might note – continue to question the very foundations of the A-IRB approach.
- The implementation of the A-IRB approach in individual banks will necessarily be highly opaque to anyone outside the bank, with the *possible* exception of a team of unusually expert regulators dedicated to that bank alone.
- The whole approach is a monitoring nightmare – from the difficulty in monitoring how the banks are implementing A-IRB, to the near impossibility of public and Congressional monitoring of how well the regulators are doing their job under A-IRB, to the enormous challenge for U.S. regulators in determining how successfully their foreign counterparts are in administering this enormously complex approach to capital regulation.
- There is no plausible plan for reaching international agreement on the nearly continuous revisions of A-IRB that will be necessary if it is to satisfy its stated aim of utilizing state-of-the-art risk assessment techniques in calculating minimum regulatory capital.

Thus, just as was the case last November, it would not be prudent regulatory policy to rely on this approach to set regulatory capital requirements. Indeed, it has become increasingly clear that the A-IRB approach is fundamentally flawed.

However, despite my misgivings about the path on which Basel II could put bank regulation in the United States, I do not think we can or should delay action indefinitely.

The challenge is how to move forward without endangering regulatory capital levels, imposing large unproductive compliance costs on banks, or ignoring the international arrangement into which the banking agencies have entered. Fortunately, there have been two significant positive developments address this challenge.

First, the four federal banking regulators have, in their Notice of Proposed Rulemaking (NPR) for implementing Basel II in the United States, recognized the potential risk posed to capital levels by the A-IRB approach. This recognition is evidenced by their inclusion of a series of floors limiting how much minimum capital levels can fall for banks adopting this approach.

Second, four of the largest U.S. banks have recently suggested a sensible way to move forward in implementing Basel II. They propose permitting U.S. banks to choose among all three Basel II methodologies, rather than requiring our largest banks to adopt the A-IRB approach, as has been the stated intention of the banking agencies to date. Coupled with the floors on capital reductions under A-IRB, making this option available would protect capital levels while allowing banks that so choose to avoid assuming substantial compliance costs for a methodology that may ultimately prove unworkable.

In the balance of my testimony I will first review the key aspects of the current, somewhat dispiriting situation. Next I will elaborate on the steps I believe the federal banking agencies should take to move forward, including accepting the proposal of the four banks. Finally, I will suggest how, with this provisional solution in place, our regulators and industry might proceed towards a satisfactory longer-term regulatory capital regime.

The Current Situation

This hearing is certainly not the place to recount the long and tangled history of Basel II. However, certain elements of that history shed light on the circumstances in which we find ourselves today.

First, it is important to note that, as a group, large banks were not proponents of the A-IRB approach to capital regulation. At the outset of the Basel II process, in 1998, many large banks had urged the Basel Committee to allow them to use their internal credit risk models as the basis for determining minimum capital levels. The Committee quite properly rejected that approach, citing problems with data reliability and model validation. Instead, it began what turned out to be a long, painful process to develop what is, in effect, a new credit risk model – but one created from scratch by the banking supervisors, to be imposed on banks.

The Committee appeared to regard the internal-ratings based approach as a compromise that would utilize the internal credit ratings systems of banks to calibrate exposure risks more precisely than the rather blunt Basel I categories, while keeping under the control of the Committee the formulas by which capital requirements would be generated from the banks' risk ratings. While banks did not reject this approach outright, many criticized – often severely – the specifics of each Committee proposal. There was definitely merit in some, though by no means all, of these complaints. For three years, the Committee was largely on the defensive, responding to criticisms by making numerous modifications – some of them major – in its proposal.

Second, the attitude of large banks towards the A-IRB approach seems to have changed only as it became likely that the nearly continuous revisions to this proposal in response to industry complaints would result in sizeable reductions in minimum capital requirements. Although the banks certainly never stated their position as such, I inferred their view to be that the A-IRB approach might not be a very good way to assess risk, but they were willing to adopt this methodology if it would reduce their capital requirements substantially. This, of course, is exactly what the later Quantitative Impact Studies suggested would happen.

This observation about the banks' position should be neither surprising nor read as a criticism of the banks themselves. It is understandable that banks would seek to minimize their regulatory obligations in pursuit of higher profits. The problem, of course, is that banks are not like most companies. Because of deposit insurance and market perceptions that the Federal Reserve will rescue large banks that encounter serious financial difficulties, American taxpayers actually bear some of the risk that banks themselves assume. That is one of the principal reasons why we have capital regulation in the first place, and that is why the protection of regulatory capital minimums is so important.

Third, as already mentioned, the four federal banking agencies have responded to the prospect of significant declines in minimum capital under A-IRB by proposing stronger safeguards in their recently approved NPR. At this Committee's November 2005 hearing, the regulators reiterated their previously announced intention to limit the amount by which the regulatory capital of any A-IRB bank could decline during its first three years under the new methodology. They further offered the rather vague signal that, at the end of the three-year transition period, the primary federal regulator would decide whether or not the final (lowest) transitional floor should be retained.

In their recent NPR, the federal banking agencies have proposed three safeguards: (1) As they suggested last year, the agencies propose a transition floor for each bank in its first three years under A-IRB of 95%, 90%, and then 85% of the amount of capital that would be required under "general" capital rules.[1] (2) The agencies also commit to modify the A-IRB framework if the aggregate capital of banks covered by this framework decline by more than 10%. This is considerably firmer safeguard than their previously stated intentions. (3) Finally, the agencies have strongly stated their intention to retain the leverage ratio requirement and other prudential safeguards as "critical for the preservation of a safe and sound regulatory framework."

In proposing these safeguards, the agencies have referred explicitly to the uncertainty surrounding the impact that the A-IRB approach will have on minimum capital requirements. Significantly, the agencies also invoked in the NPR the original stated aim of the Basel Committee to maintain the overall level of risk-based capital requirements.

Fourth, the attitude of most large banks (that is to say, those which would presumptively be required to adopt the A-IRB approach) has again shifted since a draft of the NPR began circulating last spring. The capital safeguards proposed by the banking agencies will, by definition, limit the extent to which the regulatory capital requirements of large banks can decline. Now the banks face a dilemma. Their expectations for large declines in regulatory capital requirements have been dashed. But, under the terms of the NPR as circulated last spring, they will still be required to adopt A-IRB. This

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[1] The NPR's reference to "general" capital rules is apparently intended to refer to the rules that will be applicable to U.S. non-A-IRB banks as of the time the A-IRB approach is adopted by a bank. Today those rules would be existing capital rules. By the time of implementation, those rules may have been changed under the so-called Basel IA initiative of the federal banking agencies.

methodology will require them to expend substantial resources in creating and maintaining the elaborate systems required to implement this approach.

A-IRB is a credit risk model created by the supervisors. It is not tailored to a bank's particular mix of business, to its own portfolio, or to its own propensity to regularly enhance its internal credit risk model with state-of-the-art innovations. Thus our largest and most sophisticated banks will continue to use their own credit risk models. They will operate parallel credit risk modeling systems – one for business purposes, and the other for regulatory purposes. Accordingly, the banks will have to expend substantial additional resources on the A-IRB system, but without getting the benefits of large capital reductions they had anticipated.

Confronted with this situation, a number of large banks have had a dual response. First, in prior testimony and in other venues, they have urged removal of the safeguards for A-IRB imposed by the banking agencies in the NPR.[2] Second, in a letter to the banking agencies, four banks have requested the banking agencies to reverse their decision of several years ago that only the A-IRB portion of Basel II will be available to U.S. banks (and required for the largest banks). Instead, they suggest that all three of the Basel II methodologies – which, most importantly, include the standardized approach – be available for adoption by any bank. The banks' request to remove the A-IRB capital safeguards should be strongly resisted, but their proposal to make all the Basel II methodologies available to any bank has great merit and should be implemented.

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[2] They have also requested a number of other changes in the implementation of the A-IRB as proposed in the NPR. It appears as though their general position is that U.S. banking agencies should not impose any requirements more rigorous than those included in the Basel II Revised Framework itself.

Sensible Steps for Moving Forward

Building on the banks' proposal to allow a choice between the standardized and IRB approaches, here are four steps I would recommend to break the logjam that has developed from the combination of concerns about capital levels, cost, and competition. The banking agencies should:

1. Permit internationally active U.S. banks to select between the A-IRB and standardized approaches of Basel II;[3]
2. Retain the NPR capital safeguards for any banks that elect the A-IRB approach;
3. Use their supervisory powers to require banks to adopt and maintain internal risk assessment and management techniques appropriate to their size and activities; and
4. Explore and pursue more viable approaches to capital regulation, both at home and within the Basel arrangements.

Allow the Standardized Approach: This proposal of the four large banks has been gathering support since they put it forward during the summer. Groups with rather different perspectives, including the American Bankers Association and the Conference of State Banking Supervisors, have now endorsed their proposal.

Permitting large U.S. banks to adopt the standardized approach resolves the clash of interests and goals discussed earlier. All indications I have seen are that the standardized approach would not produce major declines in capital levels, either within individual banks or in the aggregate. At the same time, bank compliance costs would not be anywhere near the order of magnitude of costs associated with the A-IRB methodology. Thus capital levels can be protected while not forcing banks to expend

[3] The four banks specifically proposed allowing banks to choose among all three of the Basel II methodologies. However, the third methodology – the "foundational" IRB approach – has not to date been the subject of any planning for implementation by either banks or the banking agencies. Because it involves many of the same considerations as A-IRB, it cannot be implemented without substantial study and guidance. Both the banks and the agencies are better advised to spend their time developing guidelines and plans for adopting the standardized approach and continuing work on the A-IRB approach if they so choose.

large sums that neither assist them in their business assessments of risk nor yield them big capital reductions.

Adoption by large banks of the standardized approach would have other virtues. It is worth noting that the standardized approach does reflect some improvements from the Basel I rules, notably in the expansion in the number of risk-weighting categories and the use of external credit ratings to differentiate among the creditworthiness of debtors of the same type (i.e., corporations or sovereigns). It would also allay the concerns of non-A-IRB banks that the differential capital rules would give the A-IRB banks a systematic advantage in the amount of capital set-asides required for certain classes of loans. Finally, it will allow the United States to implement, without further delay, the Basel II Revised Framework, albeit in a somewhat different way than most had anticipated.

Retain the NPR Capital Safeguards: It is of course true that, if the standardized approach becomes an option, retention of the NPR capital safeguards will make bank adoption of the A-IRB methodology less likely. Frankly, that is probably a desirable outcome for a host of reasons. In any case, the safeguards should remain. No one, certainly no one in the banking agencies, has provided a rationale for why the capital requirements of our largest banks should be significantly reduced.

It is no answer to say that the A-IRB formulas indicate that capital levels could be lower. The Basel Committee regulators, after all, made up the formulas. While credit risk modeling can be helpful in calculating the relative risk associated with particular bank exposures, it cannot answer the ultimate question of how high minimum capital levels should be. This determination is not a mathematical computation. It necessarily involves a judgment on the optimal trade-off between the benefits of making more bank resources available for investment in productive activities and the costs that will be borne by taxpayers and the economy if banks fail or are rescued through injection of public resources.

Another response to the banking agencies' proposal for capital safeguards under A-IRB has been that the competitiveness of U.S. banks will be adversely affected if large banks from other countries are able to operate under the A-IRB rules without these safeguards. The concern appears to be that the required (and actual) capital levels of foreign banks will decline dramatically, and the resulting lower effective cost of capital will allow those banks to extend credit in international markets at lower interest rates than U.S. banks could profitably offer.

I certainly do not dismiss competitiveness concerns out of hand. As with so much else surrounding Basel II, we cannot say with assurance what will happen. Indeed, the entire Basel exercise has come to look disconcertingly like a leap into the unknown. However, I would make two observations on the competitiveness point.

First, despite the pervasiveness of competitive equality concerns in international capital negotiations, the nature of the relationship between capital requirements and competitiveness is complicated. Today our banks are among both the best capitalized and the most profitable in the world. Higher capital levels signal strength to counterparties, which may then be willing to extend funds at lower risk premiums. Moreover, although academic studies on competitiveness and capital requirements are far from definitive, some work that has been done suggests that national differences in tax, accounting, and other regulatory measures outweigh any leveling achieved by harmonized minimum capital standards.

Second, we do not yet know how Basel II will be administered in other Basel Committee countries – yet another of the significant unanswered questions surrounding the whole process. But if some competitiveness problem does arise because of lax implementation of A-IRB abroad, the solution is not to engage in a matching reduction of regulatory capital. The end result of a fragile international banking system in which everyone is similarly undercapitalized is hardly desirable. We should not become captive to the flaws of the A-IRB approach. The solution instead is to return to the Basel Committee with proposals for fair, effective, and cost-efficient capital requirements that will apply to all internationally active banks. I shall have more to say on this subject in a moment.

Exercise Supervisory Powers to Assure Appropriate Capital Levels and Risk Management. Minimum capital requirements are not, and should not be, the only means by which regulators assure that bank capital levels are appropriately high. Nor are they, or ought they to be, the principal means of risk management. Often lost in the discussion of the minimum capital levels of Basel II are Pillars 2 and 3 of the Revised Framework, which deal with supervision and market discipline, respectively. The United States already has perhaps the strongest tradition in the world of bank *supervision* -- by which I mean a non-rules-based interaction by supervisors with banks to understand their risks and direct them to take appropriate prophylactic or remedial measures.

Some U.S. banking officials have rightly expressed concern that large, complex banking organizations have systems in place that will allow them to recognize and provide for the risks they actually face, as well as to provide supervisors with an accurate picture of the bank's risk profile. They are correct that no relatively simple set of minimum capital rules will account for all such risks. But, of course, neither will the flawed A-IRB approach. Indeed, that approach would require large compliance expenditures that could better be spent on risk-management systems tailored to the circumstances of each bank.

If large U.S. banks choose to adopt the standardized approach to minimum capital requirements under Basel II, there is nothing to prevent their primary federal regulators from requiring those banks to establish and maintain sophisticated internal credit risk modeling systems. To the contrary, I would encourage them to do just that.

This initiative would be a natural extension of existing U.S. supervisory practice and the principles enunciated in Pillar 2, but in a way that converges more closely with expenditures and practices that banks will undertake for business reasons in any case. It would also build on the progress that both banks and supervisors say has been made in credit risk systems as a result of work prompted by the Basel II process. Supervision by banking agencies can promote further improvement of those systems and facilitate suitable supervisory responses, but without the skewed incentives that are created when a bank's internal system becomes the basis for determining its minimum capital levels.

Pursue Alternatives to Basel II. The last thing many Basel Committee members want to do is return to negotiations over international capital standards. Understandable as that sentiment may be, I would nonetheless urge our banking agencies to use the breathing space created by adoption and implementing regulations for Basel II to pursue alternatives, both domestically and internationally. The problems with the A-IRB approach more than justify this response. At this juncture, the most promising approach may be a relatively simple international minimum capital rule, accompanied by complementary domestic measures for achieving appropriate bank risk management and by enhanced international cooperation in supervising complex multinational banks.

Specifically, I would suggest that the banking agencies raise with the Basel Committee the idea of an international minimum leverage ratio. As you know, the U.S. leverage ratio requirement is unusual within international banking regulation. On the one hand, as a very simple rule, it cannot be relied on to counteract some of the complicated risks assumed by modern banking organizations. Indeed, it does not even purport to be risk-weighted. But, because of its very simplicity, it is far more transparent in its application, and far less easy to manipulate than more complex regulatory capital requirements. It can serve, as it does today in the United States, as a useful warning sign to regulators and markets. Its application could be fairly easily monitored, domestically and internationally.[4] It would, in short, be a straightforward, uniformly applied minimum capital standard.

The current U.S. leverage ratio does not take off-balance-sheet assets into account and thus should be modified before adoption as an international rule. Other changes might also be worthwhile. But the goal would remain a simple rule.

This would not, and could not, be the extent of capital regulation and oversight, either domestically or internationally. I have already suggested one potential complementary mechanism for large, complex banking organizations. Additional supervisory measures could also be developed. It is possible that, over time, some form of an A-IRB or internal credit models approach would itself be a feasible complement. Market discipline might more readily be harnessed to promote regulatory ends. My aim

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[4] The question of what should count as bank capital, whatever capital ratios apply, remains an important one that has been ignored in Basel II.

here is not to lay out the results of the international consultative process, but to urge that it be recommenced, with a view to a negotiated arrangement at some later date.

Conclusion

When I began my academic work on Basel II, I was principally interested in some of the unique features of the Basel Committee as an international arrangement. Yet the more I studied it, the more concerned I became that the A-IRB methodology was neither a good approach to domestic regulation of large banks nor a good basis for an international banking arrangement. We could reconvene here each fall for the rest of the decade and, I suspect, our concerns and uncertainties would remain.

But this is not an academic exercise. Our supervisors must regulate and our banks must be allowed to get on with the business of banking. We cannot turn back the clock and start over.

The proposal offered by the four large banks to permit a choice between the standardized and internal-ratings based approaches to Basel II is the best suggestion I have heard for moving the process forward without endangering our healthy and profitable banking system. We should not allow regulatory capital levels to fall significantly – hence the need for capital safeguards. At the same time, we should not force banks to spend large sums on ultimately unhelpful regulatory requirements.

I cannot endorse the additional request by some banks to remove the capital safeguards in the banking agencies' Notice of Proposed Rulemaking. However, I believe that there is, despite recent appearances to the contrary, substantial room for a convergence of positions on a long-term approach to capital regulation. Adoption of the four-part plan of action I have put forward here would not only break the immediate impasse; it would also, I hope, create some momentum towards that longer-term solution.

Thank you for your attention. I would be pleased to answer any questions you might have.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM JOHN C. DUGAN

Q.1.a. Your agency had previously decided that Basel II banks would be allowed to use only the Advanced Approach. Why did your agency originally decide *not* to allow banks to use the Standardized approach?

A.1.a. In the United States, the Agencies chose not to subject all US. banks to Basel II, but instead to focus on only the largest and most internationally active banks. There were four primary reasons for not subjecting all U.S. banks to mandatory application of Basel II, which by definition was designed for applicability to internationally active banks. First, a very large number of U.S. banks, particularly smaller institutions, maintain capital well above any regulatory minimums or PCA requirements, and changes to risk-based capital rules for these institutions impose a regulatory burden in exchange for very little, if any, supervisory benefit. We have heard this message repeatedly from the industry in response to earlier regulatory capital proposals. Second, in our assessment, Basel II's Standardized Approach for credit risk offers only marginal improvements in risk sensitivity. Perhaps the most significant improvement in the Standardized Approach is the introduction of rules to capture the risks of securitizations, which is notably absent from the 1988 Accord, but which the United States has had in place for many years. Consequently, the relative improvement in the Standardized Approach versus current rules is much less in the United States than in many Basel Committee member countries. Third, the Standardized Approach to credit risk was calibrated on the premise of an accompanying charge for operational risk. The OCC remains strongly opposed to a specific charge for operational risk for most U.S. banks, which have neither the ability nor the need to measure operational risk under the Advanced Measurement Approaches. Finally, because some of the changes in Basel II, such as charges for securitizations or operational risk, result in capital charges where none previously existed in some countries, the Basel Committee was under great pressure to make compromises to ease the burden on countries adopting new charges for the first time. That resulted in risk weights for some specific exposure types, such as, for example, retail and small business exposures, that we believe are inappropriately low.

In contrast to the simpler approaches of Basel II, the Agencies believed that the advanced methodologies—that is, the Advanced Internal Ratings Based (AIRB) and Advanced Measurement Approach (AMA)—were the most appropriate approaches for calculating credit and operational risk capital requirements for the largest and most complex internationally active U.S. banks.

We proposed that the largest banks be required to use the Advanced Approaches for the following reasons: (1) the Advanced Approaches are the most consistent with—although certainly not identical to—large bank practices in the areas of risk management and risk measurement, and (2) the risks that large banks take warrant the application of more advanced risk measurement and management techniques to better ensure the safety and soundness of these institutions.

Q.1.b. Why have you now decided to re-evaluate this decision?

A.1.b. Prior to the official U.S. publication of the Basel II notice of proposed rulemaking (NPR) the Agencies received comments from numerous interested parties requesting additional options for Basel II implementation. These requests most often cited competitive equity issues, especially in an international context. We have been and remain concerned about competitive equity issues raised by the implementation of Basel II, and because these unsolicited comments clearly generated a great deal of interest in the industry, we felt it appropriate to specifically solicit a wider range of comment on this particular issue.

Q.1.c. What factors will you consider when deciding whether to allow banks to use the Standardized Approach? Given that Fed Chairman Ben Bernanke during his last appearance before the Banking Committee expressed concerns about whether the Standardized Approach is appropriate for large, global banks, is the Standardized Approach a realistic alternative for our biggest banks?

A.1.c. Like Chairman Bernanke, we question whether the Standardized Approach would be appropriate for the largest and most sophisticated banks. Nonetheless, as noted above, we are open to comments on that question. Ultimately, a decision whether or not to provide the largest and most sophisticated U.S. banks with the option of the Standardized Approach will depend on further analysis of the extent to which U.S. banks' competitors are likely to use that approach, and more importantly, whether it can in fact provide an appropriate measure of capital adequacy at the most sophisticated banks we supervise.

Q.2. The Basel II NPR has been criticized by several banks because it deviates from the international Basel II accord by imposing floors on the amount capital can fall. As a result, some banks maintain that the Basel II NPR would not be cost effective for them to adopt.

A.2. The Basel Committee's June 2004 publication (the "New Accord" or "Basel II") includes transitional floors on the amount that an individual bank's minimum required capital can fall in each of the first two years of implementation. The U.S. NPR also incorporated temporary floors on the amount capital may fall, with a three-year transitional period. In addition to lengthening the transitional period by one year, the Agencies modified the floor calculation in a way that made the floor a more effective measure than the calculation contained in the New Accord. We did so because of the safety and soundness concerns that arose as the result of our fourth quantitative impact study (QIS–4), where we saw significant dispersion and drops in capital requirements. Authorities in several other countries do not anticipate similar reductions in required capital under Basel II. Because the underlying calculations of the Basel II capital requirements are generally not affected by these broad, bank-level and system-wide floors, it is not clear how the removal of the U.S.-specific floors would make the U.S. implementation more cost effective (apart from the fact that the level of required capital would be decreased). We believe that the underlying calculations of the U.S. NPR are entirely consistent with both the international implementation of Basel II and with bank risk management practices, and that the U.S. deviations from the Basel II Framework reflect a prudent approach to implementation in the United States.

Q.2.a. Do you believe that these concerns about the costs of Basel II as set forth in the NPR are justified?

A.2.a. We believe these concerns may be overstated. They focus only on the perceived private "benefit" of a reduction in required capital for individual Basel II banks, and ignore other legitimate public policy considerations. It may be natural that banks would prefer not to incur costs that do not result in a direct benefit to the bank or its shareholders. It is also fair to say that some banks believe a more risk-sensitive regulatory capital regime should lower their capital requirements—in some cases, lower than we will allow under Basel II. While we recognize the significant expenditures required of banks (and tried to limit these costs by designing Basel II requirements to reflect existing risk management systems and processes to the extent possible) these costs must be weighed against the benefits of greater safety and soundness of the banking system, which, by their nature, are much more difficult to quantify. Ultimately, decisions about capital regulations cannot be based on bank-by-bank evaluations of costs and benefits or "cost effectiveness," since much of the benefit may not accrue to individual banks. However, as with all aspects of this proposal, we are interested in hearing the views of all interested parties on the cost-benefit tradeoffs.

Q.2.b. Could you please give us a comparison of the estimated costs to implement Basel II versus the expected benefits of Basel II for a typical bank?

A.2.b. The OCC considered the costs and benefits to implement Basel II as part of our regulatory impact analysis. Our analysis of the proposed rule identified the following potential benefits, some of which accrue to individual banks, others to the banking system or to the public more generally.

1. Better allocation of capital and reduced impact of moral hazard through a reduction in the scope for regulatory arbitrage.
2. Improves the capital measure as an indicator of capital adequacy.
3. Encourages banking organizations to improve credit risk management.
4. More efficient use of required bank capital.
5. Incorporates and encourages advances in risk measurement and risk management.
6. Recognizes new developments and accommodates continuing innovation in financial products by focusing on risk.
7. Better aligns capital and operational risk and encourages banking organizations to mitigate operational risk.
8. Provides for enhanced supervisory feedback.
9. Enhanced disclosure promotes market discipline.
10. Preserves the benefits of international consistency and coordination achieved with the 1988 Basel Accord.

11. The ability to opt in offers long-term flexibility to nonmandatory banking organizations.

As for costs, because banking organizations are constantly developing programs and systems to improve how they measure and manage risk, it is often difficult to distinguish between expenditures explicitly caused by adoption of the proposed rule and costs that would have occurred irrespective of any new regulation. Nevertheless, we included several questions related to compliance costs in QIS–4. Based on figures supplied by 19 QIS–4 respondents (out of 26 total QIS–4 participating banks) that provided estimates of their implementation costs, we estimate that organizations will spend roughly $42 million on average to adopt the proposed rule. We expect to receive additional information on implementation costs in the NPR comment process.

Q.2.c. What impact will the deviations from the international Basel II accord have on the global competitiveness of U.S. banks?

A.2.c. Our intent is to have a regulatory capital framework that enhances the safety and soundness of the U.S. banking system without compromising its competitiveness, either internationally or domestically. Data show that large U.S. banks have more capital and are more profitable than their European Union counterparts, so it is clear that strong capital positions can be fully consistent with strong performance and profitability. We do not believe that there is a trade-off between safety and soundness and competitiveness. In particular, we have not yet seen evidence that the absence of the option of the Standardized Approach for U.S. mandatory Basel II banks will impair their ability to compete with their foreign counterparts. Large U.S. banks and almost all large foreign banks would be using the Advanced Approaches. Our understanding is that the largest foreign banks plan on using the Advanced Approaches, even though many of them technically have the option of using the less sophisticated Standardized Approach. While there are certainly differences in how these Advanced Approaches are being implemented in the United States, many of these differences are temporary. For example, the biggest difference is that the U.S. proposal has a limit on the amount that capital requirements may drop during the first three years of implementation. We felt this was needed to ensure that safety and soundness is not compromised. There are other technical differences as well, and we will use the comment process to further evaluate these.

While harmonization of regulatory capital rules will advance the goal of a level playing field, there are limits to how much consistency we can achieve on an international basis due to differences in accounting regimes and significant differences in the process of bank supervision. However, even with existing differences, including difference in capital requirements, U.S. banks are extremely competitive internationally.

Q.3. Are banks presently over-capitalized? Please explain how you arrive at your conclusion.

A.3. We do not believe that the U.S. banking system is overcapitalized. Various independent indicators of bank soundness—such as bank failure rates, external ratings of debt issued by banking institutions, and credit spreads on bank debt—are reasonably aligned with historical norms for the U.S.; they are neither especially high nor especially low. These indicators suggest that, at least in very broad terms, both market forces and regulatory requirements are achieving appropriate levels of bank capital. However, we believe that the current regulatory capital regimes need improvements to better reflect risks that banks are taking. Basel II does that for the most sophisticated U.S. banks, and through the Basel IA NPR we are exploring improvements in the risk-based capital rules that might apply to other banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM JOHN C. DUGAN

Q.1. What is the ratio of tangible equity to assets at the 15 largest bank holding companies? Would it be appropriate to allow this ratio to drop substantially? What floor if any would you place under this ratio? Should it go below 5%?

A.1.

TABLE 1. CAPITAL RATIOS FOR LARGE U.S.-OWNED BANK HOLDING COMPANIES JUNE 30, 2006

BHC Name	Tier I Leverage Ratio (%)*	Tangible Equity Ratio (%)**
Citigroup	5.19	4.56
Bank of America Corp.	6.13	3.73
JPMorgan Chase	5.85	4.60
Wachovia	6.57	4.59
Wells Fargo	6.99	6.29
U.S. Bancorp	8.23	5.52
Countrywide Financial	6.96	7.04
Suntrust Banks	6.82	5.88
National City	6.89	6.66
BB&T	7.26	5.50
Bank of New York	6.22	4.99
Fifth Third	8.38	6.94
State Street	5.46	4.39
PNC Financial	7.71	5.24
Keycorp	8.82	6.71

*Tier 1 Leverage ratio equals regulatory tier 1 capital divided by average total assets.
**Tangible Equity ratio equals GAAP equity, less intangibles (except mortgage servicing assets that have an identifiable stream of income) divided by average total assets.

The OCC has no intention of allowing bank capital requirements to drop precipitously. Our experiences in the late 1980s and early 1990s, and the role that capital played in the subsequent resurgence of the industry's survivors, reinforce our belief in strong capital. Moreover, the leverage ratio is a crucial element of our current regulatory capital and prompt corrective action frameworks, and has coexisted with the risk-based regime for many years now. We are not proposing any changes to the leverage ratio requirements.

Q.2. We have been led to believe that the goodwill and other intangibles represent roughly one-third of the U.S. industry's equity. Is that correct?

A.2. In June 2006, there were 7,559 insured commercial banks. In the aggregate, the ratio of these banks' intangible assets to equity was 30.5 percent. Note that, in forming a bank's tier 1 ratio for regulatory capital purposes under 12 CFR Part 3, the largest portion of these intangibles (*i.e.,* goodwill and core deposit intangibles) are deducted from the measured amount of tier 1 capital. Thus, the Agencies, in effect, assign a dollar-for-dollar requirement on these intangibles. Because the regulatory measure of the tier 1 capital ratio deducts these intangibles first, before dividing by assets, we are confident that the measured ratios reflect a sound regulatory standard.

Q.3. At this point, only the U.S. and Canada have minimum leverage ratio requirements. Should U.S. bank regulatory agencies be comfortable with an international system for bank capital that does not impose such requirements in other countries? With the subjectivity involved with the Advanced Approach of Basel II, does this lack of a leverage ratio requirement concern you from the perspective of international financial stability?

A.3. The issue of an international leverage ratio is currently being discussed internationally. From these discussions it appears that other countries use tools other than a leverage ratio to provide a capital cushion. The Basel Committee's Accord Implementation Group has surveyed the countries that participate on the Basel Committee to determine what other mechanisms are being used to ensure capital adequacy above the regulatory minimums.

Q.4. The Standardized Approach would (1) be less costly than the Advanced Approach for both banks and agencies, (2) be less likely to substantially reduce capital requirements, and (3) have a lower chance of opening competitive disparities between U.S. banks of different sizes. Under these circumstances, why should the agencies not allow such an approach for any U.S. bank?

A.4. The Standardized Approach and the Advanced Internal Ratings-Based Approach (AIRB) share a primary goal—improved risk sensitivity in the risk-based capital regime. The crucial distinguishing factor between the two efforts turns on (1) the need for improved measurement and management of complex risks in the largest banks, and (2) the need to avoid both complexity and expense in the Standardized Approach to the maximum extent possible. AIRB is designed for the systems that very large, complex organizations should be capable of building and can afford to develop and operate.

In our assessment, Basel II's Standardized Approach for credit risk offers only marginal improvements in risk sensitivity for the United States. Perhaps the most significant improvement in the Standardized Approach is the introduction of rules to capture the risks of securitizations, which is notably absent from the 1988 Accord, but which the United States has had in place for many years. Consequently, the relative improvement in the Standardized Approach versus current rules is much less in the United States than in many Basel Committee member countries. Moreover, the Standardized Approach to credit risk was calibrated on the premise of an accompanying charge for operational risk. The OCC remains strongly opposed to a specific charge for operational risk for most U.S. banks, which have neither the ability nor the need to measure operational risk under the Advanced Measurement Approaches. Finally, because some of the changes in Basel II, such as charges for securitizations or operational risk, result in capital charges where none previously existed in some countries, the Basel Committee was under great pressure to make compromises to ease the burden of countries adopting new charges for the first time. That resulted in risk weights for some specific exposure types, such as, for example, certain retail and small business exposures, that we believe are inappropriately low.

In the Basel II NPR we asked for comment on whether the largest U.S. banks should be given the option of choosing the Standardized Approach and are open to evaluating the responses. Ultimately, a decision whether or not to provide the largest and most sophisticated U.S. banks with the option of the Standardized Approach will depend on further analysis of the extent to which U.S. banks' competitors are likely to use that approach, and more importantly, whether it can in fact provide an appropriate measure of capital adequacy at the most sophisticated banks we supervise.

Q.5.a. The Advanced Approach of Basel II has been touted as addressing safety and soundness concerns related to hidden and undercapitalized risks that large, complex banks now take under the current rules. In the results of QIS–4, what was the aggregate change in minimum risk-based capital requirements for securitized exposures?

A.5.a. The minimum required capital (MRC) for securitization exposures decreased 17.9% from Basel I to Basel II. Note that this change includes all securitization exposures, rather than solely off-balance sheet exposures. As we have noted in other contexts, we have proposed measures in the U.S. Basel II NPR to limit potential declines in regulatory capital during an extended transition period. We also note that for a number of reasons, highlighted in our interagency release of QIS–4 results, the results of QIS–4 should not be considered definitive indicators of expected results upon full implementation of Basel II. Finally, it should be recognized that unlike the United States, many countries currently have no specific framework for securitizations.

Q.5.b. For other off-balance sheet exposures?

A.5.b. The aggregate MRC for other off-balance sheet exposures decreased by 10%.

Q.5.c. If the current rules are insufficient to address these complex risks, is it because they require too much capital, or too little capital?

A.5.c. We believe the current regulatory capital regime needs improvements to better reflect risks that banks are taking. For example, the current Accord assigns a 100 percent risk weight to the large majority of private sector borrowers. This single risk weight assignment is not at all reflective of the true differences in credit risk (i.e., the risk of default) across borrowers. Thus, from a supervisory perspective, the issue is not driven by a portfolio-by-portfolio assessment of whether the current rules require too much or too little capital; the strength of the Advanced Approach is its improved accuracy in the areas of risk management and risk measurement. The improvements in risk measurement—riskier assets will be assigned a higher risk weight, which is more reflective of the risk they pose to the bank—will result in a more risk sensitive bank specific capital requirement.

Q.6. If the goal is to encourage sophisticated risk measurement and management at our largest banks, why can't they be encouraged adequately through pillar 2's supervisory guidance and pillar 3's transparency through public disclosure?

A.6. The Agencies considered requiring large banks to implement advanced risk management systems without tying those requirements to minimum regulatory capital. However, this approach was rejected because of the need to have a more risk sensitive regulatory capital framework that: (a) reflects the sophistication and complexity of modern day risk measurement systems and practices; (b) more closely aligns regulatory capital with actual risk taking; and (c) provides appropriate recognition to credit risk mitigation techniques in order to provide an incentive for risk mitigation behavior and pro-active risk management on the part of banks. In addition, Basel II is expected to greatly facilitate the use of a common set of credit-risk measurement metrics that will enhance the ability of the OCC and other regulators to conduct benchmarking and early warning analysis across the population of large complex banks.

Q.7. If the mandatory banks operate under the Advanced Approach and other banks operate under Basel IA, how much do you expect capital requirements to change on average for the two groups of banks? Will that affect the competitive position of banks not using the Basel II Advanced Approach?

A.7. As a general matter, the OCC does not believe that the U.S. implementation of the Basel IA or the Basel II framework will likely result in a material reduction in aggregate minimum required capital. However, the relative impact on minimum capital required for various products and institutions may differ. One concern with any regulatory change is the possibility that it might create a competitive advantage for some organizations relative to others, a possibility that certainly applies to a change with the scope of Basel II.

The OCC has considered various ways in which competitive effects might be manifest, and has examined the limited available evidence related to those potential effects. We reviewed research on the potential impact on competition in the residential mortgage market, in small business lending, and in the credit card market, as well as the potential competitive effects of introducing explicit capital requirements for operational risk. We also reviewed research on the issue of whether Basel II might affect mergers and acquisitions. Overall, this body of recent economic research does not reveal persuasive evidence of any sizeable competitive effects. For many financial products, it is reasonable to think that competitive effects would be limited; capital is one of many factors influencing an institution's ability to offer products competitively. Knowledge of customer needs, knowledge of the risks associated with the product and with the customer, cost of funding, and efficiencies of operation all contribute significantly to an institution's pricing and offering of many products.

Nonetheless, we recognize that a number of banks and industry groups are concerned that banks operating under Basel II might gain a competitive edge over banks not governed by Basel II. One of our motivations for undertaking the Basel IA exercise concurrently with Basel II was to reduce potential competitive effects between large and small U.S. banks by making improvements to the risk sensitivity of the current U.S. capital rules. While we believe that the combination of Basel II and Basel IA will result in limited competitive issues across the U.S. banking sector, we are very interested in industry comment on this issue. To facilitate comment, we plan to have an overlap in the comment periods of the proposals so that interested parties can look at the capital treatments side by side in making their assessment of potential competitive effects.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM SHEILA C. BAIR

Q.1.a. Your agency had previously decided that Basel II banks would be allowed to use only the Advanced Approach. Why did your agency originally decide not to allow banks to use the Standardized Approach?

A.1.a. ,When the banking agencies developed the Basel II ANPR in August 2003, the prevailing view was that only the Advanced Approaches would be appropriate for large, internationally active banks. In our judgment there were three main reasons for this view:

- Only the Advanced Approaches were thought sufficient from a safety and soundness perspective to address large banks' complex risks;
- The largest banks were thought to have robust and accurate internal risk measurements that would provide a suitable basis for capital regulation; and
- Tying regulatory capital to internal models was thought necessary to encourage large banks to develop and refine these models.

Many large banks endorsed these views and encouraged the development of the Advanced Approaches in their comment letters to the Basel II ANPR.

Q.1.b. Why have you now decided to re-evaluate this decision?

A.1.b. the FDIC has decided to re-evaluate this issue because more recent evidence, including the results of the fourth Quantitative Impact Study (QIS–4), casts doubt on the premises for the original decision.

- Absent significant safeguards, the Advanced Approaches could undermine banks' safety and soundness by substantially lowering the bar on capital requirements, including for the most complex risks.
- The robustness and accuracy of internal risk models is in doubt based on wide dispersion in capital requirements for similar or identical exposures.

- Comment is needed on whether tying internal models to regulatory capital would improve or interfere with the evolution of banks' internal capital models for management purposes.

In addition, a number of core banks, industry trade associations, regulators, and other commentators have recently requested that the banking agencies allow banks to compute their regulatory capital using the Standardized Approach contained in the international Basel II framework.

Q.1.c. What factors will you consider when deciding whether to allow banks to use the Standardized Approach? Given that Fed Chairman Ben Bernanke during his last appearance before the Banking Committee expressed concerns about whether the Standardized Approach is appropriate for large, global banks, is the Standardized Approach a realistic alternative for our biggest banks?

A.1.c. The FDIC is open to considering some version of the Standardized Approach as an alternative for any U.S. bank. We will review the comments on this issue with an open mind.

In reaching a decision on whether to allow banks to use the Standardized Approach, we will consider the attributes that need to be present in any regulatory capital system.

- A regulatory capital system must require banks to hold adequate capital to avoid costly draws on the federal banking safety net. The Standardized Approach avoids the potential for substantial reductions in bank capital requirements inherent in the Advanced Approaches.
- A regulatory capital system should avoid undue burden on the banking industry. The Standardized Approach is simpler and less costly to implement than the Advanced Approaches.
- A regulatory capital system should not tilt the playing field in favor of one group of banks over another. The Standardized Approach does not appear to pose the same potential for competitive inequities across banks of different sizes as does the Advanced Approaches.
- A regulatory capital system should not interfere with innovation or the evolution of risk management. Some believe it is necessary to base regulatory capital on internal models in order to encourage sound risk management. The FDIC will be attentive to comments on this point.

There also are a number of more technical issues that would need to be addressed if the banking agencies chose to allow large internationally active banks to use a version of the Standardized Approach. A notable example is the issue of capital requirements for operational risk. The agencies are seeking comment on how to address this and other technical issues with the Standardized Approach as we decide whether it would provide an appropriate framework for capital regulation in the United States.

Q.2.a. The Basel II NPR has been criticized by several banks because it deviates from the international Basel II accord by imposing floors on the amount capital can fall. As a result, some banks maintain that the Basel II NPR would not be cost effective for them to adopt. Do you believe that these concerns about the costs of Basel II as set forth in the NPR are justified? Could you please give us a comparison of the estimated costs to implement Basel II versus the expected benefits of Basel II for a typical bank?

A.2.a. The FDIC believes that the Advanced Approaches of Basel II would be costly for banks to implement. Some evidence on the costs of implementation was provided by banking organizations participating in the QIS–4. As the Office of the Comptroller of the Currency reported in their Regulatory Impact Analysis, the average expected cost reported by the QIS–4 banks for implementing the Basel II rules was approximately $42 million per bank. However, of that $42 million, banks reported that an average of $21 million would likely be spent absent the implementation of Basel II. Therefore, according to QIS–4 data, the incremental cost of implementing Basel II would average $21 million per bank for the 26 banking organizations participating in QIS–4. Additionally, the QIS–4 banks estimated that the recurring annual expense associated with Basel II would average $2.4 million per year per banking organization. More recent information suggests these cost estimates may be understated.

The benefits of Basel II are more difficult to quantify. Some suggest that the "benefit" to banks of the Advanced Approaches is the reduction in capital requirements they would realize. The FDIC does not believe that substantially reducing bank capital standards, as compensation for implementing a costly and burdensome regulatory framework, is wise policy. From a public policy perspective, a substantial reduction in bank capital standards could prove to be simply an increase in the implicit subsidy provided to banks by the federal government.

Another possible source of indirect financial benefits to banks that implement Basel II would be if it reduced their future deposit insurance premiums. Specifically, each bank might benefit indirectly from a more safe and sound banking system, by virtue of not having to pay substantial premiums to cover the cost of resolving problems at a large bank. Whether the Advanced Approaches would in fact enhance the safety and soundness of our banks is a key question, and as outlined above, there are difficult and unanswered questions in this regard.

Q.2.b. What impact will the deviations from the international Basel II accord have on the global competitiveness of U.S. banks?

A.2.b. For 15 years, the U.S. has had in place a dual framework of capital regulation, consisting of risk-based rules and a leverage requirement that capital exceed specified ratios of balance sheet assets. During this 15-year period, U.S. banks have been required to hold more capital than foreign banks. There is no indication that our framework of capital regulation has hurt the competitive position of U.S. banks. Quite the contrary, our dual framework of capital regulation has supported the safety, soundness, and resilience of the U.S. banking system. Our banks enjoy not only strong capital but high profitability, and there is no evidence that our capital framework has constrained banks' ability to extend credit.

Going forward, the Advanced Approaches of Basel II clearly point to reductions in risk-based capital requirements. The U.S. has proposed safeguards to ensure that such reductions are moderate and consistent with explicit goals stated in the international Basel II agreement. Other Basel Committee countries have no explicit mechanisms to constrain the potential reductions in their banks' capital requirements. This opens up the possibility of reductions in capital requirements for their banks far in excess of what was contemplated in the international agreement.

This difference in posture is consistent with long-held U.S. views on the importance of a strong private sector banking system that does not become a source of economic or fiscal weakness through over reliance on implicit or explicit safety net supports. We believe the U.S. approach will ensure that strong capital will remain a competitive strength of the U.S. banking system, as it has been in the past.

Q.3. Are banks presently overcapitalized? Please explain how you arrive at your conclusion.

A.3. No, we do not believe that U.S. banks are overcapitalized.

The level of capital at U.S. banks should be evaluated from at least three perspectives: their ability to prosper and compete; their ability to provide credit to fund economic growth; and the government's interest in avoiding costly draws on the federal banking safety net. The FDIC does not believe banks are overcapitalized by any of these standards.

During the 10-year period 1995–2005, FDIC-insured banks' growth in loans, assets, and net income significantly outpaced the growth of the broader economy (see table below). Insured banks have had record profits in 13 of the last 14 years, topped by the most recent net income of $134 billion in 2005. This suggests that capital levels have not hindered banks' ability to prosper and compete or their ability to extend credit to fund economic growth. :

TABLE A. BANK GROWTH AND PROFITABILITY OUTPACE THE BROADER ECONOMY

[Average annual percent growth in nominal dollars, 1995–2005]

FDIC-insured institutions			U.S. economy
Assets	Loans	Net income	GDP
7.5%	7.5%	9.1%	5.3%

Source: Calculations are based on information from FDIC "Statistics on Banking" (http://www2.fdic.gov/SDI/SOB/) and data compiled by the Bureau of Economic Analysis.

The FDIC also does not believe banks are overcapitalized from a safety net protection standpoint. While current industry capital is adequate, substantial reductions in that capital would not be prudent from a safety and soundness perspective. Capital serves an important shock absorber function by ensuring that unforeseen economic events, significant errors in model assumptions or accounting methodologies, or other undetected problems do not cause serious problems for banks. Banking problems, especially at our largest and most systemically important banks, can impose costs on the broader economy and financial system, on the deposit insurance funds, and on the fiscal position of the U.S. government. Appropriate levels of bank capital need to reflect the government's interest in avoiding such costs.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM SHEILA C. BAIR

Q.1. What is the ratio of tangible equity to assets at the 15 largest bank holding companies? Would it be appropriate to allow this ratio to drop substantially? What floor, if any, would you place under this ratio? Should it go below 5%?

A.1. The weighted average ratio of tangible Tier 1 equity capital to assets for the 15 largest bank holding companies was 4.66 percent as of June 30, 2006.[1]

While we believe current industry capital is adequate, the FDIC does not believe substantial reductions in that capital would be prudent from a safety and soundness perspective. Our experience with insured banks is that as core capital measures begin to fall, the margin for error for both banks and supervisors can narrow dramatically. The lower a bank's capital relative to its overall volume of business as measured by assets, the greater the likelihood that unforeseen economic events, significant errors in model assumptions or accounting methodologies, or other undetected problems might create serious problems for the bank. For a large, systemically important bank, such problems could have important spillover costs for the broader economy, the deposit insurance funds, or the fiscal posture of the United States.

It is therefore appropriate that the agencies have established floors for certain core capital ratios and that these floors strictly limit the type and amount of intangible assets that banks can include in regulatory capital. For example, to be considered well-capitalized, insured banks must maintain a ratio of Tier 1 capital to assets of at least 5 percent. Tier 1 capital excludes goodwill, the banking industry's most significant intangible asset by dollar volume.

Since this question pertains specifically to bank holding companies, it is important to note that bank holding companies have different regulatory capital standards than do insured banks. This includes a less conservative definition of Tier 1 capital and lower requirements for the leverage ratio. Also, statutory Prompt Corrective Action applies to insured banks, not bank holding companies. The FDIC does not have any safety and soundness concern with the current regulatory and supervisory framework for bank holding companies.

Q.2. We have been led to believe that the goodwill and other intangibles represent roughly one-third of the U.S. industry's equity. Is that correct?

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[1] This number was calculated using the "Tangible tier 1 leverage ratios" as reported on in the Federal Reserve's Bank Holding Company Performance Report (BHCPR) for each of the top 15 bank holding companies. In the BHCPR user's guide, the Federal Reserve defines "Tangible tier 1 leverage ratio" as "Tier 1 capital, net of intangible assets, divided by average assets for the latest quarter, net of intangible assets." This number does not include mortgage servicing assets, which are intangible assets that may be included in the Tangible equity ratios of insured depository institutions, subject to certain limitations. The User's Guide for the Bank Holding Company Performance Report can be found at *http://www.federalreserve.gov/boarddocs/supmanual/bhcpr_03-05_total_access.pdf.* The largest 15 bank holding companies were determined using the FFIEC list of the largest bank holding companies, which can be found at *http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx.* This list includes both domestic and foreign-owned bank holding companies operating in the United States.

A.2. For all FDIC-insured institutions, about one-third of GAAP equity is composed of goodwill and other intangibles, as illustrated below.

TABLE B. ABOUT ONE-THIRD OF GAAP EQUITY IS COMPOSED OF GOODWILL AND OTHER INTANGIBLES

[All FDIC-Insured Institutions, June 30, 2006]

		Percent of equity
Total Equity Capital ($ millions)	$1,183,807	
Goodwill	280,889	23.7%
Other Intangible Assets	109,536	9.3%
Total Percent of Goodwill and Other Intangible Assets		33.0%

Source: FFIEC Quarterly Reports of Condition and Income.

It is important to note that these intangibles make up a much smaller proportion of regulatory capital, since regulatory capital does not include goodwill and imposes limits on the amount of other intangible assets that can be counted as regulatory capital. For FDIC-insured institutions, 9.43 percent of Tier 1 capital is composed of intangibles.

Q.3. At this point, only the U.S. and Canada have minimum leverage ratio requirements. Should U.S. bank regulatory agencies be comfortable with an international system for bank capital that does not impose such requirements in other countries? With the subjectivity involved with the Advanced Approach of Basel II, does this lack of a leverage ratio requirement concern you from the perspective of international financial stability?

A.3. The FDIC is concerned about the lack of explicit mechanisms in other Basel Committee countries to constrain potentially substantial reductions in bank capital requirements. Therefore, the FDIC supports the idea of an international leverage ratio. A simple capital to assets measure is a critically important complement to risk-based capital regulations. The leverage ratio provides U.S. supervisors with comfort that banks will maintain a stable base of capital in good times and in bad times. The establishment of an international leverage ratio would go far in strengthening the soundness and stability of the international banking system and would help to ensure that differences in capital requirements do not lead to competitive inequality among internationally active banks.

In addition, because the Advanced Approaches of Basel II clearly point to reductions in risk-based capital requirements, the U.S. has proposed safeguards to ensure that such reductions are moderate and consistent with explicit goals stated in the international Basel II agreement. Most other Basel Committee countries have no explicit mechanisms to constrain the potential reductions in their banks' capital requirements. This creates the possibility of reductions in capital requirements for their banks far in excess of what was contemplated in the international agreement.

Our analysis suggests that reductions in bank capital requirements under the Advanced Approaches could be more pronounced, by a large margin, than has been reported in any of the recent quantitative impact studies. There also is a large and possibly irreducible element of subjectivity in how banks and supervisors will calculate and validate those capital requirements.

A substantial reduction in bank capital requirements worldwide would increase the likelihood of problems in the global banking system and financial instability. In an increasingly world-wide economic and financial marketplace, the U.S. economy and banking system could not expect to be insulated from problems in the global banking system.

Q.4. The Standardized Approach would (1) be less costly than the Advanced Approach for both banks and agencies, (2) be less likely to substantially reduce capital requirements, and (3) have a lower chance of opening competitive disparities between U.S. banks of different sizes. Under these circumstances, why should the agencies not allow such an approach for any U.S. bank?

A.4. The agencies have sought comment on allowing the Standardized Approach for any U.S. bank. As noted in the question, there are a number of attractive features of the Standardized Approach as compared with the Advanced Approaches. We also are aware of the argument that only the Advanced Approaches would adequately encourage the development of risk management systems at large banks. The FDIC will review the comments on the availability of the Standardized Approach with an open mind.

Q.5.a. The Advanced Approach of Basel II has been touted as addressing safety and soundness concerns related to hidden and undercapitalized risks that large, complex banks now take under the current rules. In the results of QIS–4, what was the aggregate change in minimum risk-based capital requirements: For securitized exposures?

A.5.a. Observers of the Basel II process frequently point to securitization as an example of a regulatory capital loophole not adequately addressed under current rules. However, the Advanced Approaches would result in lower capital requirements for these exposures. According to QIS–4 data, minimum required capital under the Advanced Approaches would fall by approximately 17.9 percent for securitization exposures.

Q.5.b. For other off-balance sheet exposures?

A.5.b. The QIS–4 exercise suggested that participating banks' aggregate capital requirement for off-balance sheet exposures would decline by about 10 percent compared to the current rules. The QIS–4 data reflected a total decline in capital requirements for off-balance sheet exposures, despite showing a significant increase in the capital requirements for over-the-counter (OTC) derivatives. However, subsequent to the requirements for over-the-counter (OTC) derivatives. However, subsequent to the completion of QIS–4, regulators added to Basel II the expected positive exposure method for computing capital requirements for OTC derivatives. Recent evidence suggests that when this new methodology is in place, capital requirements for OTC derivatives would fall substantially.

Q.5.c. If the current rules are insufficient to address these complex risks, is it because they require too much capital, or too little capital?

A.5.c. A frequent criticism of current risk-based capital rules is that they are "insufficient" to address complex risks. It is not generally understood, however, that the current rules require, in aggregate, substantially more capital for the complex risks undertaken by large banks than would be required under the Advanced Approaches of Basel II.

Q.6. If the goal is to encourage sophisticated risk measurement and management at our largest banks, why can't they be encouraged adequately through pillar 2's supervisory guidance and pillar 3's transparency through public disclosure?

A.6. Large banks measure and manage risk for their own internal management purposes and supervisors are actively engaged in the review of these processes. Banks make a substantial volume of risk-related disclosures in reports filed with both the Securities and Exchange Commission and the federal banking agencies. There is a case to be made that bank risk measurement systems would evolve satisfactorily using the current system of supervisory review and market disclosures without tying regulatory capital to these systems. Others believe that the lack of an explicit regulatory capital calculation based on banks' internal credit risk estimates would be detrimental to the long-term evolution of risk-management. This will be an important issue to resolve, and the FDIC will view the comments with an open mind.

Q.7. If the mandatory banks operate under the Advanced Approach and other banks operate under Basel IA, how much do you expect capital requirements to change on average for the two groups of banks? Will that affect the competitive position of banks not using the Basel II Advanced Approach?

A.7. Risk-based capital requirements under Basel II's Advanced Approaches would probably be much lower than would be available under Basel 1A, as indicated below.

TABLE C. CREDIT RISK WEIGHTS WOULD FAVOR BASEL II ADOPTERS

Exposure type	Risk weights based on:	
	Basel II ANPR (%)	Basel II advanced QIS–4 (median) (%)
Small business loans:		
Retail	100	61
Other	100	74
Commercial real estate:		
High volatility	100	70
Other	100	48
Other commercial	100	47
Typical 1–4 residential mortgage	35	16
Typical home equity loan	100	19
Credit cards	100	117
Other retail loans	100	56
AAA-rated Fannie or Freddie MBS	20	7

Source: Summary Findings of the Fourth Quantitiative Impact Study and additional calculations.

Notes: Advanced Approaches median risk weights come from Summary Findings of the Fourth Quantitative Impact Study. Tables B and C. The 7 percent risk weight on Fannie Mae and Freddie Mac mortgage-backed securities is based on the Basel II NPR proposals. Advanced Approaches capital requirements for credit cards are likely understated in this table because of the large importance of capital requirements for undrawn lines, requirements that are not present in the Basel IA ANPR.

Community banks are steadily losing market share in certain retail lending businesses that are becoming commoditized. For example, residential mortgage loans, auto loans, and other consumer revolving credit are becoming scale businesses that are increasingly dominated by the largest lenders. Community banks have responded by concentrating increasingly on small business lending—often the loans are secured by commercial real estate.

Thus far, the competitive fortunes of banks of different sizes have been driven by the economics of the various businesses and not by differences in capital requirements. There is no precedent, however, for large differences in capital requirements across U.S. banks such as those illustrated above. While the competitive effects of these large differences in capital requirements are unclear, the potential exists for such differences to cause industry consolidation to accelerate.

The FDIC believes the capital rules for large and small banks need to be decided together. One of our important goals for any overall package of regulatory capital changes is to avoid tilting the competitive playing field substantially in favor of one group of banks over another.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM SUSAN S. BIES

Q.1. Your Agency had previously decided that Basel II banks would be allowed to use only the Advanced Approach. Why did your agency originally decide not to use the Standardized Approach? Why have you now decided to re-evaluate this decision? What factors will you consider when deciding whether to allow banks to use the Standardized Approach? Given that Fed Chairman Ben Bernanke during his last appearance before this committee expressed concerns about whether the Standardized approach is appropriate for large, global banks, is the Standardized approach a realistic alternative for our biggest banks?

A.1. In the August 2003 Basel II Advance Notice of Proposed Rulemaking (ANPR), the U.S. banking agencies (Agencies) proposed (i) to require only the largest, most internationally active U.S. banking organizations to adopt Basel II and (ii) to mandate that the largest, most internationally active U.S. banking organizations adopt Basel II's advanced internal ratings-based approach to credit risk and advanced measurement approaches to operational risk. The Agencies decided to take this limited approach to U.S. implementation of Basel II because the Agencies felt the Basel II approaches would be too burdensome for most smaller U.S. banks, and that the Basel II Standardized Approach would be insufficiently risk sensitive for the largest, most complex U.S. banks. The comments on the ANPR generally did not criticize the Agencies for failing to make available to U.S. banking organizations the simpler approaches of Basel II, nor did those comments advocate making the Standardized Approach available to U.S. banks.

Further, the Agencies indicated in October 2005 that they would make amendments to the existing Basel I-based capital rule to make it more risk sensitive and to reduce potential competitive impacts from Basel II. This revised version of Basel I is now popularly known as Basel IA. The NPR for Basel IA was just approved by all the agencies for release for comments. Basel IA is intended to apply to all U.S. banks that do not use Basel II and gives banks a choice to stay on Basel I or adopt a slightly more risk sensitive option.

In the spring and summer of 2006, the Agencies received comment letters from a number of banks, trade associations, and other interested parties that requested that the Agencies consider the merits of allowing all U.S. banking organizations to use the simpler approaches available in Basel II. Because of the significant interest in the Basel II Standardized Approaches, the Agencies requested further comment in the Basel II NPR and Basel IA NPR on whether and, if so, how the Basel II Standardized Approaches might be applied in the United States. The Agencies continue to consider this issue and will carefully consider public input on this question.

Chairman Bernanke has indicated his concern that the Basel II Standardized Approach would not appropriately reflect the risks that large, complex, internationally active banks take. In designing the Basel II Advanced Approaches, banking supervisors sought to improve the risk sensitivity of our risk-based regulatory capital framework, remove opportunities for banks to conduct regulatory capital arbitrage, improve supervisors' ability to evaluate a bank's capital adequacy, improve market discipline on banks, and ultimately enhance the safety and soundness of the banking system. These objectives cannot fully be met with the Basel II Standardized Approach.

The Basel II Standardized Approach was designed for small, noncomplex, and primarily domestic banking institutions and is somewhat more risk sensitive than Basel I. It was intended to be used in those countries where, after the implementation of Basel II, Basel I would no longer be available. In contrast, the U.S. Agencies have not expected to eliminate Basel I-based rules for most of our banks and have not heretofore considered the Basel II Standardized Approach as an option for U.S. banks because of the additional costs and only marginal benefits expected.

In deciding whether to allow our large, internationally active banks to use the Basel II Standardized Approach, the Agencies will have to carefully weigh the advantages and disadvantages of doing so. The disadvantages of Basel II standardized include (i) limited risk sensitivity—for example, first lien mortgage loans would generally be assigned a 35 percent risk weight, other retail loans would generally get a 75 percent risk weight, and unrated corporate loans generally would get a 100 percent risk weight, in each case regardless of the creditworthiness of the borrower; and (ii) lack of meaningful connection between capital regulation and risk management.

Q.2. The Basel II NPR has been criticized by several banks because it deviates from the international Basel II accord by imposing floors on the amount capital can fall. As a result, some banks maintain that the Basel II NPR would not be cost effective for them to adopt. Do you believe that these concerns about the costs of Basel II as set forth in the NPR are justified? Could you please give us a comparison of the estimated costs to implement Basel II versus the expected benefits of Basel II for a typical bank? What impact will the deviations from the international Basel H accord have on the global competitiveness of U.S. banks?

A.2. The NPR contains a summary discussion of the costs and benefits of Basel II as part of 'the Executive Order 12866 requirement. In particular, it notes that cost and benefit analysis of changes in regulatory capital requirements entails considerable measurement problems. On the cost side, it can be difficult to attribute particular expenditures incurred by institutions to the costs of implementation because banking organizations would likely incur some of these costs anyway as part of their ongoing efforts to improve risk measurement and management systems. On the benefits side, measurement problems are even greater because the benefits of the proposal are more qualitative than quantitative and as is the case with many regulations, the benefits accrue to the U.S. society in terms of a healthier financial system and better risk management at our largest banking institutions. Measurement problems exist even with an apparently measurable benefit like lower regulatory capital requirements because lower regulatory capital requirements do not necessarily mean that a bank's actual capital will fall. Healthy banking organizations generally hold an amount of capital well above regulatory minimums for a variety of reasons, and the effect of reducing the regulatory minimum is uncertain and may vary across institutions.

Among the expected benefits of Basel II are enhanced risk sensitivity (resulting in more efficient use of regulatory capital by banks and a reduction in the scope for regulatory capital arbitrage); a closer relationship between capital regulation and bank internal risk measurement and risk management processes; enhanced ability of the regulatory capital framework to incorporate future product innovation and future advances in risk measurement and risk management; and enhanced capacity for supervisory feedback and improved market discipline. All of these benefits would strengthen the safety and soundness of the banking organizations subject to the Basel II NPR and of the U.S. financial system as a whole.

As noted in the Basel II NPR, based on estimates provided by those institutions that responded to the QIS–4 question on cost, on average, a banking organization would spend approximately $42 million to adapt to capital requirements implementing the Advanced Approaches in Basel II. Not all of those respondents are likely mandatory institutions. Responses further indicated that roughly half of organizations' Basel II expenditures would have been spent on improving risk management anyway. These numbers should be viewed only as very rough estimates since not all participants responded, the data are more than two years old and in many cases were difficult to compare across institutions due to the qualitative nature of the responses. However, at this time, no other estimates from the banks are generally available.

The Basel II NPR includes three transitional floor periods that would limit the amount by which a bank's risk-based capital requirements could decline over a period of at least three years. The Basel II Mid-Year Text issued in July 2005 (New Basel Accord) includes only two transitional years, with somewhat lower floors. The U.S. transitional floor periods are designed to provide a smooth transition to the Advanced Approaches and will help the Agencies evaluate both the overall functioning of the Advanced Approaches, and the impact of the Advanced Approaches on specific portfolios and overall capital requirements, before Basel II becomes fully operational. Preserving the safety and soundness of the U.S. banking system is the Agencies' primary motivation for implementing Basel II, and the transitional floor periods would help ensure that safety and soundness are maintained as banks transition to the new capital framework. Similarly, a desire to ensure the continued safety and soundness of the U.S. banking system motivated the Agencies' statement in the preamble of the Basel II NPR that a 10 percent or greater decline in aggregate minimum risk-based capital requirements, compared to minimum risk-based capital requirements under the existing rules, would serve as a benchmark and may warrant modification to the framework.

Some significant differences do exist between the United States and other countries in the proposed implementation of Basel II's Advanced Approaches, beyond the transitional safeguards. National differences in capital regulation are not unique to the Basel II capital regime, and some of the existing differences would carry over into Basel II. For example, the U.S. banking agencies currently impose a leverage ratio and Prompt Corrective Action requirements on U.S. banks that are more conservative than the Basel I capital accord (and would continue to do so under Basel II), yet U.S. banking organizations are among the most profitable and competitive in the world. Nevertheless, early comments on the Basel II NPR suggest that, whatever the merits of these international differences in rules, they are likely to add to implementation costs and raise home-host issues, particularly for globally active banks operating in multiple jurisdictions. Before the Federal Reserve issues a final rule, we will carefully consider any differences in the implementation of Basel II that could adversely affect the international competitiveness of U.S. banks.

Q.3. Are banks presently overcapitalized? Please explain how you arrive at your conclusions.

A.3. My response will focus on the large, complex U.S. banking organizations that would be subject to Basel II's Advanced Approaches under the recently issued Basel II NPR. Clearly, there is a natural tension between the private interests of these banks in maximizing shareholder profits, on the one hand, and the public interest in protecting the federal safety net, maintaining a safe and sound banking system, and promoting financial stability, on the other hand. As bank regulators, we seek to strike the right balance between public benefit and private burden. In particular, it is in no one's interest to set capital requirements too high, so as to impair the banking system's financial health, competitiveness, or ability to efficiently provide the credit and other financial services necessary for a growing economy, nor too low, so as to undermine safety and soundness and financial stability.

Within this context, I do not believe that, in the aggregate, current U.S. regulatory capital requirements are excessive in relation to banking risks or that the general level of capital requirements impairs the overall competitiveness of U.S. banks. In evaluating this issue, one needs to be careful to appropriately consider the competitive impact of regulatory capital requirements within the financial services industry. Competition in this arena is affected by many factors besides formal regulatory capital requirements, such as tax policies, economies of scale and scope, risk management skills, and the ability to innovate. Moreover, banks' actual capital levels generally exceed the regulatory minimums by considerable amounts, reflecting not only market discipline from rating agencies, liability holders, and counterparties, but also explicit decisions to build capital buffers in order to weather unanticipated events or facilitate the pursuit of future investment opportunities.

Some insight into the relationship between regulatory capital requirements and bank competitiveness is possible by observing that, even under Basel I, there have been significant differences in capital regulation across countries. The United States generally has been viewed as having one of the most rigorous and conservative capital regimes among major countries, reflecting the minimum leverage ratio requirement; prompt corrective action; the definition of regulatory capital—particularly our insistence that losses be recognized promptly by banks; and the willingness of the federal banking Agencies to set risk-based requirements above Basel I levels for certain higher-risk activities. Significantly, the greater rigor and conservatism in our capital rules under Basel I does not appear to have created international competitiveness problems for our major banking organizations. Quite the contrary: even though U.S. banks have generally been among the most strongly capitalized internationally, they are consistently also among the most profitable.

Nor do strong overall U.S. capital standards appear to impair the competitiveness of U.S. banks relative to nonbank competitors. Owing to limited data on profit rates across lines of business, one cannot directly compare relative profitability across these institutions on a risk-adjusted basis. However, research suggests that, at the margin, the federal safety net provides a significant positive net subsidy for U.S. banks, a subsidy which obviously is unavailable to nonbanks operating outside the safety net,[1] One manifestation of this subsidy is the ability of large banking organizations to operate with substantially lower capital ratios than their nonbank competitors.

While the general level of current U.S. capital standards does not impair the overall competitiveness of our largest and most complex banking organizations, it would be inappropriate to conclude that current capital standards provide an adequate framework for promoting bank safety and soundness. Capital regulation is the cornerstone of our efforts to maintain a safe and sound banking system. However, the lack of risk sensitivity in our Basel I-based capital framework means that it cannot distinguish between those banks that have taken on greater risk and those that have not. As a result, current capital rules do not provide supervisors with an effective framework for assessing overall capital adequacy in relation to risks, for judging which institutions are outliers, and for assessing how capital adequacy may evolve over time. Nor does it provide banks with appropriate incentives for improving their measurement and management of risk. The Basel II framework is intended to address these shortcomings.

[1] See Myron L. Kwast and S. Wayne Passmore, "The Subsidy Provided by the Federal Safety Net: Theory and Evidence," Journal of Financial Services Research, Vol. 16, Numbers 2/3, (September/December 1999), pp. 125–146.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM SUSAN S. BIES

Q.1. What is the ratio of tangible equity to assets at the 15 largest bank holding companies? Would it be appropriate to allow this ratio to drop substantially? What floor if any would you place under this ratio? Should it go below 5%?

A.1. The chart below lists the tangible equity and the tier 1 leverage ratios for the top 15 U.S. owned bank holding companies (BHCs).

RATIOS FOR TOP 15 U.S. OWNED BHCS, AS OF JUNE 30, 2006

[In percent]

BHC	Tier 1 leverage ratio *	Tangible equity ratio% **
Citigroup	5.19	4.56
Bank of America	6.13	3.73
JPMorgan Chase	5.85	4.60
Wachovia	6.57	4.59
Wells Fargo	6.99	6.29
U.S. Bancorp	8.23	5.52
Countrywide	6.96	7.04
Suntrust	6.82	5.88
National City	6.89	6.66
BB&T	7.26	5.50
Bank of N.Y.	6.22	4.99
Fifth Third	8.38	6.94
State Street	5.46	4.39
PNC Financial	7.71	5.24
Keycorp	8.82	6.71

* Tier 1 Leverage Ratio is equal to regulatory tier 1 capital divided by average total assets.
** Tangible Equity Ratio is equal to GAAP equity, less intangibles (except mortgage servicing assets, which have an identifiable stream of income), divided by average total assets.
Source: Federal Reserve Y–9C Reports.

Neither U.S. banks nor U.S. BHCs are subject to a minimum capital ratio based on tangible equity as defined in the chart above. They are, however, subject to a minimum tier 1 leverage ratio. While tangible equity and tier 1 capital are similar, they are not identical. Tier 1 capital includes elements not included in tangible equity and vice versa. The minimum tier 1 leverage ratio is 3 percent for all BHCs that are rated a composite “1” under the Federal Reserve’s BHC rating system or that have implemented the market risk amendment. The minimum tier 1 leverage ratio for all other BHCs is 4 percent. Although banks and thrifts also are subject to a minimum tier 1 leverage ratio of 3–4 percent, banks and thrifts obtain important regulatory privileges by maintaining a 5 percent tier 1 leverage ratio in order to be deemed “well capitalized” for purposes of the prompt corrective action framework and the financial holding company provisions of the Gramm-Leach-Bliley Act. Prompt corrective action does not apply to BHCs, so there is no “well capitalized” tier 1 leverage ratio threshold.

The Federal Reserve believes that constraining the overall leverage of a BHC helps ensure that the holding company does not pose a threat to the financial health of its subsidiary insured depository institutions.

The BHC supervision manual directs examiners to consider a BHC’s tier 1 leverage ratio as a supplement to its risk-based capital ratios when assessing the BHC’s capital adequacy. However, the tier 1 leverage ratio is only one of several indicators used to assess the capital strength of a BHC and should not be used in isolation. For example, Federal Reserve examiners also analyze the composition and quality of the BHC's capital instruments, the BHC's asset quality, and the BHC's exposure to interest rate risk, concentration risk, liquidity risk, and operational risk. Depending on all the factors that Federal Reserve staff takes into consideration when reviewing the capital adequacy of a BHC, a tier 1 leverage ratio below 5 percent could be acceptable for certain BHCs while for other BHCs a tier 1 leverage ratio above 5 percent could be appropriate.

Q.2. We have been led to believe that the goodwill and other intangibles represent roughly one-third of the U.S. industry's equity. Is that correct?

A.2. Intangibles, including goodwill but excluding mortgage servicing assets, which have an identifiable stream of income, represent approximately 30 percent of the total equity of U.S. commercial banks. (See chart below.)

U.S. COMMERCIAL BANKS INTANGIBLES TO EQUITY DATA AS OF JUNE 2006

Group of banks	Number of banks	Weighted average% of intangibles to equity
Under $250m	5,584	4.83
$250m–$500m	994	6.87
$500m–$1b	495	13.77
$1b–$5b	342	20.11
Greater than $5b	144	35.55
All Banks	7,559	30.53

Almost all of these intangibles are deducted from the calculation of regulatory Tier 1 capital, as are excess amounts of mortgage servicing assets. The vast majority of intangibles are in the form of goodwill and, as a result, intangibles are greater as a percentage of equity in the larger banks, which have been most active in acquisitions. As long as tangible capital levels are strong, a significant percentage of intangibles to capital does not pose a supervisory concern.

Q.3. At this point, only the U.S. and Canada have minimum leverage ratio requirements. Should U.S. bank regulatory agencies be comfortable with an international system for bank capital that does not impose such requirements in other countries? With the subjectivity involved with the Advanced Approach of Basel II, does this lack of a leverage ratio requirement concern you from the perspective of international financial stability?

A.3. The Basel Committee and national authorities will continue to monitor the impact of Basel II Pillar 1 capital requirements during the transition period of the Basel II framework and thereafter. Countries on the Basel Committee indeed want to ensure as much consistency as possible in implementing Basel II, and obviously agree on the goal of promoting financial stability more broadly. However, there are important legal, market, and cultural differences across countries that require a certain amount of national discretion for the Basel II framework to be suitable for each individual country. This is not a new development; national discretion has been applied since the initial implementation of Basel I, and many differences exist today across countries in the application of capital rules.

In all Basel member countries, Basel II's Pillar 1 risk based capital standard is being implemented in conjunction with other measures under Pillars 2 and 3 to ensure that banks maintain adequate capital levels. Some countries impose supplementary minimum capital standards, such as the leverage ratio requirements imposed by the United States and Canada. However, other countries employ different approaches, tailored to their specific institutional and supervisory regimes to ensure their comfort with banks' overall capital levels. Because Basel member countries are committed to identifying potential differences across countries in their capital adequacy frameworks and the potential effects of those differences, members of the Accord Implementation Group (AIG) are sharing information on supervisors' Pillar 2 techniques to assess banks' capital cushions over the regulatory minimum. In this context, the AIG is collecting information on a variety of supplementary measures of capital adequacy that members may be employing in their jurisdictions, and plans to report back to the Committee. In the case of the United States, the leverage ratio has served as a very valuable complement to the risk-based capital rules, and we believe it should continue to do so under Basel II.

Q.4. The Standardized Approach would (1) be less costly than the Advanced Approach for both banks and agencies, (2) be less likely to substantially reduce capital requirements, and (3) have a lower chance of opening competitive disparities between U.S. banks of different sizes. Under these circumstances, why should the agencies not allow such an approach for any U.S. bank?

A.4. The financial costs to a bank associated with implementing a much more simplistic framework would be lower than under the Advanced Approaches. But many of the costs being incurred by banks under the auspices of the Basel II Advanced Approaches are in our view costs associated with improving risk management more generally. In fact, the desire to avoid unnecessary regulatory costs is one reason why we have limited the number of banks that are required to be on Basel II and have tried to build Basel II on what banks are already doing. In contrast, the Standardized Approach bears little resemblance to what large, complex banks actually do to manage their risk.

The concern that Basel II will unfairly tilt the competitive playing field is something that we and the other U.S. agencies take very seriously. Some have argued that the bifurcated application of Basel II within the United States could allow domestic banks that adopt the framework both lower minimum required capital charges on certain activities and lower minimum required capital requirements compared with other domestic banks. Lower minimum required capital charges would, it has been argued, translate into a cost advantage for adopters that would place non-adopters at a competitive disadvantage. In addition, some fear that adopters would use any newly created excess regulatory capital to acquire smaller banks.

In part to address these concerns, the banking agencies proposed revisions to the existing Basel I-based capital rules (so-called Basel IA) that would aim to mitigate potential competitive inequities. Furthermore, we want to emphasize that during the comment period for Basel II and Basel IA NPRs, we urge interested parties to give us specific advice regarding what else we may need to do to reduce any unintended consequences of Basel II.

The Basel II Standardized Approach was designed for small, noncomplex, and primarily domestic banking institutions and is somewhat more risk sensitive than Basel I. It was intended to be used in those countries where, after the implementation of Basel II, Basel I would no longer be available. In contrast, the U.S. Agencies have not expected to eliminate Basel I-based rules for most of our banks and have not heretofore considered the Basel II Standardized Approach as an option for U.S. banks because of the additional costs and only marginal benefits expected.

In deciding whether to allow our large, internationally active banks to use the Basel II Standardized Approach, the Agencies will have to carefully weigh the advantages and disadvantages of doing so. The disadvantages of Basel II standardized include (i) limited risk sensitivity—for example, first lien mortgage loans would generally be assigned a 35 percent risk weight, other retail loans would generally get a 75 percent risk weight, and unrated corporate loans generally would get a 100 percent risk weight, in each case regardless of the creditworthiness of the borrower; and (ii) lack of meaningful connection between capital regulation and risk management.

In the Standardized Approach, the relatively crude method of assigning risk weights to assets, as well as an emphasis on balance-sheet risks as opposed to other risks facing financial firms, limits the overall responsiveness of capital requirements to risk, which renders that framework inadequate for supervising the largest and most complex banking organizations. It is quite telling that none of the largest foreign institutions signaled an intention to adopt the Standardized Approach in the QIS–5 study (see below).

Number of observations in each cell classified as "most likely"	Standardized approach	FIRB approach	AIRB approach
G10 Group 1	0	23	33

Source: Federal Reserve calculations based on "Results of the Fifth Quantitative Impact Study," Table 3, BCBS

Note: Group 1 consists of the largest institutions, namely those that have tier 1 capital in excess of €3bn, are diversified, and are internationally active. This table differs from the one in the BCBS study in that US banks are excluded.

Q.5. The Advanced Approach of Basel II has been touted as addressing safety and soundness concerns related to hidden and undercapitalized risks that large, complex banks now take under the current rules. In the results of QIS–4, what were the aggregate changes in minimum risk-based capital requirements for (a) securitized exposures, and (b) other off-balance sheet exposures? If the current rules are insufficient to address these complex risks, is it because they require too much capital, or too little capital?

A.5. Relative to the current risk-based rules, the aggregate QIS–4 change in minimum required risk-based capital (MRC) for securitization exposures was -17.9%, while that for all other off-balance sheet exposures (including operational risk) was +40.3%. In addition to the general caution that should be exercised when interpreting QIS–4 results, several specific factors should be considered in the context of results for securitization exposures and other off-balance sheet exposures.

Special Considerations When Interpreting QIS–4 Results for Securitization Exposures

First, with regard to securitization exposures, it should be noted that some key elements of the Basel II treatment are already incorporated into the current risk-based capital rules as a result of revisions the agencies made to the U.S. rules in 2001 to address risk sensitivity and capital arbitrage concerns. These revisions were not adopted at the time by other countries, implying that U.S. banks faced more conservative risk-based capital charges against most securitization exposures than their foreign competitors. With the adoption of Basel II, the U.S. and foreign treatments for securitization exposures will be brought into alignment. Based on QIS–5 results, it is estimated that the Basel II treatment of securitization exposures will produce approximately a 10% increase in risk-based capital charges for non-U.S. Group I banks, relative to Basel I.

Second, most of the -17.9% change in risk-based capital charges for securitization exposures in QIS–4 appears to reflect lower risk-weights under Basel II, compared to the current rules, for very highly-rated (e.g., AAA or AA) asset-backed securities held mainly in banks' securities (ABS) portfolios. In QIS–4, this category also included residential mortgage-backed securities issued by Fannie Mae and Freddie Mac. Under Basel II, these very low-risk ABSs typically receive risk-weights ranging from 7% to 15%, compared with 20% under current risk-based capital rules. These Basel II risk-weights will better reflect the actual credit risks of these ABSs, and will provide more appropriate risk-based capital incentives for banks to hold low-risk securities and maintain adequate liquidity. While below-investment-grade ABSs will receive much higher capital charges under Basel II compared to current rules, the QIS–4 respondents held relatively small amounts of such instruments.

Lastly, the QIS–4 results do not reflect changes proposed in the recently issued Market Risk NPR that would increase risk-based capital charges for certain (unrated) high-risk, illiquid securitization exposures held in trading accounts. These revisions are intended, in part, to close an emerging loophole in our capital rules. In recent years, some banks have shifted such positions from the banking book to the trading account, where they currently incur much lower capital requirements.

Special Considerations When Interpreting QIS–4 Results for Other Off-Balance Sheet Exposures

With regard to off-balance sheet exposures (excluding securitization exposures) the aggregate 40.3% increase in estimated MRC under Basel II was driven largely by the operational risk capital charge. Operational risk is one of the most important of the hidden, off-balance sheet risk for which there is no explicit capital charge under the current risk-based capital rules. The estimated change in off-balance sheet credit exposures alone was -10.0%; inclusive of the 1.06 multiplier this change would have been around -5.3%.

Q.6. If the goal is to encourage sophisticated risk measurement and management to our largest banks, why can't they be encouraged adequately through Pillar 2's supervisory guidance and Pillar 3's transparency through public disclosure?

A.6. Pillar 2 and Pillar 3 are indeed vitally important elements of the Basel II framework, and should not be overlooked. Their value is enhanced and strengthened by linking them with the advanced Pillar 1 approaches. Key advantages of the advanced Pillar 1 approaches of Basel II are that they: (i) encourage improvements in risk measurement and management at the participating banking institutions; (ii) facilitate the integration of minimum regulatory capital requirements with internal risk measurement and management processes; and (iii) provide a common risk measurement and management vocabulary for banks and supervisors to use. Another key objective of Basel II is to improve risk sensitivity of risk-based capital requirements at the largest U.S. institutions.

In developing the Basel II NPR, the U.S. agencies did consider whether they should simply encourage risk management improvements at these large institutions and not tie those practices directly to regulatory capital. But it became clear that for safety and soundness reasons the relative riskiness of these banks' positions needed to be included in minimum regulatory capital measures, that is, in the advanced Pillar 1 approaches. Just looking at risk measurement practices and models (Pillar 2) does not provide the appropriate backstop that actual capital does; in turn, minimum required capital measures at the largest institutions lack meaning when they are not risk sensitive. Additional disclosure of risk measurement and management (Pillar 3) without a discussion of the advanced Pillar 1 approaches would not necessarily represent an improvement over traditional risk management disclosures. We believe the Pillar 1 measures, when complemented by Pillars 2 and 3, provide a sound framework for bankers, supervisors, and market participants to assess how capital and risk evolve over time.

Q.7. If the mandatory banks operate under the Advanced Approach and other banks operate under Basel IA, how much do you expect capital requirements to change on average for the two groups of banks? Will that affect the competitive position of banks not using the Basel II Advanced Approach?

A.7. At this point in the implementation process, we cannot estimate accurately what the average change in capital requirements would be for banks operating under the Basel II Advanced Approaches and those operating under Basel IA. As you know, the Basel II proposal is now in the formal comment period. Under current implementation plans, we have overlapping comment periods for the two proposals so that commenters will be able to assess the potential effect of both proposals on their minimum required capital positions and provide meaningful information to the agencies about the overall impacts of the proposals as well as identify areas of potential competitive pressure.

As we review and analyze public comments on both proposals, one objective we will keep in mind is to mitigate, to the extent possible, areas of demonstrated negative competitive impact. However, we must also keep in mind the fundamental point that the Basel II Advanced Approaches are designed to be as risk-sensitive as possible and the Basel IA proposal currently under interagency discussion is intended to fit within the structure of the existing broad-brush risk-based capital framework without imposing undue regulatory burden on smaller financial institutions. It is inevitable that under the two frameworks similar exposures may be subject to different minimum risk-based capital charges. As we move forward with implementing Basel II, we will continue to be mindful of potential competitive concerns and will propose and implement modifications to our capital rules as appropriate to address competitive issues.

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The Subsidy Provided by the Federal Safety Net: Theory and Evidence

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Abstract

Views about the value to depository institutions of the federal safety net differ widely. Resolution of the issue is important because defining the appropriate relationship between the federal safety net and financial institutions is central to the design of efficient financial modernization strategies. A heuristic model is presented of how the safety net subsidy affects the size of the banking system and the behavior of banks. The model suggests that banks should have lower capital ratios than similar nonbank financial firms. Evidence is presented that supports this prediction and that banks have organized themselves in ways that take advantage of safety net benefits.

Key words: banking, subsidy, safety net

1. Introduction

Views about the value to depository institutions of the federal safety net—federal deposit insurance, access to the Federal Reserve's discount window, and direct access to the Federal Reserve's payments system—differ widely. Some observers argue that there is a significant net subsidy, others that there is none at all—or that, to the extent there is a subsidy, it can be controlled equally well in either the bank holding company (BHC) or the bank subsidiary structure. Here, we argue that banking has benefited from the safety net.

The paper begins with intuitive and analytical discussions of the nature of the safety net subsidy. Emphasis is placed on the importance of distinguishing between fixed and marginal costs and on the implications of our model for measuring the subsidy. We then turn to the issue of how, in practice, to measure, or at least to test for the existence of, the safety net subsidy and present some new empirical results. Finally, we examine whether banking organizations have structured themselves to take advantage of the safety net.

2. The nature of the safety net subsidy

The benefits to banks created by the federal safety net can be thought of as the confidence of *bank* creditors that banks will be supported in times of financial crisis. This confidence is based on banks' access to federal deposit insurance, the Federal Reserve's discount window, and Federal Reserve payment system guarantees. But none of these features by itself, is necessary for the expression of this confidence. Ultimately, this confidence is created by the widely held belief on the part of the public and bank liability holders that, while individual banks may be allowed to fail, *the banking system is backed by the United States government.*[1]

Alan Greenspan, chairman of the Federal Reserve Board, has argued that confidence in the government's support of the banking system effectively grants banks access to the "sovereign credit" of the United States. Because access to the sovereign credit of the United States is limited to specific sets of institutions in our society, the associated benefits, or "rents," are a subsidy to those favored institutions. Our use of the word *subsidy* is consistent with broad definitions of the word, which include the granting of implicit benefits, or privileges, by the government to a particular group.[2]

Part of the subsidy provided by the safety net—that part which can be actuarially evaluated—can be measured and in principle be offset by explicit charges for the services provided. However, measuring the value of the public's absolute confidence in the government's support of the banking system is extremely difficult. Therefore, determining an appropriate charge for this portion of the safety net is problematic. The U.S. government is the only entity that cannot become insolvent in dollar obligations. For this reason, absolute public confidence in the viability of the banking system cannot be reproduced in the private sector.[3]

Because of banks' access to the safety net, bank creditors are willing to accept lower risk premiums on bank liabilities, thus lowering a bank's weighted average cost of capital relative to what would otherwise be the case. For deposits fully insured by the FDIC, this risk premium is reduced essentially to zero, *no matter how risky the bank's assets.* Other debt instruments also benefit, although to a lesser degree than insured deposits. The result is that banks enjoy lower total and marginal costs of funding, including lower capital ratios, than would otherwise be required by the market.[4]

3. An analytical description of the effects of the safety net subsidy

This section describes an analytical model of how the federal safety net affects the banking industry and suggests a test for the existence of the safety net subsidy. The presentation emphasizes the importance of distinguishing between *fixed* and *marginal* benefits and costs when attempting to understand the net effect of government benefits and costs on bank behavior. Most analyses of the safety net subsidy fail to make these distinctions.

3.1. The marginal cost of funds for banks

As depicted in figure 1, in a world without government backing, the banking system faces a marginal cost of funds that rises as its holdings of liabilities increase, assuming that banks hold their leverage ratios and other relevant factors constant. Bank liability holders have different risk preferences, and profit-seeking bank managers minimize the cost of funds by first using funds raised from the least risk-averse liability holders. This marginal cost of funds curve is illustrated by $MC_1(k)$ in figure 1, where k is the banking system's constant capital-to-assets ratio.[5]

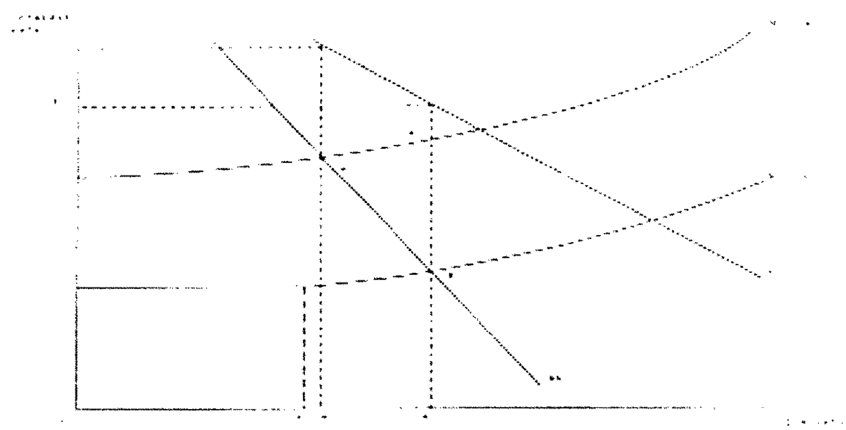

Figure 1. Possible competitive equilibria for the banking system.

To maximize profits, banks equate the marginal cost of funds to the marginal revenue earned by deploying these funds. Therefore, in the no-subsidy world, the banking industry maximizes profits at point *A* (figure 1), holding assets of a_1 with a yield of r_1. Once the public accepts that the government supports the banking system, the marginal cost of funds declines (in figure 1 from $MC_1(k)$ to $MC_2(k)$), because all bank liability holders now have confidence that, in a banking crisis, the system will be preserved.[6] Part of this support is explicit, through the deposit insurance fund, and for insured funds the risk premium is essentially zero. Thus, as illustrated by $MC_2(k)$, the marginal cost curve is flat until assets exceed the availability of insured deposits (this level of assets is denoted in figure 1 by a_f) and then rises, although at a flatter slope than in the no-subsidy case because of government support implicit in times of financial crisis.

With the introduction of government support, the banking system moves to a new (partial) equilibrium, denoted by point *B*. In this new equilibrium, the banking system is bigger ($a_2 > a_1$) and the yield on assets is lower ($r_2 < r_1$).

The vertical distance between the marginal cost curve in the case of an unregulated and purely private banking system ($MC_1(k)$) and that in a credible government-backed banking system ($MC_2(k)$) reflects the difference in the way market participants view their losses during extreme circumstances. As discussed in detail later, this suggests that a natural measure of the marginal value of the safety net subsidy in equilibrium is the distance BB* in figure 1. Note also that, if economic times are good and bank failures rare, this distance may be small or even zero, while during bad times, this distance may be great. Thus, the measurement of the value of the subsidy at a particular time depends on the perceptions of market participants at that time.[7]

Similarly, the difference between these curves for any given bank can differ significantly based on the conditions faced by that bank at a given time. The curves presented in figure 1, being industry-based marginal costs, represent the summation of individual banks' marginal cost curves. Again, during good economic times, the dispersion across banks may be small.

It is interesting to note that, while in our figure the marginal cost of insured deposits is constant and the cost of liabilities rises only after the ability of banks to attract insured deposits is exhausted, the marginal cost of insured deposits need not be constant and in practice almost surely is not. This can occur for several reasons. For example, all depositors do not value FDIC insurance similarly. Some would not put their funds anywhere but in an FDIC-insured account, whereas others are somewhat sensitive to yield differentials. If a bank seeks to attract this latter type of customer, it must eventually raise its rates on insured deposits. Also, since raising insured deposits is often heavily dependent on a branch network, at some point the marginal cost of building and maintaining branches will exceed the marginal cost of uninsured, wholesale deposits. In short, we would expect to observe use of a variety of funding sources, especially at the largest banks.

3.2. The importance of distinguishing between fixed and marginal costs

The fixed costs of access to the safety net are almost surely a large proportion of the costs imposed by bank regulations and examinations. Fixed costs include, for example, many of the costs associated with an examination, regulatory reporting requirements, compliance with consumer regulations, and other regulatory and supervisory activities. Small banks often argue that fixed costs are frequently quite large and independent of bank size and, thus, are *relatively* more burdensome on small than on large banks. Marginal costs, in contrast, vary with the level of an activity. For example, deposit insurance premium rates vary somewhat with the riskiness of the bank, and each new dollar of discount window loans is charged a (marginal) rate. Put differently, fixed costs cannot be avoided by a bank once the bank has made the decision to be a bank. Marginal costs vary with the size and other characteristics of the bank and result in large part from decisions the bank makes regarding how to conduct its ongoing business.

Fixed costs enter our analytical framework through the average cost function, illustrated by $AC_1(k)$ and $AC_2(k)$ in figure 2. The fixed costs of the banking system are depicted by the point where the long-run average cost functions intersect the vertical axis (denoted by F), and the minima of the average cost functions are at points A and B, the points where marginal costs equaled marginal revenues in figure 1. Average costs (per dollar of assets) borne by the banking system are denoted c_1 in the no-subsidy case and c_2 in the subsidy case. The key point to note in figure 2, and a standard result of economic theory, is that the long-run equilibrium levels of output and interest rates are unchanged by the level of fixed costs.

In practice, distinguishing between fixed and marginal costs is often quite difficult. For example, any level of bank examination, or even the anticipation of an examination, imposes fixed costs on a bank. But decisions by the bank regarding its degree of risk taking also can impose marginal examination costs because supervisors may spend more time examining the bank and perhaps imposing sanctions. While measurement difficulties make estimating fixed and marginal costs difficult, the distinction between the two is of more than academic interest. Marginal costs are relevant for understanding how a bank

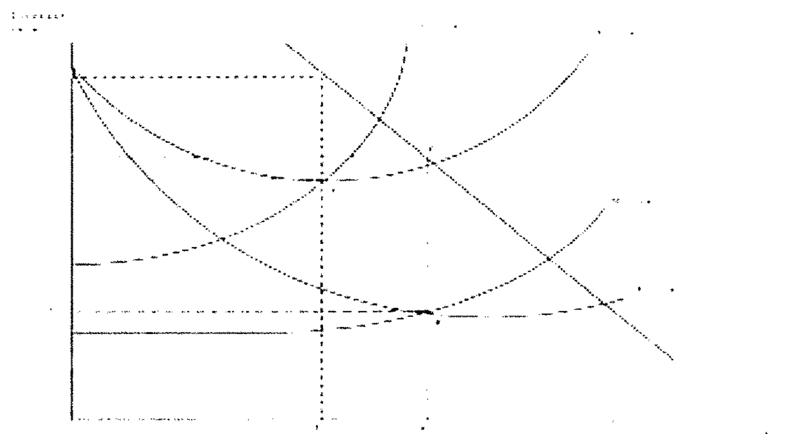

Figure 2. Costs and profits for the banking system.

will choose to behave in attempting to exploit any safety net subsidy, and such attempts are our primary concern.

3.3. Profits and benefits from the subsidy

A bank will exploit the marginal value of the safety net to the bank's advantage regardless of whether the safety net's *total* net benefits are positive or negative. For example, a bank's decision regarding whether to shift low-cost funding downstream to an insurance subsidiary will not depend on the (largely fixed) costs the bank incurs when it undergoes a bank examination. Examination costs are borne by the bank whether the funds are downstreamed or not.

In figure 2, the banking system's profits are denoted by the rectangle r_1c_1AZ in the no subsidy case, and r_2c_2BY in the subsidy case. In our drawing, profits with the subsidy exceed profits without a subsidy, but this does not have to be the case. If a subsidy also implies substantially higher fixed costs, say, as a result of regulatory or supervisory costs, profits could be lower in the case of a subsidy. Indeed, if fixed costs were high enough in either case, profits could be driven to zero or even become negative.[8] As noted later, in this latter case, capital (and probably firms) would exit the industry.

While marginal benefits and costs are critical for understanding bank behavior in the presence of a federal safety net, there is one key circumstance where the total benefits and total costs of the safety net clearly enter a bank's profit-maximizing calculations—when the bank seeks to determine whether it should escape the costs of the safety net by giving up its bank charter. The fact that we do not observe banks voluntarily relinquishing their charters suggests that the total net benefits of the safety net are positive for the vast majority of banks. Indeed, many indicators strongly suggest that the bank charter continues to have significant value.[9]

The values of both total and marginal benefits will increase with upward shifts in the marginal revenue curve. In particular, *new* activities will provide *new* opportunities for banks to take advantage of the safety net by using funds raised at marginal costs below those of nonbanks already engaged in the same activities. Again, this is because the (subsidized) marginal cost of funding does not reflect the full risk premium that bank creditors would charge the bank if there were no safety net. Therefore, the riskier the activity, the larger is the spread between banks' cost of funds and banks' expected rate of return on the activity, assuming banks engage in risk-based pricing.

These effects are illustrated using figure 3. Here, the nonbank equilibrium represents an industry that banks could not enter historically but are now permitted to enter. With the entry of banks, the marginal cost curve falls to $MC_{Bank}(k)$, and thus yields drop from r_{old} to r_{new} and assets increase from a_{old} to a_{new}. The firms in the industry prior to the entry of banks were profitable, but without access to the subsidy, these firms suffer losses as the new competitive yield is less than their breakeven yield ($r_{even} > r_{new}$).[10] To survive, nonbank firms must lower their average and marginal costs or differentiate their products to increase marginal revenues, until their earnings rise enough to provide a competitive return on equity.

3.4. How can we observe the subsidy?

In the model just described, the marginal value of the subsidy depends, ceteris paribus, on the size and leverage of the banking industry. Returning to figure 1, as noted earlier, the safety net's marginal value (in equilibrium) is the difference between the two marginal cost curves at a_2; here, the distance BB*. Viewed in this light, measuring the value of the

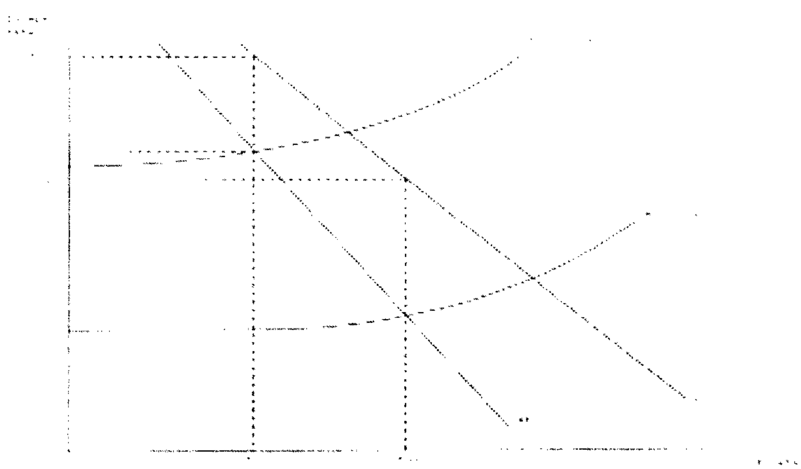

Figure 3. Bank and nonbank competition in new industries opened to banks.

safety net subsidy is clearly problematic, since the marginal cost curve of the nonsubsidized banking industry, $MC_1(k)$, is a hypothetical construct.

A natural approach to estimating $MC_1(k)$ in figure 1 is to estimate a marginal cost curve for firms that are very similar to banks but lack access to the safety net. Unfortunately, it is extremely difficult to find such firms that *also* have publicly available data and traded debt sufficient to make reliable estimates.

In contrast, the book value of leverage—defined as the ratio of a firm's equity to assets—is relatively easy to observe. A leverage calculation can be made for any firm that makes a balance sheet publicly available. Of course, comparison of leverage across industries can be difficult because of different accounting conventions and business strategies and because the difficulty of controlling for a variety of industry factors bedevils leverage comparisons as well as marginal cost comparisons.

Still, leverage is easier to calculate than marginal costs, and our analytical framework suggests that firms receiving benefits from the federal safety net, all other things equal, should operate with a lower capital-to-assets ratio. This is illustrated in figure 4, which shows that as the banks' capital-to-assets ratio falls from k_H to k_L the marginal cost-of-funds curve rises (moving from $MC_3(k_H)$ to $MC_4(k_L)$) for all liabilities except insured deposits (which, recall, are available to fund assets only up to a_f). Note that an infinite number of marginal cost curves lie between $MC_3(k_H)$ and $MC_4(k_L)$, each characterized by a different leverage ratio.[11] The jump in the marginal cost curve (MC_3 to MC_4 at a_f) represents the risk premium demanded by the lowest cost, noninsured debtholder.[12] Again, in good times or for a well run bank, this may be a small jump; while in bad times or for a poorly run bank, it may be very large.

Since each leverage ratio defines a different marginal cost curve, the possible equilibrium for the banking industry could be anywhere along the line segment *CD*, with

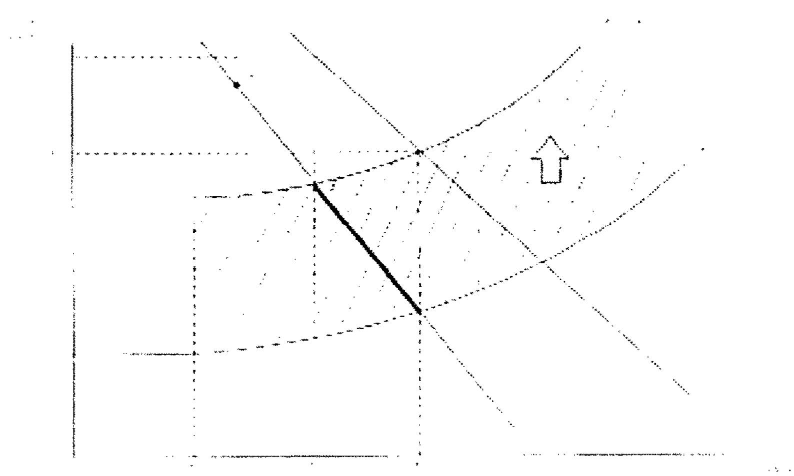

Figure 4. The effect of leverage on banks' marginal costs.

all levels of assets associated with this line segment larger than the level associated with an unregulated and purely private banking system (equilibrium point A). In fact, in a perfectly private and competitive market, as the capital-to-assets ratio falls, the rise in marginal costs should precisely offset the lower costs associated with less capital.

However, we argue that, in practice, banks have strong incentives to substitute debt for equity, and so the equilibrium will tend toward *C*, the equilibrium characterized by a relatively low capital ratio. In part, this is because debt finance has tax advantages. However, in the context of safety net effects, the key consideration is that bank debtholders, unlike debtholders of nonbank firms, expect that banking organizations will be protected during some, if not all, financial crises, thereby allowing them to avoid many of the substantial costs associated with bankruptcy. (The most extreme form of this expectation is held by bank creditors who believe that their banking organizations are "too big to fail.") Such expectations are probably strongest for (short-term) debt instruments that are more like deposits and probably are weakest for (longer-term) debt instruments that are more like equity.[13] Therefore, risk premiums on debt that is closely related to deposits are relatively smaller than those on debt instruments more like equity, providing bank owners and managers with a profit incentive to maximize their use of debt, all other things equal.

4. Observing the safety net subsidy using leverage ratios

The analytical approach advanced in section 3 suggests that the subsidy advantage of banks can be tested for, although not measured precisely, by comparing either the marginal cost schedules for funding or the equity-to-assets ratios of banks and their nonbank competitors. For the reasons already discussed, we focus our attention on equity ratios. We make a variety of comparisons because no one data set is ideal and because any cross-industry study is subject to substantial uncertainty.

Our first set of comparisons is summarized in table 1, which provides data on publicly traded BHC and nonbank financial institutions' equity-to-assets ratios.[14] Because a primary goal of the FDIC Improvement Act (FDICIA) was to shrink the size of the safety net subsidy provided to banks, table 1 splits the total 1985–1997 sample period into pre-FDICIA (1985 through 1992) and post-FDICIA (1993 through 1997) periods. In this way we should be able both to roughly control for any "regime" change in regulatory policy due to FDICIA and examine whether evidence of such a regime shift exists. In the table, the average median equity-to-assets ratio for each type of firm is given pre-FDICIA (column 1) and post FDICIA (column 3). In addition, the differences between the average medians of the appropriate (large or small firm) BHC capital ratio and nonbank firms' capital are given pre-FDICIA (column 2) and post-FDICIA (column 4).

The results in table 1 indicate that, in both the pre- and post-FDICIA periods, large BHCs have considerably higher equity-to-assets ratios than large investment banks. Interpretation of these results is complicated by the fact that large investment banks hold relatively greater shares of their assets in very short-term, low-risk "matched book" securities. Once the low levels of capital needed to support matched book securities are taken into account, it appears that large investment banks' lower capital ratios relative to

Table 1. Average median equity-to-assets pre- and post-FDICIA (percent)

	Pre-FDICIA (1985–1992)		Post-FDICIA (1993–1997)	
Type of Firm	(1) Level	(2) BHC-nonbank	(3) Level	(4) BHC-nonbank
BHCs				
Large	6.2	NA	7.9	NA
Small	6.7	NA	8.9	NA
Investment banks				
Large	3.7	2.5	3.5	4.4
Small	21.9	−15.1	27.3	−18.5
Life insurance				
Large	12.4	−6.2	8.0	−0.2
Small	17.5	−10.8	14.1	−5.2
Property-casualty				
Large	15.9	−9.7	13.6	−5.8
Small	26.5	−19.8	27.5	−18.7
Personal credit				
Large	10.8	−4.6	11.0	−3.1
Small	16.4	−9.7	17.9	−9.0
Noncaptive finance				
Large	11.3	−5.1	11.0	−3.2
Small	18.5	−11.7	19.4	−10.5
Captive finance				
Large	9.0	−2.7	9.8	−1.9
Small	14.7	−7.9	13.5	−4.7

Note: For all definitions see notes to Appendix tables A1 and A2. Differences may not be exact due to rounding.

BHCs diminish greatly or disappear.[15] Turning to comparisons with large life insurance companies, in the pre-FDICIA period, equity ratios at large BHCs were considerably below those at large life insurance companies, but this difference has shrunk considerably since FDICIA. Still, for 10 of the 13 years shown in table A1, the median equity-to-assets ratio at large life insurance companies exceeded the median ratio at large BHCs.[16] Stronger patterns are evident in the comparisons between large BHCs and large property casualty insurers. In particular, capital ratios at large property casualty insurers are considerably above those at large BHCs both before and after FDICIA, although the difference declines by 40% between the two periods. Similar qualitative results are observed across all three classes of large finance companies—personal credit companies, noncaptive, and captive finance companies.[17]

Comparisons across the small firm rows in table 1 demonstrate the critical role of size. While equity ratios at small BHCs rise relative to those at large BHCs, this increase pales in comparison to the increases at small nonbank financial institutions. Thus, the average median equity ratio at small BHCs is, in both the pre- and post FDICIA periods, always substantially smaller than the average median ratio at small nonbank firms. In addition, except for the comparisons with small investment banks where the small BHCs actually fall further behind small investment banks post FDICIA, the difference between small BHCs and small nonbank firms is larger in the pre- than in the post FDICIA period. The decline in the gap is not always large, but a decrease does appear to exist.

The data presented in table 1 are consistent with three broad conclusions. First, with the understandable exception of large investment banks, BHC equity ratios are much lower than equity ratios at nonbank financial institutions. Second, FDICIA may have reduced somewhat the ability of BHCs to operate with lower capital ratios than do nonbank financial firms. The gap between equity ratios at BHCs and nonbank financial firms generally, but not always, narrows post FDICIA. Finally, with the exception of large life insurance companies, the post FDICIA differences remain quite large.

An alternative comparison of capital ratios at banks and finance companies is provided in table 2. Here, commercial bank and finance company equity-to-assets ratios in only 1996 are contrasted using a different data set—the Federal Reserve's June 1996 Survey of Finance Companies and regulatory Call Report data—and a somewhat different methodology.[18] Table 2 presents averages weighted by total assets, excludes finance company subsidiaries of BHCs, and separates firms into various size classes, including those used to define large and small firms in table 1.

As can be seen in the last column of table 2, finance company equity ratios are considerably larger than those at commercial banks. Size, once again, clearly is important. At firms with total assets between $1 billion and $10 billion, the finance company ratio is 5.4% points above that of comparably sized commercial banks, while for firms under $1 billion the difference climbs to 9.0% points.

In general, the market will require relatively risky firms to hold higher capital ratios. Since finance companies normally are viewed as having riskier portfolios than banks, this perception could account, at least in part, for the higher capital ratios at finance companies. In an effort to control for risk differences, we compare equity-to-assets ratios of commercial banks and finance companies that had equivalent S&P ratings on a bank's uninsured long-term CDs and on a finance company's long-term senior debt. Table 3 presents the results of this analysis, as of each December 31 post-FDICIA; that is, from 1993 through 1997. All means are weighted by total assets and use data only for publicly traded companies that have issued publicly traded debt rated by a major rating agency.

Table 2. Equity-to-assets ratios of commercial banks and nonbank holding company finance companies (percent as of 6/30/96)

Size Class	Commercial Banks (CB)	Finance (FC)	CB-FC
TA $\geq$ $10 billion	7.4	9.5	−2.1
	(70)	(13)	
TA < $10 billion	9.3	14.8	−5.5
	(9531)	(191)	
$1 bil $\leq$ TA < $ 10 billion	9.0	14.4	−5.4
	(319)	(34)	
TA < $1 billion	9.7	18.7	−9.0
	(9212)	(157)	
All	8.3	10.8	−2.5
	(9601)	(204)	

Notes: Number of firms in parentheses. All ratios are weighted by total assets. Commercial bank data from Call Reports. Finance Company data from the Federal Reserve's 1996 Survey of Finance Companies.

Table 3. Equity-to-assets ratios of commercial banks and finance companies with equivalent S&P ratings (percent as of December 31)

	Year					No. of Firms,
	1993	1994	1995	1996	1997	12/31/97
S&P Rating = A						
(1) Commercial banks (CB)	7.6	7.3	7.6	7.7	7.6	51
(2) Finance companies (FC)	10.4	8.9	9.3	9.5	10.1	8
(3) CB-FC	−2.8	−1.6	−1.7	−1.8	−2.5	
S&P Rating = BBB						
(4) Commercial Banks	8.1	8.1	8.6	8.8	9.2	16
(5) Finance Companies	21.6	21.1	20.0	18.8	17.9	5
(6) CB-FC	−13.5	−13.0	−11.4	−10.0	−8.7	

Notes: All ratios are weighted by total assets. All data are from SNL securities database and are only for publicly traded companies. Rating for commercial banks is on a bank's long-term uninsured CDs. Rating for finance companies is on a company's long-term senior debt.

As may be seen in row 3 of table 3, for firms rated single A, finance companies averaged equity ratios 2.5% points higher than that at banks in 1997 and between 1.6 and 2.8% points higher over the rest of the sample period. Differences are even more dramatic for banks and finance companies with debt rated BBB. The average ratio at commercial banks was 8.7% points below that at finance companies in 1997 and ranged from 10.0% points to 13.5% points below the finance companies' mean between 1993 and 1996. In contrast to the single A results, the difference in means for the BBB-rated firms declined during the post-FDICIA years.

Our final set of comparisons (table 4) attempts to replicate the analysis of table 3 for comparison of commercial banks, property-casualty insurance companies, and life-health insurance companies. Unfortunately, it is not possible to do this exactly. The comparisons in table 4 use a different data set (Compustat), include only the largest firms (those with total assets of $10 billion or more), and use ratings on BHC senior debt.[19]

Table 4. Equity-to-assets ratios of bank holding companies, life and health insurance companies, and property and casualty insurance companies with equivalent S&P ratings (%)

	Year					No. of Firms,
	1993	1994	1995	1996	1997	in 1997
S&P rating = A+						
(1) Bank holding companies (BHC)	7.3	7.2	7.3	7.6	7.8	9
(2) Property-casualty insurance (PCI)	17.5	17.9	18.3	18.5	18.1	4
(3) BHC-PCI	−10.2	−10.7	−11.0	−10.9	−10.3	
S&P rating = A						
(4) Bank holding companies (BHC)	6.8	7.1	8.1	8.0	8.0	7
(5) Life-health insurance (LHI)	8.2	9.1	9.5	9.7	9.5	6
(6) BHC-LHI	−1.4	−2.0	−1.4	−1.7	−1.5	

Notes: All firms have total assets of $10 billion or more. All ratios weighted by total assets. All data are from Compustat. Rating are for firms' publicly traded senior debt.

Rows 3 and 6 of table 4 show that the weighted average equity ratios of both property-casualty and life-health insurance firms are uniformly above those of equally rated BHCs. The differences are particularly striking for the BHC-PCI comparisons, with equity ratios ranging from 10.2 to 11.0% points higher at the property-casualty firms. In both sets of comparisons, the differences show little variability over time, with the differences in 1997 being virtually the same as the differences in 1993.

In sum, recent data on bank, BHC, finance company, and insurance company equity ratios strongly support the general conclusions reached from our analysis of table 1. That is, with the understandable exception of large investment banks, equity capital ratios at banks and BHCs generally are considerably below those of nonbank financial intermediaries, even in the post-FDICIA period. In our judgment, these continuing differences are quite likely due, in substantial part, to the fact that banks have direct access to the federal safety net.

5. The structure of banking organizations

Debate over whether the BHC subsidiary or the bank subsidiary organizational form is best at containing subsidies has focused on the current choice of organizational structures by banking organizations and on how bank subsidiaries might be constrained in their ability to absorb safety net subsidies. This section considers some key arguments put forward recently in this debate and examines some additional data that suggest further that banks have tended to behave in ways that take advantage of the safety net subsidy.

5.1. The current structure of banking organizations

It has been argued that, if a safety net subsidy exists, banks are the most direct recipients of that subsidy, and therefore the existence of a significant subsidy would imply that all BHCs would use the bank subsidiary structure for those nonbank activities that could be conducted either in the bank or in a BHC affiliate. Whalen (1997) presents data to show that, as of 1996, banking organizations in fact have chosen both structures in a large number of cases. Whalen views this evidence as being either inconsistent with the widespread existence of a substantial subsidy or as suggesting that the subsidy is the same for both the bank subsidiary and the BHC subsidiary organizational forms.

In our view, while banks indeed are the direct recipients of the safety net subsidy, such data on banking organizations' choices of structure do not make a persuasive case for the lack of a significant safety net subsidy. As a general matter, we would expect to observe both bank subsidiary and BHC subsidiary structures, since prudent managements will weigh all relevant factors, in addition to the value of the safety net, when deciding on the best organizational structure. For example, in past years, BHCs have moved many activities out of the bank to avoid geographic restrictions. Over time, some of these bank affiliates have established names (or already had established names when they were purchased by a BHC) and an interstate network whose value would be reduced if subsumed within a bank. In addition, shifting existing activities back to the bank can have adverse tax implications. Finally, some of these activities may not be both asset intensive and relatively risky and, hence, may not benefit significantly from subsidized bank funding.

More important, Whalen's methodology ignores the fact that banking organizations' ability to exploit a safety net subsidy directly in the bank has improved over the last decade as legal barriers to interstate banking have declined. The removal of legal restrictions imposed by the states on geographic diversification began in earnest during the mid-1980s. By the passage of the Riegle-Neal Act by Congress in late 1994, only Hawaii had not enacted some form of interstate banking at the state level.

The progressive relaxation of legal constraints on interstate banking suggests that a more compelling test of whether banking organizations prefer a bank or a bank holding company subsidiary structure would be to examine trends over the last decade in the structure of banking organizations. In addition, rather than focusing on the number of subsidiaries in each structure, a more persuasive approach would be to look at the proportion of the total dollar volumes in various organizational structures and how these proportions have changed over time. Dollar volumes are particularly important because the subsidy would be greatest for those activities in which the bank must acquire significant funding and smaller for those activities in which the bank acts only as a broker. A tendency for banking organizations to move permissible activities back into the bank as geographic restrictions were relaxed would be consistent with the view that banks are the most direct recipients of the safety net subsidy and that banking organizations seek to structure themselves in ways that take advantage of that subsidy.

Table 5 presents our calculations of the dollar value and the percent of total BHC assets in nonbank subsidiaries of bank holding companies for selected activities that can be conducted in both a bank and a BHC subsidiary over the years 1986 through 1997.[20] The dollar value of total BHC assets is also given in the penultimate row of table 5. The activities selected are major activities that can be conducted in both a bank and a BHC subsidiary. Given that total BHC assets increased by 46% between 1986 and 1994 (and by 89% from 1986 to 1997), a substantial decline over time in the percent of assets held at the BHC subsidiary level would be consistent with the migration of such activities from holding company subsidiaries back into the bank. A decline in dollar values would be further supportive of this view.

The results shown in table 5 indeed are consistent with the view that, over the last decade, BHCs have been moving those activities that could be conducted in banks from BHC subsidiaries back into the bank. Looking at the last row of the table, a steady decline in the percent of BHC assets held in BHC subsidiaries in the included activities is clear. For example, the percentage of the included activities in BHC subsidiaries fell from around 3.8% in 1986–1988 to about 1.8% in 1993–1994. More specifically, the drop between 1986 (3.83%) and 1994 (1.68%) was 56%. Even for the three years of data after the break in series, the percentage falls from 2.4% to 2.0%.

Equally striking, the percentages for the three most important individual activities—commercial finance, mortgage banking, and consumer finance—*all* show substantial declines. In addition, the nominal dollar assets in all three of these activities declined, even across the break in series.

It is interesting to observe that the activities most frequently transferred back into the bank are finance intensive. The two activities that require relatively little financing—data

Table 5. Assets of selected nonbank subsidiaries of bank holding companies by type of activity, 1988–1997 ($ billions and percent of BHC assets)

	New Report			Year								
Activity	1997	1996	1995	1994	1993	1992	1991	1990	1989	1988	1987	1986
Commercial finance	27.5	25.0	31.3	23.1	20.1	16.2	18.0	23.9	26.7	37.1	34.1	30.0
	0.58%	0.59%	0.80%	0.63%	0.60%	0.52%	0.60%	0.80%	0.92%	1.40%	1.32%	1.20%
Mortgage banking	24.5	16.9	24.9	12.1	19.4	19.2	20.8	22.1	30.3	27.8	29.6	34.2
	0.52%	0.40%	0.64%	0.33%	0.58%	0.62%	0.69%	0.74%	1.05%	1.05%	1.15%	1.37%
Consumer finance	22.1	20.1	20.6	17.0	14.5	11.8	15.7	18.8	23.6	24.0	25.2	22.2
	0.47%	0.48%	0.53%	0.47%	0.43%	0.38%	0.52%	0.63%	0.82%	0.90%	0.98%	0.89%
Leasing	12.8	13.7	10.6	6.2	5.2	5.6	6.7	9.4	11.5	9.6	9.0	6.8
	0.27	0.32%	0.27%	0.17%	0.15%	0.18%	0.22%	0.31%	0.40%	0.36%	0.35%	0.27%
Data processing	4.6	5.1	3.2	2.3	1.9	1.8	1.7	2.2	2.0	1.9	2.0	1.8
	0.10%	0.12%	0.08%	0.06%	0.06%	0.06%	0.06%	0.07%	0.07%	0.07%	0.08%	0.07%
Insurance' agency	3.5	3.1	2.2	0.5	0.7	0.4	0.4	0.3	0.6	0.3	0.5	0.4
	0.07%	0.07%	0.06%	0.01%	0.02%	0.01%	0.01%	0.01%	0.02%	0.01%	0.02%	0.02%
Total included nonbank activities	95.0	83.9	92.8	61.2	61.8	55.0	63.3	76.7	94.7	100.7	100.4	95.4
Total BHC assets	4705.6	4225.7	3909.3	3640.4	3371.3	3091.9	3011.8	2984.5	2894.5	2654.2	2576.3	2491.6
Included nonbank as % of total BHC	2.02%	1.99%	2.37%	1.68%	1.83%	1.78%	2.10%	2.57%	3.27%	3.80%	3.90%	3.83%

Notes: The nonbank activity reporting system changed in 1995. For 1995 onward, individual subs are grouped to approximate the groupings used in the years 1986–1994. Therefore, changes between 1995 and earlier years should only be viewed as general trends. Data are from the F-R Y-11AS for 1986–1994, and the FR Y-11Q and FR Y-11I for 1995 and 1997.

processing and insurance agency—show little change in their percentages of total BHC assets. These facts are consistent with our analytical framework, which predicts that the primary means by which banks can take advantage of the safety net subsidy is via lower funding costs.

Qualitative impressions gained from a survey of Reserve Bank supervisory staff are consistent with the empirical results just discussed. While emphasizing the importance of case-by-case factors, Reserve Banks reported that the trend over many years has been for large BHCs to consolidate nonbank operations into the bank, in some cases through the direct transfer of nonbank subsidiaries. However, Reserve Banks noted that BHCs rarely formally transfer a nonbank subsidiary to a bank through organizational restructuring; instead, the activity is often transferred by booking transactions in the bank and by permitting the nonbank BHC subsidiary to wind down and become less active. Despite this observation, in early 1997, Reserve Banks reported more than 20 instances since the 1980s where ''material'' nonbank subsidiaries were transferred directly under the bank. In contrast, no cases were identified of significant credit-extending activities being moved from a bank to a BHC subsidiary. More recent data suggest that these trends have continued. In addition, supervisory staff report that a trend appears to be emerging in which agency functions are performed increasingly at the BHC, and principal activities requiring financing are conducted at the bank subsidiary.

When asked why they might prefer conducting nonbank activities in a bank, banking organizations typically cite three reasons: (1) lower funding costs and improved liquidity, (2) elimination of sections 23A and 23B restrictions,[21] and (3) operating efficiencies. The first two reasons are highly consistent with efforts to maximize the subsidy provided by the federal safety net.

6. Concluding remarks

While reasonable people can differ on the size of the safety net subsidy, the available evidence strongly suggests that the subsidy has real value to banking organizations. Moreover, banking organizations appear to organize themselves in ways that allow them to take advantage of safety net benefits. To some extent this is inevitable, since the subsidy is a necessary product of public policies designed to deter and limit a systemic crisis in the banking and financial system. This value, however, does not come without cost. The safety net reduces market discipline, gives banks an incentive to exploit the moral hazard inherent in any insurance scheme, and provides banks with a competitive advantage over nonbank providers of financial services. To reduce moral hazard incentives and limit extension of the safety net subsidy, an extensive structure of supervisory and regulatory policies has been constructed.

Many critics of the current bank regulatory system maintain that, to the extent a safety net subsidy exists, it is preferable to eliminate the subsidy (and the corresponding regulatory burdens) rather than attempt to contain the subsidy through restrictions on banking structure. Advocates of this view generally argue that public policy should go considerably further than the FDICIA and other reforms that were aimed at reducing and limiting the safety net subsidy and, more recently, at reducing regulatory burden.

When considering such policies, it is important to remember that the safety net also provides benefits and that these benefits are the reason for its existence. From a public policy point of view, the safety net helps to ensure a stable banking and financial system, the substantial benefits of which accrue not only to banks but to the entire nation. Moreover, it is critical to recall that the value of the safety net is lowest when economic growth is robust and the financial condition of banks is strong. Equally critical, the value of the subsidy soars when the economy turns sour and banks start to look shaky. Therefore, while the safety net subsidy can and perhaps should be reduced further, complete elimination of the subsidy would either entail risk to the economy as a whole or impose higher private costs on the banking system. Indeed, it seems likely that reducing the value of the safety net to the point where market participants ceased to consider government's role in the banking system would likely impose very high costs on healthy banks and their customers.

Given these considerations, not to mention the risk that the political process might expand coverage of the federal safety net, it seems prudent to design financial modernization strategies in ways that reinforce recent and continuing efforts to maintain the safety net's public benefits and minimize its costs. A core component of such a strategy is to minimize the chances that safety net protections will be expanded into new activities and beyond insured depository institutions. While, in our judgment, expanded powers for banking organizations are essential for many reasons, it is also our view that such powers should not be financed with expanded taxpayer subsidies.

Appendix

Table A1. Comparison of bank holding company and nonbank equity-to-assets ratios (%)

	Bank holding companies			Investment banks			Life insurance companies			Property-casualty companies		
Year	Large (median)	Small (median)	All (mean)	Large (median)	Small (median)	All (mean)	Large (median)	Small (median)	All (mean)	Large (median)	Small (median)	All (mean)
1985	5.8	6.2	6.2	3.3	20.5	25.5	15.6	22.0	19.8	15.8	23.0	24.4
1986	6.0	6.3	6.4	2.9	19.8	24.7	15.9	22.5	21.9	17.6	28.6	26.6
1987	5.9	6.9	6.5	3.7	22.9	25.5	14.4	21.7	20.7	17.0	26.2	25.9
1988	6.3	6.6	6.6	4.0	25.3	26.9	14.1	19.9	20.8	16.6	24.9	24.7
1989	6.2	6.9	6.7	4.0	24.6	24.7	10.1	16.4	16.8	16.0	25.6	25.4
1990	6.0	6.8	6.5	3.7	21.6	25.9	9.5	13.2	15.2	14.8	27.2	24.2
1991	6.5	6.8	6.7	4.1	19.7	25.1	9.6	11.5	14.8	14.9	28.8	26.4
1992	7.2	7.5	7.4	3.9	20.5	24.2	10.2	13.1	13.5	14.3	27.8	26.5
1993	8.0	8.5	9.0	3.4	25.0	25.8	9.3	14.0	14.3	15.1	26.9	28.0
1994	7.5	8.5	8.7	4.1	26.9	28.1	7.4	12.5	14.5	12.2	24.8	25.7
1995	7.9	9.1	9.1	3.4	27.4	29.2	8.7	14.7	15.0	13.5	27.7	28.4
1996	8.1	9.1	9.1	3.3	28.6	29.2	7.4	14.7	14.1	13.0	28.2	28.2
1997	7.8	9.1	9.1	3.1	28.8	29.5	7.3	14.6	14.9	14.3	30.1	30.1

Notes: Large intermediaries are those with $10 billion or more in total assets. *Small* intermediaries are all others appearing in Compustat. Each firm was classified into a size group according to the value of its total assets in the most recent year for which data for the firm were available. Fluctuations in a column from one year to the next are partly due to changes in the set of firms for which Compustat offers data. Means are unweighted averages of individual firm's equity-to-asset ratios.

All data are taken from the June 1998 Compustat tape. Because the fiscal year-end dates of institutions differ and because year-end data appear in Compustat with a lag, computations based on tapes released earlier in 1998 may reflect incomplete data for 1997.

Bank holding companies are those Compustat firms with DNUM (roughly, SIC code) values from 6020 to 6028. Investment banks are those with DNUM in the range 6210–6219. Life insurance companies are in the range 6310–6319. Property-casualty insurers are in the range 6330–6339. All ADR firms, as well as Berkshire Hathaway, were omitted from calculations.

Equity-to-assets ratios are measured as stockholders' equity less the carrying value of any redeemable preferred stock. Firms with zero total assets or with negative equity-to-assets ratios were dropped from the analysis.

Table A2. Equity-to-assets ratios for various categories of finance company (%)

	"Personal credit companies"			Noncaptive finance companies			Captive finance companies			All finance companies		
Year	Large (median)	Small (median)	All (mean)	Large (median)	Small (median)	All (mean)	Large (median)	Small (median)	All (mean)	Large (median)	Small (median)	All (mean)
1985	10.7	14.4	20.1	11.8	22.6	24.4	8.2	18.4	13.8	10.9	21.0	23.4
1986	9.6	15.3	19.6	10.1	21.1	26.6	7.5	14.9	12.7	9.7	20.7	25.4
1987	11.7	16.2	19.8	11.7	19.4	25.4	8.5	14.4	12.4	11.6	17.0	24.0
1988	11.3	19.2	23.5	11.3	19.0	28.1	8.4	13.9	12.1	10.8	18.7	26.6
1989	10.4	16.2	21.8	11.4	16.1	25.9	9.2	13.5	11.7	11.2	15.7	24.3
1990	11.0	16.8	22.3	11.3	16.5	27.1	9.7	13.5	11.7	11.3	16.5	25.3
1991	11.1	16.5	20.9	11.8	16.0	26.4	10.1	14.2	11.8	11.4	15.4	24.6
1992	10.6	16.5	18.7	11.3	17.0	24.8	10.2	14.4	12.5	10.7	16.5	23.5
1993	10.3	16.4	19.3	10.6	19.5	25.3	10.5	15.1	13.7	10.5	17.8	24.0
1994	10.4	15.4	19.0	10.3	19.1	24.5	10.4	14.1	12.0	10.3	17.8	23.1
1995	11.3	19.1	23.3	11.0	18.9	24.0	9.7	13.2	12.4	10.6	17.9	22.9
1996	11.6	17.4	25.0	11.3	18.6	25.8	9.2	12.2	12.4	11.0	16.8	24.6
1997	11.5	21.2	23.0	11.9	20.8	24.6	9.3	13.0	13.1	11.0	19.2	23.5

Notes: Large finance companies are those with $10 billion or more in total assets. *Small* finance companies are all others appearing in Compustat. Each firm was classified into a size group according to the value of its total assets in the most recent year for which data for the film were available. Fluctuations in a column from one year to the next are at least partly due to changes in the set of firms for which Compustat offers data. Means are unweighted averages of individual firm' equity-to-asset ratios.

All data are taken from the June 1998 Compustat tape. Because the fiscal year-end dates of institutions differ and because year-end data appear in Compustat with a tag, computations based on tapes released earlier in 1998 may reflect incomplete data for 1997.

Personal credit companies are those Compustat firms with DNUM (roughly, SIC code) values of 6140 or 6141. Captive finance companies are the finance company affillates of Ford, GM, Chrysler, Toyota, Xerox, IBM, Pitney Bowes, John Deere, and McDonnell Douglas. Noncaptives are all others with DNUM in the ranges 6150–6159 (business credit) and 6172 (leasing companies) as well as the personal credit companies.

All ADR firms were omitted from calculations, as was Dean Witter Discover. GE finance subsidiaries and Associates Corp. and Household Finance units each appear twice in Compustat; only the lower-level subsidiary of each was included because the higher level appears to be a holding company controlling a wide variety of types of financial intermediary.

Equity-to-assets ratios are measured as stockholders' equity less the carrying value of any redeemable preferred stock. Firms with zero total assets or with negative equity-to-assets ratios were dropped from the analysis.

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Notes

1. We emphasize that preservation of the banking system does not imply protection of any individual bank. In our view, no bank should be considered too big to fail in the sense that existing stockholders can lose all, current management be replaced, uninsured liability holders take losses, and the remaining firm be shrunk or sold in an orderly manner.
2. As defined in *The New Encyclopedia Britannica* (1992, p. 344), a *subsidy* is "a direct or indirect payment, economic concession, or privilege granted by a government to private firms, households, or other governmental units in order to promote a public objective."
3. As we discuss later, individual banks could manage themselves so that investors view them as virtually risk free, but it is not clear that such a high level of "safety and soundness" is in the public, much less the private, interest.
4. This argument is not new. For example, Peltzman made a very similar point in his discussion regarding the substitutability of deposit insurance and capital in Peltzman (1970).
5. In figure 1, the horizontal axis measures total assets (a) in the banking system, and the vertical axis measures interest rates (r) earned on assets or paid on liabilities. Market demand for bank assets is represented by the downward sloping demand curve, D, and its corresponding marginal revenue curve, MR. The notion of costs embodied in $MC_1(k)$ is the broadest possible and includes regulatory and supervisory costs. Since the equity-to-assets ratio is held constant along a given marginal cost curve, there is a simple linear relationship between assets and liabilities, which allows assets, rather than liabilities, to be represented on the horizontal axis.
6. Note that the lower marginal cost of funds has nothing to do with the risk-spreading benefits of deposit insurance but rather derives from government guarantees supported by access to the sovereign credit of the United States. Some have argued (see Ely, 1997) that the risk-spreading nature of federal deposit insurance is key. If this were true, the private sector could provide such insurance. In our view, no private insurer, or group of insurers, can credibly indemnify systemic risk—a fact that explains the failure of the few private and even state-government-supported deposit insurance plans. In addition, we see no evidence that either banks or their customers view the FDIC's primary benefit as spreading risk among depository institutions. Rather, the benefit is the security that only access to government guarantees can provide. Last, if, as Ely argues, the key problem with federal deposit insurance is the fact that low-risk banks subsidize high-risk banks, then a private deposit insurer should be able to "cherry pick" the low-risk banks into its own plan. The fact that no such private insurer has arisen is further evidence that there is (much) more to federal deposit insurance and the rest of the safety net than risk spreading across banks.
7. Indeed, the prolonged good health of the U.S. banking system since 1992, and the resulting low-risk premiums on most banks' liabilities, likely help explain why many bankers today argue strongly that there is no safety net subsidy. However, the extreme turmoil in the capital market in September and October 1998 and the subsequent minimal adverse effects on the banking system, highlight the importance of government support of the banking system.
8. Thus, shareholders (as opposed to bondholders who clearly benefit) may or may not benefit from the presence of the safety net subsidy.
9. For example, from 1980 through 1997, 3,621 new insured banks were formed. More generally, calculation of the net benefits of being a bank is complex. While net benefits of the safety net subsidy may be small in good times, even small values accumulated over a long time horizon can yield a substantial present value for the safety net subsidy. In addition, a bank needs to consider the value of the subsidy over the course of the business cycle, where the subsidy increases significantly in value during a recession.
10. Of course, it is possible for the marginal cost curve to shift down by a small enough amount to allow $r_{new} > r_{even}$. However, as is the case for the example discussed in the text, this equilibrium is not sustainable. Nonbanks must either lower their marginal costs to the level of banks or raise marginal revenues.
11. In figure 4, the equity-to-assets ratio is fixed *along* a given marginal cost curve, allowing us to graph assets on the horizontal axis. In contrast to figures 1–3, across marginal cost curves the ratio is not fixed, meaning that assets are not the same along the horizontal axis for two marginal cost curves. However, since the equity ratio falls as the marginal cost curve rises, the direction of change in optimal assets is correct for a changing equity-to-assets ratio, making our geometric misrepresentation a minor concern.

12. In figure 4, this premium is depicted as a constant for all levels of noninsured debt. However, this clearly need not be the case (indeed, as discussed shortly, it probably is not the case), and our analytical framework does not depend on this assumption.
13. This view is consistent with that of safety net reform proposals that advocate requiring increased use of subordinated debt by banks. See Litan and Rauch (1997).
14. The data in table 1 are based on the annual data given in appendix tables A1 and A2, all of which are drawn from Compustat. Because only BHC data appear on Compustat, we are forced to use BHCs, not banks. However, since over our period of analysis the bank(s) portion of a BHC constituted the vast majority of the assets for virtually all BHCs, use of the BHC data should not seriously distort our comparisons. Nevertheless, this deficiency in the data is one reason we examine other comparisons, most of which use bank data.
15. To investigate this conjecture, we adjusted the balance sheets of the three largest investment banks—Merrill Lynch, Morgan Stanley, and Salomon—by assuming that their current (1997) short-term liabilities are used to fund inventories and marketable securities and separating these liabilities (and a corresponding amount of assets) into a "matched book" business. We then assumed that this line of business had a 2.5% capital requirement (the minimum amount required of Freddie Mac and Fannie Mae for their portfolios and probably much less than that required by the SEC) and allocated the remaining capital to the investment bank's other activities. As a result of these adjustments, the equity-to-assets ratio on the firm's other activities rose to 7.2% for Merrill Lynch, 6.4% for Salomon, and 13.9% for Morgan. This calculation, while suggestive, is clearly rough. On the one hand, it may understate the adjusted capital ratios because the capital needed for a matched book of securities may be less than assumed here. On the other hand, our estimate of the size of the matched book may be too large.
16. Interpretation of the results for large insurance companies is especially difficult because many of the largest insurers are mutual organizations and so not included on Compustat. Seven of the 10 largest life insurers are mutual firms, as are 3 of the top 10 property-casualty companies. The relatively lower capital ratios at insurance companies over the past several years may be partly accounted for by the increasing use of "separate account" assets by insurance companies. These assets are transparent to the policyholder, transfer the market risk of assets from the insurance company to the policyholder, and limit the policyholder's exposure to the possible insolvency of the insurance company. All these characteristics of separate account assets imply that insurance companies need to hold relatively less capital than if their assets consisted exclusively of "general account" assets.
17. By *captive finance companies*, we mean firms that are closely associated with a parent corporation (e.g., General Motors Acceptance Corporation, Ford Motor Credit). However, it is important to note that separating captive and noncaptive finance companies is a very uncertain undertaking. This is because even firms that claim to be noncaptive often appear to benefit from substantial explicit guarantees (not to mention implicit guarantees) from a deep-pocket parent.
18. The 1996 Survey of Finance Companies is described in August et al. (1997).
19. Use of the BHC's rating rather than the rating on a bank's long-term CDs introduces some distortion into our comparisons because a BHC typically is rated slightly lower than its lead bank. However, for the reason discussed in note 14 and because rating differences (and their interest rate implications) are especially small during good economic times, we believe that any distortion to our comparisons is minor. In addition, it is worth noting that we made other comparisons using the Compustat data but excluded them from the table because they either repeated earlier results or too few firms were in the groups. Nevertheless, we note that comparisons using smaller firms reinforce the results given in table 4, and comparisons of BHCs' and finance companies' equity ratios reinforce the conclusions drawn from table 3. Data to make similar comparisons between commercial and investment banks are not available.
20. As noted in the table, there is a break in series in 1995 that makes interpretation across this date difficult.
21. Sections 23A and 23B of the Federal Reserve Act limit credit transactions and asset purchases between a bank and its holding company affiliates and require that such transactions occur at arm's length.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM DIANA L. TAYLOR

Q.1. The Advanced Approach of Basel II has been touted as addressing safety and soundness concerns related to hidden and undercapitalized risks that large, complex banks now take under the current rules. In the results of QIS–4, what was the aggregate change in minimum risk-based capital requirements for securitized exposures? For other off-balance sheet exposures? If the current rules are insufficient to address these complex risks, is it because they require too much capital, or too little capital?

A.1.

Securitized Exposures

The Banking Department (like other members of CSBS) has only seen the public report on the QIS–4 results, so we can't provide any new information about the changes in minimum risk-based capital requirements for securitized exposures found in QIS–4. The paper, "Summary Findings of the Fourth Quantitative Impact Study," released by the federal agencies in February 2006, includes little specific mention of changes in capital for securitized assets, but does show weighted average and median changes in required capital in Table 4. The weighted average change in minimum regulatory capital for securitized assets at the QIS–4 banks was −17.9%, and the median change was −39.7%. However, there is no discussion of these median and average changes, nor of the types of securitized assets held by QIS–4 banks, in the text of the paper.

Basel II proposes three different approaches to calculating capital for securitization exposures: the Ratings-Based Approach (RBA) for securitizations with external ratings, the Internal Assessment Approach (IAA) and the Supervisory Formula Approach (SFA) for unrated securitizations. Banks allowed to use the IAA approach map their own assessments of the credit risk of their securitization exposures to external ratings and then use the RBA risk weights. The reduction in risk-weighting for investment-grade rated securitizations, and those with inferred investment grade ratings, is significant under Basel II:

REPRESENTATIVE RISK WEIGHTS FOR SECURITIZATIONS WITH EXTERNAL RATINGS (OR INFERRED RATINGS)

Long-Term rating	Current (%)	Basel II RBA—senior positions (%)	Basel II RBA—base (%)
AAA	20	7	12
AA		8	15
A+	50	10	18
A		12	20
A-		20	35
BBB+	100	35	50
BBB−		60	75
BBB		100	100
BB+	200	250	250
BB		425	425
BB−		650	650

REPRESENTATIVE RISK WEIGHTS FOR SECURITIZATIONS WITH EXTERNAL RATINGS (OR INFERRED RATINGS)—Continued

Long-Term rating	Current (%)	Basel II RBA—senior positions (%)	Basel II RBA—base (%)
Below BB –	Deduct	Deduct	Deduct

If most of the securitizations held by the QIS–4 banks were at least investment grade or could be inferred to be at least investment grade, then it is clear that these banks would report significant declines in required capital for their securitization portfolios. As mentioned above, the QIS–4 report contains no information about the portfolio breakdown for participating banks, although the QIS–4 worksheets and questionnaire requested extensive information about banks' securitized asset portfolios: for example, the exposures for which each of the three capital calculation methods apply, the amount of credit risk mitigation (collateral and guarantees) that banks applied to each exposure type, and the amount of exposures that the early amortization requirement applied to. It is very difficult to understand the impact of the changes in capital treatment for securitizations without access to information from the QIS–4 submissions, and CSBS has requested such access.

Some evidence of banks' securitization holdings can be found in the current Call Report, as banks report BB-rated securitization amounts as a negative number on Schedule RC-R.[1] We don't know which banks participated in the QIS–4, but presumably the banks identified by the OCC as meeting the definition of mandatory bank[2] were among the participants. Reviewing the June 30, 2006, Call Reports for the ten banks identified by the OCC suggests that few of their securitized assets had low ratings, as only two of these banks show evidence of possibly holding securitizations rated BB. In both cases, the amount indicated as possibly representing BB-rated securitizations was less than 5% of total privately issued securitizations. (The breakdown of deducted assets cannot be determined from the Call Report alone, as different types of deductions are lumped together.) The federal agencies have collected information that enables them to describe in detail the securitization portfolio at each of the 26 QIS–4 banks; understanding these portfolios is essential to interpreting the impact of Basel II.

Banking Department

It seems unlikely that the banks that participated in QIS–4 are currently holding large positions in poorly rated securitizations or unrated securitizations for which they are unable to infer ratings. The median change in capital requirements for securitization was −39.7%, and it is hard to see how this decline would have resulted if there had been sizeable holdings that received double or triple risk-weighting, or had to be deducted. It seems probable that large, complex banks already tend to hold securitizations rated at least

[1] Banks report as a negative number the amortized cost of mortgage-backed and asset-backed securities that are rated one grade below investment grade in item RC–R 35 Col. B and RC–R 36 Col. B., in addition to the difference in fair value and amortized cost of their other securities. These items indicated securities rated BB in only two cases.

[2] "Regulatory Impact Analysis for Risk-Based Capital Standards: Revised Capital Adequacy Guidelines," *http://www.occ.treas.gov/law/Basel%20II%20RIA.pdf*

investment grade (or that can be inferred to be investment grade), and the net effect of Basel II on their securitization portfolio will be to reduce capital requirements. Basel II might even have the perverse effect of allowing banks to hold a greater percentage of poorly rated or unrated securitizations without increasing required capital, since the risk weights for investment-grade rated securities are so much lower than currently.

The concept behind Basel II's treatment of securitization is very close to that of current U.S. treatment. The major differences are in particular risk weight specifications and in allowing banks to use the Supervisory Formula Approach for some securitizations that previously would have been deducted from capital. It seems probable that the framers of Basel II felt that current treatment is inadequate because banks are required to hold too much capital for their securitization exposures. More detailed information about the QIS–4 securitization portfolios would help in determining if this is so.

However, it's interesting to note that the impact of Basel II's treatment of securitization varies widely across countries that are adopting it, as current rules are very different. For example, German QIS–4 results included an increase of 153% in required capital for participating Group 1 banks (those with more than 3 billion euros in tier 1 capital) using the Advanced IRB approach. [3] The Basel Committee's release [4] on results of QIS 5 reported that "The average change in minimum required capital from the securitisation portfolio for G10 Group 1 banks varies between −42% and +60% for the IRB approach. This seems to be the result of different types of positions and differences in current national regulations. Some countries have already under their current national regulation a stricter treatment than the current Accord provides (this affects in particular liquidity facilities and retained securitisation positions)." The U.S. is clearly one of these countries.

The Department is also concerned with the potential incentives presented to banks through the Basel II revisions. A paper released last year by Fitch Ratings [5] discussed some of the capital incentives contained in Basel II's treatment of securitized exposures. This report was published before the federal agencies released the Basel II NPR, which included changes in the treatment of securitized exposures from the earlier ANPR, but Fitch Rating's analysis of the Basel II treatment of a sample portfolio of securitizations is still relevant. Fitch analysts found that Basel II banks would have differing incentives to securitize assets depending on portfolio type, and that Basel II could lead to inconsistencies in capital charges across different securitization deals and might influence deal structuring. These potential consequences need serious consideration before Basel II is implemented.

[3] *http://www.bundesbank.de/download/bankenaufsicht/pdf/qis4/basel__qis__laenderbericht__dt.pdf*

[4] *http://www.bis.org/bcbs/qis/qis5results.pdf*

[5] *"Basel II: Bottom-Line Impact on Securitization Markets," FitchRatings, September 12, 2005, www.fitchratings.com*

Other Off-Balance Sheet Exposures

The QIS–4 results reported in the Summary paper include the effects of credit risk mitigation, and group all types of exposure (both on- and off-balance-sheet exposures) so it is difficult to determine aggregate changes in capital requirements for off-balance sheet exposures. Although the A–IRB approach of Basel II requires banks to hold capital for undrawn commitments for which current requirements impose a 0% risk weight, this approach also allows banks to calculate capital based on their own estimation of the actual exposure at default, probability of default, and loss given default. In addition, Basel II includes a much broader recognition of the credit risk mitigation afforded by off-balance sheet exposures.

The QIS–4 Summary paper provides too limited information to allow us to determine the impact on off-balance sheet exposures. The federal agencies have reported summary statistics for credit conversion factors (CCF) for the exposure at default (EAD) for undrawn lines in different portfolios, but have not reported PDs or LGDs for these undrawn lines, nor have they reported the exposure at default credit conversion factors for drawn lines, so comparison of on-balance sheet and off-balance sheet exposures is almost impossible. Again, the QIS–4 templates and questionnaire requested extensive information on off-balance sheet positions, and their use as credit mitigants. More detailed information on the QIS–4 results would allow us to determine the impact of Basel II on these exposures.

The federal agencies did state,[6] however, that one of the factors that might have caused minimum capital requirements in QIS–4 to be understated was "the lack of incorporation of credit risk mitigation." Further, they state, "The Agencies expect that as we move closer to implementation, systems will capture the information necessary to permit the assignment of lower risk weights to these exposures."

Q.2. If the goal is to encourage sophisticated risk measurement and management at our largest banks, why can't they be encouraged adequately through pillar 2's supervisory guidance and pillar 3's transparency through public disclosure?

A.2. We believe that supervisory guidance and public disclosure have proven to be very effective methods of encouraging improvements in risk management. Many institutions have found market recognition of sophisticated risk management a very valuable goal. We have utilized "best practices" discussions and supervisory guidance papers to help banks develop improvements in their risk management and modeling systems. Encouraging improvement is an integral part of supervision, either through peer analysis, benchmarking, or consultation.

One of the complaints we hear from banks about Basel II is that the federal agencies have not released supervisory guidance on implementation, and this complaint highlights the need for Pillar 2. Another complaint that we've heard is that the Basel II supervisory formulas aren't appropriate for large complex banking institutions.

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[6] *http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060224/qis4*__attachment__revised.htm

Promoting improvements in risk management through Pillar 2 and Pillar 3 would have the advantages of allowing banks to pursue the quantitative modeling and data collection that best fits their own risk profile and allowing supervisors to assess each bank's system without imposing constraints on their modeling efforts. Advanced research and data collection in credit and operational risk modeling are so new that development in this field might be improved if banks were not constrained by the Basel II supervisory models. However, supervisors would have to be assured that safe and sound capital requirements remained in place while this development took place.

Q.3. If the mandatory banks operate under the Advanced Approach and other banks operate under Basel IA, how much do you expect capital requirements to change on average for the two groups of banks? Will that affect the competitive position of banks not using the Basel II Advanced Approach?

A.3. We believe that overall risk-based capital requirements will fall at the mandatory banks, and are convinced that transitional floors and safeguards are necessary. Although the reductions in risk weights proposed under Basel IA are in some cases similar to the weighted average changes reported by the QIS 4 banks—QIS–4 banks reported a weighted average reduction in minimum capital requirements for small business loans of 26.6% and Basel IA suggests reducing the risk weight for small business loans to 75% from 100%, a drop of 25%—in other portfolios, the weighted average change is much greater for QIS 4 banks. For example, QIS–4 banks reported a weighted average decrease in minimum regulatory capital for residential mortgages of 61.4% and a weighted average decrease of 74.3% for home equity loans.

Our survey[7] of the change in capital requirements at several New York banks under Basel IA proposed risk weights, however, produced an estimate of 34% as the average risk weight for the banks residential mortgage portfolio, or a reduction of 30% from current risk weights. And even in the cases where Basel IA suggests a lower risk weight, the restrictions attendant on using the new risk weight are much greater than under Basel II. A case in point is the treatment of home equity loans, where Basel IA banks can only apply a risk weight based on LTV or other risk factors if the bank holds both first and junior liens. There is no such restriction for Basel II banks. It is unlikely that Basel IA banks will have many externally rated borrowers for commercial real estate loans; thus these loans will probably be risk-weighted at least at 100%. However, the weighted average change in minimum required capital for the riskiest commercial real estate loans at QIS 4 banks was a reduction of 33.4%.

There is a great danger that if mandatory banks are allowed to hold less risk-based capital than Basel IA banks, then these IA banks will be at a competitive disadvantage. We believe that Basel IA banks and mandatory banks do compete in many of the same markets and offer many of the same products. Seven of the ten banks identified as meeting the definition of mandatory bank by the OCC have branches in New York State; these branches ac-

[7] *http://www.banking.state.ny.us/rp0605.pdf*

counted for 33% of New York insured bank branches and held 58% of total insured deposits in the state as of June 30, 2006. Nine of the "mandatory" banks reported originating small business loans to New York addresses in their 2005 CRA reports—these nine banks reported a significant share—close to half—of total small business loans reported in the state. We are well aware of the many services and products these banks provide for New York residents. However, we are uneasy when one group of banks with already substantial market power is provided—through regulation—with a competitive advantage over smaller banks that they compete with. We are particularly concerned when a substantial part of their capital advantage—much lighter risk weights for retail loans—comes from the great volume of their retail loan portfolios. Smaller banks cannot compete in volume with the large retail banks.

In the U.S., if the large Basel II banks have an advantage over the smaller banks because their cost structure is so much more attractive, this could push acquisition of regional and community banks by the Basel II banks. Increased acquisition of Basel IA banks could leave local communities, which rely on their local banks for products and services that meet their specific needs, with access to a limited number of bank products; we could find ourselves in a situation in which it is no longer profitable to provide a range of financial services to small businesses in smaller communities.

In other words, a business model in which smaller banks, by design, are at a competitive disadvantage to Basel II banks could have a significant negative impact on small businesses in the U.S.—the backbone of our economy. The impact of Basel II on competition in U.S. banking markets must be seriously assessed before implementation goes forward.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

Statement

of

Independent Community Bankers of America
Washington, DC

"Basel Capital Accord Update"

United States Senate
Committee on Banking

September 26, 2006

The Independent Community Bankers of America[1] welcomes the opportunity to provide a statement on the bank regulatory agencies" proposed rulemaking to implement the Basel II rules.

ICBA compliments this committee for taking up this difficult issue late in the Congressional session. It could deeply affect community banks and so your continued oversight is very important.

Recently, the banking agencies issued for comment a notice of proposed rulemaking (Basel II NPR) that would implement new risk-based capital standards in the United States for large, internationally active banking organizations. The proposed Basel II rules would require some and permit other banks to use an internal ratings-based approach (IRB) to calculate regulatory credit risk capital requirements and advanced measurement approaches (AMA) to calculate regulatory operational risk capital requirements. Banks with consolidated total assets of $250 billion or more or with consolidated total on-balance sheet foreign exposure of $10 billion or more would be subject to the proposed Basel II rules. Other banks would have the opportunity to opt-in to the new capital standards provided they receive the approval of their primary federal supervisor.

Summary of ICBA's Position on Basel II and IA

- Although ICBA commends the banking agencies for their decision to retain the leverage capital ratio as part of Basel II and to include other safeguards during the transition period, ICBA remains concerned that Basel II may place community banks at a competitive disadvantage.

- ICBA is also concerned about the costs and complexity of Basel II and the ability of Basel II adopters to understand and implement the new accord. ICBA supports allowing the Basel II banks the option of using the "standardized approach" in lieu of the advanced approach.

- ICBA fully supports the current effort by the regulators to revise Basel I to enhance its risk-sensitivity and to address any competitive issues with a bifurcated framework; provided that the new rules give highly capitalized community banks the option to continue using the existing risk-based capital rules.

- During 2008—the year of the parallel run (when both Basel I and II capital will be calculated)--ICBA strongly recommends that the agencies conduct a fifth quantitative impact study to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a Basel IA. If QIS5 indicates that there continues to be a competitive disparity between Basel II and Basel IA, then the three year transition period should be put on hold until the regulators fundamentally revise Basel II.

ICBA Strongly Supports Retention of the Leverage Capital Ratio
As proposed by the agencies, the Basel II banks will remain subject to the tier 1 leverage ratio (e.g., tier 1 capital to total assets) and the prompt corrective action regulations mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). **ICBA commends the banking agencies for proposing to retain the tier 1 leverage ratio as part of the Basel II. ICBA strongly believes that retention of the leverage ratio is essential to maintaining the safety and soundness of our banking system and is a needed complement to the risk-sensitive Basel II framework that is based only on internal bank inputs.** Capital requirements under Basel II depend heavily on the answers to questions that vary from bank to bank and have no objectively best answer. No matter how refined a risk-based capital framework the regulators come up with, there will always be a need for straightforward capital minimums.

Furthermore, it is very important to our economy that regulators maintain a minimum capital cushion for our largest financial institutions that pose the greatest risks to our financial system. If a trillion dollar financial institution were to become significantly undercapitalized or fail, the consequences to the FDIC's Deposit Insurance Fund and our economy would be enormous. As then Comptroller of the Currency John Hawke said before the Senate Banking Committee, "Reducing the leverage ratio would undermine our whole system of prompt corrective action which is the foundation stone of our system of supervision...I think we need to reach an appropriate accommodation where we try to make our basic system of regulatory capital rules more risk-sensitive, but we shouldn't do that at the price of dismantling or significantly impairing the basis for our supervision of U.S. banks."[2]

ICBA Supports the Transitional Capital Floors
Beginning in 2008, the Basel II banks will be able to conduct a parallel run--calculating their capital using both the present risk-based capital rules of Basel I and the advanced approaches of Basel II. During a three-year transition period from 2009 to 2011, Basel II banks would be subject to "transitional floors" that would limit the reduction of their minimum risk-based capital requirement in any year to 5%. **ICBA commends the banking agencies for proposing to adopt these transitional floors as well as committing to significantly modifying**

the supervisory risk functions of Basel II if, during the three-year transition period, there is a ten percent or greater decline in aggregate minimum risk-based capital of Basel II banks as compared to minimum required risk-based capital as determined under the existing Basel I rules. We believe that any change 10% or greater would warrant a fundamental change to the Basel II rules.

ICBA Remains Concerned about the Competitive Inequities
Despite the safeguards incorporated into Basel II mentioned above and the efforts by the regulators to revise Basel I, ICBA remains concerned that Basel II may place community banks at a competitive disadvantage. The IRB approach of Basel II will yield lower capital charges for residential mortgage, retail and small business loans for Basel II adopters, the very credits where community banks compete with large institutions. An individual loan has the same risk to an institution whether a community bank makes the loan or a mega-bank makes it. It is not appropriate for the risk-based capital charge attendant to that loan to be widely divergent depending on whether the loan is made by a Basel I or a Basel II bank.

The results of both the third and fourth Quantitative Impact Studies (QIS3 and QIS4) have confirmed our concerns about the competitive equities of the new accord. These studies show dramatic reductions in capital for residential mortgage credits, small business credits and consumer credit. For instance, QIS4 indicates that for the Basel II banks, there would be a 79% median percentage drop in minimum required capital for home equity loans, a 73% drop for residential mortgage loans, and a 27% drop for small business loans. For all credits, risk-based capital requirements would decline by more than 26%. If one considers that the current minimum capital requirement under Basel I for mortgage loans is 4%, an average drop of 79% would mean that minimum capital requirements for the Basel II banks would be less than 1% for these types of loans.

Since there is a cost to a bank for maintaining capital, the lower capital requirements would most likely result in a cost advantage, and correspondingly a pricing advantage, in retail credits for large banks that are subject to Basel II. The lower capital requirements will also make it easier for the Basel II banks to achieve a higher return on equity (ROE). **In order to compete with the cost advantage and the higher ROEs of Basel II banks, community banks may be forced to make concessions in pricing and underwriting guidelines that could impair their profitability, and ultimately their viability.**

ICBA also fears that Basel II will further accelerate the consolidation in the banking industry. Lower capital levels that large banks obtain under Basel II will likely result in more acquisitions of smaller banks by larger banks seeking to lever capital efficiencies. As more of the larger banks opt-in over the long-term, this may eventually threaten the viability of community banking. Since most community banks will remain under Basel I, they will have difficulty competing against bigger Basel II banks that benefit from reduced capital requirements and higher returns on equity. Basel I banks will become likely takeover targets for Basel II banks that believe they can deploy Basel I bank capital more efficiently. As more Basel I banks are left with riskier assets, lower credit ratings and higher costs of liabilities, they will find it more difficult to compete for the higher quality assets.

A paper released last year by J.P. Morgan Securities Ltd London entitled "Basel II—And the Big Shall Get Bigger" concludes that if Basel II were to be adopted in its present form, the Basel II banks would have a "decisive competitive advantage" over other banks and will look to expand and arbitrage their capital by purchasing smaller, less sophisticated banks. As for the effect of Basel II on community banks, J.P. Morgan says:

> It is difficult to see the future for the smaller community banks in this 'brave, new world'. This has not gone unnoticed as the S&P notes "U.S. community bankers are up in arms against Basel II, saying it gives an unfair advantage in leverage and pricing to large internationally active competitors over smaller domestic banking groups". This seems to be backed up by available information, from which it would appear that the large US and European banks are much more advanced in terms of implementing Basel II as well as likely to be big new beneficiaries of the process. We believe the best opportunities for smaller banks to combat this is perhaps through more cooperation with each other, to share data, bear costs and even swap assets. An alternative seems to be buying the risks that the bigger players do not want, which may mean the potential of adverse selection in credit risks. In our opinion, this is not a recipe for long-term success."

Community banks play not only a strong role in consumer financing in this country but also a critical role in small business financing. Commercial banks are the leading suppliers of credit to small business, and community banks account for a disproportionate share of total bank lending to small business. Community banks account for 33 percent of small business loans, more than twice their share (15%) of banking assets. **Because of the important role small businesses play in the economy (more than half the private sector workforce and two-thirds to three-quarters of new jobs), it is imperative to consider the competitive impact Basel II will have on community banks and their small business customers.**

Basel II is Too Complex and Costly

ICBA has always been concerned about the complexity of Basel II and the ability of Basel II adopters to understand and implement the new accord as well as the consequences if a mistake is made. The wide diversity in the results from QIS4 suggests that Basel II is too complex and that banks will have difficulty in applying the new accord consistently. Capital requirements in Basel II are very sensitive to inputs. Achieving consistency in Basel II depends on the idea that every bank will eventually adopt a common method for estimating their risk inputs leading to a convergence in the capital treatment of similar loan portfolios across banks. However, at least as indicated by the results of QIS4, there seems to be little commonality in the approaches that various banks used to estimate their risk inputs.

ICBA is also concerned about the high compliance and supervisory costs of Basel II. For example, nineteen of the twenty-six banks that participated in QIS4 indicated that it would cost $791 million over the next several years to implement the new accord. This estimate did not include the implicit costs of Basel II—the increased time and attention required of bank management to introduce and monitor the new programs and procedures. The OCC has estimated that its total 2005 costs for Basel II amounted to $7.1 million. Assuming that supervisory costs will increase during the Basel II transition period and that the other three banking agencies will incur comparable costs, it is easy to see that total supervisory and compliance costs for Basel II during the transition period will exceed $1 billion.

ICBA has recommended that the bank regulators consider ways of simplifying Basel II to reduce total compliance and supervisory costs and to insure that banks will understand the formulas and apply them consistently. The new accord and its capital formulas should not be so complex that banks cannot consistently apply the formulas and come to similar conclusions. Regulators should be able to readily spot intentional or unintentional errors or omissions in the formulas that are used. Basel II should also be simple enough that bank directors can monitor its implementation and auditors can certify to them as part of their internal control audits.

To reduce the costs and complexity of Basel II and enhance its flexibility, ICBA supports allowing the Basel II banks the option of using the "standardized approach" of the new accord in lieu of the advanced IRB approach. The standardized approach would provide a simpler and cheaper alternative for measuring credit risks and would be attractive option for smaller, less complex Basel II banks. The standardized approach would require fixed risk-weights to be applied to different assets much like Basel IA and would align risk weights with a borrower's creditworthiness as indicated by the borrower's external credit rating. Unlike Basel IA, banks using the standardized approach would have to assess operational risks. ICBA believes that the use of the standardized approach by the Basel II banks would reduce the impact on risk-based capital by those banks and would mitigate to some extent, the competitive disparity between Basel I and II.

ICBA Fully Supports a Basel IA

ICBA fully supports the current effort by the regulators to revise Basel I to enhance its risk-sensitivity for non-Basel II banks and to address any competitive issues with a bifurcated framework; provided that the new rules give highly capitalized community banks the option to continue using the existing risk-based capital rules. ICBA commends the issuance late last year of an Advance Notice of Proposed Rulemaking concerning a revised Basel I (ANPR) and looks forward to commenting on a notice of proposed rulemaking regarding a revised Basel I which is expected to be issued in the next few weeks.

ICBA supported the ANPR's proposal to add risk categories to Basel I to enhance its risk-sensitivity and to align capital requirements with risk levels. The risk-weightings of these categories should be modernized to better match current knowledge about actual risk exposures. More specifically, ICBA supported the proposal in the ANPR to add additional risk weights (e.g., a 20 percent and 35 percent category) for assessing a bank's one-to-four family mortgage portfolio and to base those risk weights on loan-to-value ratios. If risk-weights are based on LTV ratios, we would recommend that a mortgage loan LTV ratio be determined at the time the mortgage is originated and that banking institutions have the flexibility of changing or updating the risk weights of their mortgage loans as normal principal payments are made and/or as the LTV ratios change. While we acknowledge that pairing credit scores with LTV ratios might enhance the risk sensitivity of the mortgage loan risk weight categories, we believe the regulatory burden of including credit scores with LTV ratios outweigh the benefits.

For small business loans, ICBA recommends that the agencies establish a 75 percent risk weight category for small business loans that are under $2 million and that are (1) fully collateralized, (2) amortizable over a period of 10 years or less, and (3) have been originated consistent with the banking organization's underwriting policies. ICBA also agrees with the concept of using external credit ratings to enhance the risk-sensitivity of Basel I and supports the use of different risk weight categories for categorizing rated investment securities. ICBA agrees with the agencies that the current zero percent risk weight for short- and long-term U.S. government and agency exposures that are backed by the full faith and credit of the U.S. government should be retained as well as the 20 percent risk weight for U.S. government-sponsored entities and for general obligation municipal securities.

ICBA Strongly Supports a Basel IA Opt-Out Provision for Community Banks

ICBA has urged the regulators to adopt an "opt-out provision" as part of a revised Basel I that would give highly capitalized community banks the option to continue using the existing risk-based capital rules and avoid the regulatory burden of more complex risk-based capital rules. Many community banks have excess capital and would prefer to remain under the existing risk-based capital framework without revision to avoid unnecessary regulatory burden. This is particularly true for smaller banks that are management-owned, otherwise closely held, or not publicly traded, or banks in rural or other smaller markets. These banks generally hold higher amounts of capital than regulatory minimums—many significantly higher—for a variety of reasons including a conservative philosophy or lack of ready access to raise capital in the capital markets. For instance, the average total risk-based capital ratio for banks under $100 million in assets is 19.7% and for banks between $100 million and $1 billion is 14.55% according the FDIC's latest Quarterly Bank Profile.

For highly capitalized banks, computing risk-based capital minimums and ratios using the contemplated Basel IA could present a significant regulatory burden with no corresponding benefit. This is particularly true since the agencies expect that if Basel IA is adopted, changes in reported Call Report data will be necessary in order to capture the additional information for LTV ratios and other risk driver data points such as collateral, loan size, term to maturity, etc. We recommend that the opt-out provision be limited to community banks with under $5 billion in assets that have capital-to-asset leverage ratios of 7 percent or higher.

ICBA Recommends a QIS5

During 2008—the year of the parallel run--ICBA also strongly recommends that the agencies conduct a fifth quantitative impact study to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a Basel IA. We believe that a one-year period should provide sufficient time for the agencies to collect the data, compare the two accords, and determine the competitive effects. If, by the end of 2008, the results of QIS5 indicate that there continues to be a competitive disparity between Basel IA and Basel II, then the three-year transition period should be put on hold until the regulators determine how to fundamentally revise Basel II.

Conclusion

The ICBA again appreciates the opportunity to present our views on the proposed international capital standards. ICBA remains concerned that Basel II may place community banks at a competitive disadvantage. Improvements to Basel I, and Basel IA, could help mitigate that disadvantage. As it implements these proposals, the agencies should conduct a fifth quantitative impact statement to measure their effect on competition and on minimum risk-based capital levels. If, by the end of 2008, the results of a fifth quantitative impact statement indicate that there continues to be a competitive disparity between Basel IA and Basel II, the three-year Basel II transition period should be put on hold until the regulators determine how to fundamentally revise Basel II.

[1] The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace. For more information, visit ICBA's website at www.icba.org.

[2] Testimony before the Senate Banking Committee (April 20, 2004)